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Governmental Accounting Standards Series

Statement No. 62 of the Governmental Accounting Standards Board

Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements

GASB

Governmental Accounting Standards Board
of the Financial Accounting Foundation

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Summary

The objective of this Statement is to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in the following pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements:

1. Financial Accounting Standards Board (FASB) Statements and Interpretations
2. Accounting Principles Board Opinions
3. Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure.

Hereinafter, these pronouncements collectively are referred to as the "FASB and AICPA pronouncements."

This Statement also supersedes Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, thereby eliminating the election provided in paragraph 7 of that Statement for enterprise funds and business-type activities to apply post-November 30, 1989 FASB Statements and Interpretations that do not conflict with or contradict GASB pronouncements. However, those entities can continue to apply, as other accounting literature, post-November 30, 1989 FASB pronouncements that do not conflict with or contradict GASB pronouncements, including this Statement.

The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2011. Earlier application is encouraged. The provisions of this Statement generally are required to be applied retroactively for all periods presented.

Organization of This Statement

The provisions of this Statement are organized by topic. Each topic contains provisions derived from FASB and AICPA pronouncements that address the subject matter. The order in which the topics are presented corresponds to the order of the primary locations within the GASB *Codification of Governmental Accounting and Financial Reporting Standards*, where the topics are codified.

How the Changes in This Statement Will Improve Financial Reporting

The requirements in this Statement will improve financial reporting by contributing to the GASB's efforts to codify all sources of generally accepted accounting principles for state and local governments so that they derive from a single source. This effort brings the authoritative accounting and financial reporting literature together in one place, with that guidance modified as necessary to appropriately recognize the governmental environment and the needs of governmental financial statement users. It will eliminate the need for financial statement preparers and auditors to determine which FASB and AICPA pronouncement provisions apply to state and local governments, thereby resulting in a more consistent application of applicable guidance in financial statements of state and local governments.

In addition, all FASB and AICPA pronouncements became nonauthoritative literature for the private sector on July 1, 2009, the effective date of the *FASB Accounting Standards Codification*™. Although certain FASB and AICPA pronouncements are still available in the archive section of the FASB's Codification on a limited basis, this

Statement will make accessible in the GASB's authoritative literature all applicable accounting and financial reporting guidance previously residing only in the FASB and AICPA pronouncements.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraph 3 discusses the applicability of this Statement.

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December 2010

Governmental Accounting Standards Board
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401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

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INTRODUCTION

1. Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 17, provides that reporting for governmental and business-type activities should be based on all applicable GASB pronouncements as well as the Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure, issued on or before November 30, 1989 (collectively, the "FASB and AICPA pronouncements"), unless those pronouncements conflict with or contradict GASB pronouncements. The primary objective of this Statement is to directly incorporate the applicable guidance from those FASB and AICPA pronouncements into the state and local government accounting and financial reporting standards, with the provisions modified, as appropriate, to recognize the effects of the governmental environment and the needs of governmental financial statement users without affecting the substance of the applicable guidance.

2. Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended by Statement 34, provides guidance for business-type activities regarding the applicability of FASB and AICPA pronouncements, including FASB pronouncements issued after

November 30, 1989. An objective of this Statement also is to address the status of Statement 20.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Scope and Applicability of This Statement

3. This Statement establishes accounting and financial reporting standards for the financial statements of state and local governments. The requirements of this Statement apply to accounting and financial reporting for governmental activities, business-type activities, and proprietary funds, except that:

a. Paragraphs 5–22 pertaining to the capitalization of interest costs apply only to interest costs reported for business-type activities and enterprise funds.
b. Paragraphs 24–28 pertaining to revenue recognition when right of return exists apply only to business-type activities and proprietary funds.
c. Paragraphs 45–50 pertaining to special and extraordinary items also apply to governmental funds, subject to the accounting and financial reporting distinctions of governmental funds.
d. Paragraphs 54–57 pertaining to related parties also apply to governmental funds, subject to the accounting and financial reporting distinctions of governmental funds.
e. Paragraphs 96–113 pertaining to accounting for contingencies also apply to governmental funds, subject to the accounting and financial reporting distinctions of governmental funds.
f. Paragraphs 188–201 pertaining to inventory apply only to business-type activities and proprietary funds.
g. Paragraphs 211–271 pertaining to accounting for leases also apply to governmental funds, subject to the accounting and financial reporting distinctions of governmental funds.
h. Paragraphs 476–500 pertaining to regulated operations can apply to certain business-type activities that meet the criteria in paragraph 476.

4. This Statement supersedes Statement 20; NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles,* paragraphs 117 and 127; NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments,* paragraph 19 and footnotes 8 and 9; NCGA Interpretation

9, *Certain Fund Classifications and Balance Sheet Accounts,* footnote 5; Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues,* footnote 7; Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities,* paragraphs 4, 5, and 7; Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools,* footnote 6; Statement 34, paragraphs 17, 93, and 94; and Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards,* footnote 1. In addition, this Statement amends NCGA Statement 1, paragraph 42 and footnote 7; NCGA Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences,* paragraphs 14 and 16; NCGA Statement 5, paragraphs 11, 12, 16, 18, 22, and 24–27; NCGA Interpretation 9, paragraph 12; Statement 10, paragraph 45; Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases,* footnote 3; Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities,* paragraph 6; Statement 31, paragraph 5; Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions,* footnote 7; Statement 34, paragraphs 55, 95, 97, 115, and 147 and footnotes 12, 13, and 25; Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries,* footnote 2 and paragraph 17; Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations,* footnotes 2 and 7; Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments,* footnote 8; Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments,* paragraph 6; and GASB Interpretation No. 1, *Demand Bonds Issued by State and Local Governmental Entities*, paragraphs 7 and 8.

Capitalization of Interest Cost

5. Paragraphs 5–22 establish standards of financial accounting and reporting for capitalizing interest cost as a part of the historical cost of acquiring certain assets. For the purposes of applying paragraphs 5–22, interest cost includes interest recognized on obligations having explicit interest rates,[1] interest imputed on certain types of payables in accordance with paragraphs 173–187, and interest related to a capital lease determined in accordance with paragraphs 211–271.

6. Paragraphs 185–187 provide that the discount or premium that results from imputing interest for certain types of payables should be amortized as interest expense over the life of the payable and reported as such in the flows statement.[2] Paragraph 218 provides that, during the term of a capital lease, a portion of each minimum lease payment should be recorded as interest expense. Paragraphs 5–22 modify paragraphs 173–187 and paragraphs 211–271 in that the amount chargeable to interest expense under the provisions of those paragraphs is eligible for inclusion in the amount of interest cost capitalizable in accordance with paragraphs 5–22.

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[1]Interest cost on these obligations includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

[2]For purposes of applying paragraphs 5–22, the term *flows statement* includes the government-wide statement of activities for business-type activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

7. The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use.[3] If an asset requires a period of time in which to carry out the activities[4] necessary to bring it to that condition and location, the interest cost incurred during that period as a result of outlays for the asset is a part of the historical cost of acquiring the asset.

Assets Qualifying for Interest Capitalization

8. Interest should be capitalized for the following types of assets ("qualifying assets"):

a. Assets that are constructed or otherwise produced for a government's own use (including assets constructed or produced for the government by others for which deposits or progress payments have been made)
b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (for example, real estate developments)
c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of resources to acquire qualifying assets for its operations
d. Assets that are donated or granted to other entities.

9. However, interest cost should not be capitalized for inventories. In addition, interest should not be capitalized for the following types of assets:

a. Assets that are in use or ready for their intended use
b. Assets that are not undergoing the activities necessary to get them ready for use
c. Assets that are not included in the financial statements
d. Investments accounted for by the equity method after the planned principal operations of the investee begin
e. Investments in regulated investees that are capitalizing both the cost of debt and equity capital
f. Assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that resources are available from such gifts and grants. Interest earned from temporary investment of those resources that is similarly restricted should be considered an addition to the gift or grant for this purpose.

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[3]The term *intended use* embraces both readiness for use and readiness for sale, depending on the purpose of acquisition.

[4]See paragraph 16 for a definition of those activities for purposes of applying paragraphs 5–22.

10. Land that is not undergoing activities necessary to get it ready for its intended use is not a qualifying asset. If activities are undertaken for the purpose of developing land for a particular use, the outlays to acquire the land qualify for interest capitalization while those activities are in progress. The interest cost capitalized on those outlays is a cost of acquiring the asset that results from those activities. If the resulting asset is a structure, such as a parking facility, interest capitalized on the land outlays is part of the acquisition cost of the structure. If the resulting asset is developed land, such as land that is to be sold as developed lots, interest capitalized on the land outlays is part of the acquisition cost of the developed land.

The Amount of Interest Cost to Be Capitalized

11. The amount of interest cost to be capitalized for qualifying assets is intended to be that portion of the interest cost incurred during the assets' acquisition periods that theoretically could have been avoided (for example, by avoiding additional borrowings or by using the resources expended for the assets to repay existing borrowings) if outlays for the assets had not been made.

12. The amount capitalized in an accounting period should be determined by applying an interest rate(s) ("the capitalization rate") to the average amount of accumulated outlays for the asset during the period.[5] The capitalization rates used in an accounting period should be based on the rates applicable to borrowings outstanding during the period. If a government's financing plans associate a specific new borrowing with a qualifying asset, the government may use the rate on that borrowing as the capitalization rate to be applied

[5]If qualifying assets are financed with the proceeds of tax-exempt borrowings and those resources are externally restricted to the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost capitalized should be determined in accordance with paragraphs 19 and 20.

to that portion of the average accumulated outlays for the asset that does not exceed the amount of that borrowing. If average accumulated outlays for the asset exceed the amounts of specific new borrowings associated with the asset, the capitalization rate to be applied to such excess should be a weighted average of the rates applicable to other borrowings of the government.

13. In identifying the borrowings to be included in the weighted average rate, the objective is a reasonable measure of the cost of financing acquisition of the asset in terms of the interest cost incurred that otherwise could have been avoided. Accordingly, judgment will be required to make a selection of borrowings that best accomplishes that objective in the circumstances. However, the use of judgment in determining capitalization rates should not circumvent the requirement that a capitalization rate be applied to all capitalized outlays for a qualifying asset to the extent that interest cost has been incurred during an accounting period.

14. The total amount of interest cost capitalized in an accounting period should not exceed the total amount of interest cost incurred by the government in that period.

15. For the purposes of applying paragraphs 5–22, *outlays* to which capitalization rates are to be applied are capitalized outlays (net of progress payment collections) for the qualifying asset that have required the payment of cash, the transfer of other assets, or the incurring of a liability on which interest is recognized (in contrast to liabilities, such as trade payables, accruals, and retainages on which interest is not recognized). However, reasonable approximations of net capitalized outlays may be used. For example,

capitalized costs for an asset may be used as a reasonable approximation of capitalized outlays.

The Capitalization Period

16. The capitalization period should begin[6] when three conditions are present:

a. Outlays (as defined in paragraph 15) for the asset have been made
b. Activities that are necessary to get the asset ready for its intended use are in progress
c. Interest cost is being incurred.

Interest capitalization should continue as long as those three conditions are present. The term *activities* is to be construed broadly. It encompasses more than physical construction; it includes all the steps required to prepare the asset for its intended use. For example, it includes administrative and technical activities during the preconstruction stage, such as the development of plans or the process of obtaining permits from governmental authorities; it includes activities undertaken after construction has begun in order to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation. If the government suspends substantially all activities related to acquisition of the asset, interest capitalization should cease until activities are resumed. However, brief interruptions in activities, interruptions that are externally imposed, and delays that are inherent in the asset acquisition process should not require cessation of interest capitalization.

17. The capitalization period should end when the asset is substantially complete and ready for its intended use. Some assets are completed in parts, and each part is capable of being used independently while work is continuing on other parts. For such assets, interest

[6]In situations involving qualifying assets financed with the proceeds of tax-exempt borrowings that are externally restricted as specified in paragraphs 19 and 20, the capitalization period begins at the date of the borrowing.

capitalization should stop on each part when it is substantially complete and ready for use. Some assets need to be completed in their entirety before any part of the asset can be used. For such assets, interest capitalization should continue until the entire asset is substantially complete and ready for use. Some assets cannot be used effectively until a separate facility has been completed. For such assets, interest capitalization should continue until the separate facility is substantially complete and ready for use.

18. Interest capitalization should not cease when present accounting principles require recognition of a lower value for the asset than acquisition cost; the provision required to reduce acquisition cost to such lower value should be increased appropriately.

Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants

19. Interest earned should not be offset against interest cost in determining either capitalization rates or limitations on the amount of interest cost to be capitalized except in situations involving acquisition of qualifying assets financed with the proceeds of tax-exempt borrowings if those resources are externally restricted to finance acquisition of specified qualifying assets or to service the related debt.

20. The amount of interest cost capitalized on qualifying assets acquired with proceeds of tax-exempt borrowings that are externally restricted as specified in paragraph 19 should be all interest cost of the borrowing less any interest earned on related interest-bearing investments acquired with proceeds of the related tax-exempt borrowings[7] from the date

[7]The interest cost and interest earned on any portion of the proceeds of the tax-exempt borrowings that are not designated for the acquisition of specified qualifying assets and servicing the related debt are excluded. The entire interest cost on that portion of the proceeds that is available for other uses (such as refunding of an existing debt issue other than a construction loan related to those assets) is eligible for capitalization on other qualifying assets.

of the borrowing until the assets are ready for their intended use. Interest cost of a tax-exempt borrowing should be eligible for capitalization on other qualifying assets of the entity when the specified qualifying assets are no longer eligible for interest capitalization.

Disposition of the Amount Capitalized

21. Because interest cost is an integral part of the total cost of acquiring a qualifying asset, its disposition should be the same as that of other components of asset cost.

Disclosures

22. The following information with respect to interest cost should be disclosed in the notes to the financial statements:

a. For an accounting period in which no interest cost is capitalized, the amount of interest cost incurred and charged to expense during the period
b. For an accounting period in which some interest cost is capitalized, the total amount of interest cost incurred during the period and the amount thereof that has been capitalized.

Revenue Recognition for Exchange Transactions

23. Revenue from exchange transactions generally should be recognized when an exchange, in the ordinary course of operations, is effected unless the circumstances are

such that the collection of the exchange price is not reasonably assured. Accordingly, revenues from exchange transactions should generally be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts. In the absence of the circumstances[8] referred to above or other specific guidance, such as in paragraphs 282–349, the installment method is not acceptable.

Revenue Recognition When Right of Return Exists

24. Paragraphs 24–28 specify criteria applicable to business-type activities and proprietary funds for recognizing revenue on an exchange transaction in which a product may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate customer or by a party who resells the product to others. The product may be returned for a refund of the purchase price, for a credit applied to amounts owed or to

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[8]There are exceptional cases in which receivables are collectible over an extended period of time and, because of the terms of the transactions or other conditions, there is no reasonable basis for estimating the degree of collectibility. When such circumstances exist, and as long as they exist, either the installment method or the cost recovery method of accounting may be used. (Under the cost recovery method, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of income until that time.)

be owed for other purchases, or in exchange for other products. The purchase price or credit may include amounts related to incidental services, such as installation.

25. Paragraphs 24–28 do not apply to (a) accounting for charges for services if part or all of the service revenue may be returned under cancellation privileges granted to the buyer, (b) transactions involving real estate or leases, or (c) exchange transactions in which a customer may return defective goods, such as under warranty provisions.

Criteria for Recognizing Revenue When Right of Return Exists

26. If a government sells its product but gives the buyer the right to return the product, revenue from the exchange transaction should be recognized at the time of the transaction only if all of the following conditions are met:

a. The government's price to the buyer is substantially fixed or determinable at the date of the exchange transaction.
b. The buyer has paid the government, or the buyer is obligated to pay the government and the obligation is not contingent on resale of the product.
c. The buyer's obligation to the government would not be changed in the event of theft or physical destruction or damage of the product.
d. The buyer acquiring the product for resale has economic substance apart from that provided by the government.9
e. The government does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
f. The amount of future returns10 can be reasonably estimated (paragraph 28).

Revenue and costs associated with the exchange that are not recognized at the time of the exchange transaction because the foregoing conditions are not met should be recognized either when the return privilege has substantially expired or if those conditions subsequently are met, whichever occurs first.

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[9] This condition relates primarily to buyers that exist "on paper," that is, buyers that have little or no physical facilities or employees. It prevents governments from recognizing revenue on transactions with parties that the governments have established primarily for the purpose of recognizing such revenue.

[10] Exchanges by ultimate customers of one item for another of the same kind, quality, and price (for example, one color or size for another) are not considered returns for purposes of applying paragraphs 24–28.

27. If revenue is recognized because the conditions of paragraph 26 are met, any costs or losses that may be expected in connection with any returns should be accrued in accordance with paragraphs 96–113. Revenue and costs associated with the exchange should be reduced to reflect estimated returns.

28. The ability to make a reasonable estimate of the amount of future returns depends on many factors and circumstances that will vary from one case to the next. However, the following factors may impair the ability to make a reasonable estimate:

a. The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand
b. Relatively long periods in which a particular product may be returned
c. Absence of historical experience with similar types of exchange transactions of similar products, or inability to apply such experience because of changing circumstances
d. Absence of a large volume of relatively homogeneous transactions.

The existence of one or more of the above factors, in light of the significance of other factors, may not be sufficient to prevent making a reasonable estimate; likewise, other factors may preclude a reasonable estimate.

Statement of Net Assets Classification

29. Paragraphs 30–44 apply only when a government is preparing a classified statement of net assets for accounting and financial reporting purposes. Paragraphs 34–43 also apply to disclosures made about maturities of obligations reported in both classified and unclassified statements of net assets.

Current Assets

30. For accounting and financial reporting purposes, the term *current assets* is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed within a year. Therefore, current assets generally include such resources as (a) cash available for current operations and items that are the equivalent of cash; (b) inventories of merchandise, raw materials, goods in process, finished goods, operating supplies, and ordinary maintenance material and parts; (c) trade accounts, notes, and acceptances receivable; (d) receivables from taxpayers, other governments, vendors, customers, beneficiaries, and employees, if collectible within a year; (e) installment or deferred accounts and notes receivable if they conform generally to normal trade practices and terms within the business-type activity; (f) marketable securities representing the investment of cash available for current operations; and (g) prepayments such as insurance, interest, rents, unused royalties, current paid advertising service not yet received, and operating supplies. Prepayments are not current assets in the sense that they will be converted into cash but in the sense that, if not paid in advance, they would require the use of current assets within a year.

31. This concept of the nature of current assets contemplates the exclusion from that classification of such resources as (a) cash and claims to cash that are restricted as to withdrawal or use for other than current operations, that are designated for disbursement in the acquisition or construction of noncurrent assets, or that are segregated[11] for the

[11]Even though not actually set aside in special accounts, resources that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes also should, under this concept, be excluded from current assets. However, where such resources are considered to offset maturing debt that has properly been set up as a current liability, they may be included within the current asset classification.

liquidation of long-term debts; (b) receivables arising from unusual transactions (such as the sale of capital assets) that are not expected to be collected within 12 months; (c) cash surrender value of life insurance policies; (d) land and other natural resources; (e) depreciable assets; and (f) long-term prepayments that are applicable to the operations of several years, or deferred charges such as bonus payments under a long-term lease.

32. Unearned discounts (other than cash or quantity discounts and the like), finance charges, and interest included in the face amount of receivables should be shown as a deduction from the related receivables.

Classification and Disclosure of Allowances

33. Asset valuation allowances for losses, such as those on receivables, should be deducted from the assets or groups of assets to which the allowances relate, with appropriate disclosure.

Current Liabilities

34. 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. As a category in the statement of net assets, the classification is intended to include obligations for items that have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in providing services; collections received in advance

of the performance of services;[12] and debts that arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, and royalties. Other liabilities whose regular and ordinary liquidation is expected to occur within one year also are intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, amounts required to be expended within one year under sinking fund provisions, and certain agency obligations arising from the collection or acceptance of cash or other assets for the account of third parties. The current liability classification also is intended to include obligations that, by their terms, are due on demand or will be due on demand within one year from the date of the financial statements,[13] even though liquidation may not be expected within that period.[14] It also is intended to include long-term obligations that are or will be callable[15] by the creditor either because the debtor's violation of a provision[16] of the debt agreement at the date of the financial statements makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable. Accordingly, such callable obligations should be classified as current liabilities unless one of the following conditions is met:

[12]Examples of such current liabilities are obligations resulting from advance collections on ticket sales, which normally will be liquidated in the ordinary course of operations by the delivery of services, or security deposits received for providing water, electric, sewer, or cable service. On the contrary, obligations representing long-term deferments of the delivery of services would not be shown as current liabilities. An example of the latter is the advance receipt by a lessor of rental for the final period of a 10-year lease as a condition to execution of the lease agreement.

[13]*Date of the financial statements* means the end of the most recent accounting period for which financial statements are being presented.

[14]Specific guidance for demand bonds is provided in Interpretation 1, paragraph 10.

[15]An obligation is *callable* at a given date if the creditor has the right at that date to demand, or to give notice of its intention to demand, repayment of the obligation owed to it by the debtor.

[16]A *violation of a provision* is the failure to meet a condition in a debt agreement or a breach of a provision in the agreement for which compliance is objectively determinable, whether or not a grace period is allowed or the creditor is required to give notice of its intention to demand repayment.

a. The creditor has waived[17] or subsequently lost[18] the right to demand repayment for more than one year from the date of the financial statements.

b. For long-term obligations containing a grace period within which the debtor may cure the violation, it is probable[19] that the violation will be cured within that period, thus preventing the obligation from becoming callable.

Short-term obligations that are expected to be refinanced on a long-term basis, including those callable obligations discussed herein, should be classified in accordance with paragraphs 36–44**.**

35. This concept of current liabilities should include estimated or accrued amounts that are expected to be required to cover disbursements within the year for known obligations (a) the amount of which can be determined only approximately (as in the case of provisions for accruing bonus payments) or (b) in which the specific person or persons to whom payment will be made cannot as yet be designated (as in the case of estimated costs to be incurred in connection with guaranteed servicing or repair of products already sold). The current liability classification, however, is not intended to include debts to be liquidated by resources that have been accumulated in accounts of a type not properly classified as current assets, or long-term obligations incurred to provide increased amounts of working capital for long periods. When the amounts of the periodic payments of an obligation are, by contract, measured by current transactions, as, for example, by rents or revenues received in the case of equipment trust certificates or by the depletion of natural resources in the case of property obligations, the portion of the total obligation to

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[17]If the obligation is callable because of violations of certain provisions of the debt agreement, the creditor needs to waive its right with regard only to those violations.

[18]For example, the debtor has cured the violation after the date of the financial statements and the obligation is not callable at the time the financial statements are issued.

[19]*Probable* is defined in paragraph 100 as "likely to occur" and is used in the same sense in this paragraph.

be included as a current liability should be that representing the amount accrued at the date of the financial statements.

Classification of Short-Term Obligations Expected to Be Refinanced

36. For purposes of applying paragraphs 29–44, *short-term obligations* are those that are scheduled to mature within one year after the date of a government's financial statements. *Long-term obligations* are those scheduled to mature beyond one year from the date of a government's financial statements. *Refinancing a short-term obligation on a long-term basis* means either replacing it with a long-term obligation or renewing, extending, or replacing it with short-term obligations for an uninterrupted period extending beyond one year from the date of a government's financial statements. Accordingly, despite the fact that the short-term obligation is scheduled to mature during the ensuing fiscal year, it will not require the use of working capital during that period.

Classification

37. Short-term obligations arising from transactions in the normal course of operations that are due in customary terms should be classified as current liabilities.

38. A short-term obligation other than one classified as a current liability in accordance with paragraph 37 should be excluded from current liabilities only if the following conditions are met:[20]

a. The government intends to refinance the obligation on a long-term basis. (See paragraph 36.)
b. The government has the ability to consummate the refinancing. (See paragraph 39.)

[20]Consistent with paragraph 37 and footnote 11, resources obtained on a long-term basis prior to the date of the financial statements would be excluded from current assets if the obligation to be liquidated is excluded from current liabilities.

Ability to Consummate the Refinancing

39. The government's intent to refinance the short-term obligation on a long-term basis is supported by an ability to consummate the refinancing demonstrated in either of the following ways:

a. *Issuance of a long-term obligation after the date of the financial statements.* After the date of a government's financial statements but before those financial statements are issued, a long-term obligation has been issued for the purpose of refinancing the short-term obligation on a long-term basis; or
b. *Financing agreement.* Before the financial statements are issued, the government has entered into a financing agreement that clearly permits the government to refinance the short-term obligation on a long-term basis on terms that are readily determinable, and all of the following conditions are met:
    (1) The agreement does not expire within one year from the date of the government's financial statements and during that period the agreement is not cancelable by the lender or the prospective lender (and obligations incurred under the agreement are not callable during that period) except for violation of a provision with which compliance is objectively determinable or measurable.[21]
    (2) No violation of any provision in the financing agreement exists at the date of the financial statements and no available information indicates that a violation has occurred thereafter but prior to the issuance of the financial statements, or, if one exists at the date of the financial statements or has occurred thereafter, a waiver has been obtained.
    (3) The lender or the prospective lender with which the government has entered into the financing agreement is expected to be financially capable of honoring the agreement.

40. If a government's ability to consummate an intended refinancing of a short-term obligation on a long-term basis is demonstrated by issuance of a long-term obligation after the date of the financial statements (paragraph 39a), the amount of the short-term obligation to be excluded from current liabilities should not exceed the proceeds of the new long-term obligation. If the ability to refinance is demonstrated by the existence of a financing agreement (paragraph 39b), the amount of the short-term obligation to be excluded from current liabilities should be reduced to the amount available for refinancing

[21]Financing agreements cancelable for violation of a provision that can be evaluated differently by the parties to the agreement (such as "a material adverse change" or "failure to maintain satisfactory operations") do not comply with this condition.

under the agreement when the amount available is less than the amount of the short-term obligation. The amount to be excluded should be reduced further if information (such as restrictions in other agreements or restrictions as to transferability of resources) indicates that resources obtainable under the agreement will not be available to liquidate the short-term obligation. Further, if amounts that could be obtained under the financing agreement fluctuate (for example, in relation to the government's needs, in proportion to the value of collateral, or in accordance with other terms of the agreement), the amount to be excluded from current liabilities should be limited to a reasonable estimate of the minimum amount expected to be available at any date from the scheduled maturity of the short-term obligation to the end of the fiscal year. If no reasonable estimate can be made, the entire outstanding short-term obligation should be included in current liabilities.

41. The government may intend to seek an alternative source of financing rather than to exercise its rights under the existing agreement when the short-term obligation becomes due. The government should intend to exercise its rights under the existing agreement, however, if that other source does not become available.[22]

42. Replacement of a short-term obligation with another short-term obligation after the date of the financial statements but before the financial statements are issued is not, by itself, sufficient to demonstrate a government's ability to refinance the short-term obligation on a long-term basis. If, for example, the replacement is made under the terms of a revolving credit agreement that provides for renewal or extension of the short-term obligation for an uninterrupted period extending beyond one year from the date of the

[22]The intent to exercise may not be present if the terms of the agreement contain conditions or permit the prospective lender to establish conditions, such as interest rates or collateral requirements that are unreasonable to the government.

financial statements, the revolving credit agreement is required to meet the conditions in paragraph 39b to justify excluding the short-term obligation from current liabilities. Similarly, if the replacement is another short-term obligation accompanied by a “stand-by” credit agreement, the stand-by agreement is required to meet the conditions in paragraph 39b to justify excluding the short-term obligation from current liabilities.

43. Repayment of a short-term obligation *before* resources are obtained through a long-term refinancing requires the use of current assets. Therefore, if a short-term obligation is repaid after the date of the financial statements and subsequently a long-term obligation whose proceeds are used to replenish current assets before the financial statements are issued, the short-term obligation should not be excluded from current liabilities at the date of the financial statements.

Disclosure of Short-Term Obligations

44. A total of current liabilities should be presented in classified statements of net assets. If a short-term obligation is excluded from current liabilities pursuant to the provisions of paragraphs 29–43, the notes to the financial statements should include a general description of the financing agreement and the terms of any new obligation incurred or expected to be incurred as a result of a refinancing. If an obligation under paragraph 34b above is classified as a long-term liability (or, in the case of an unclassified statement of net assets, is included as a long-term liability in the disclosure of debt maturities), the circumstances should be disclosed.

Special and Extraordinary Items

45. Judgment is required to determine which items should be segregated in the flows statement[23] for the effects of events or transactions that are special or extraordinary items. An event or transaction should be presumed to be an ordinary and usual activity of the government, unless the evidence clearly supports its classification as a special or extraordinary item as defined in paragraph 46.

46. Special and extraordinary items are events and transactions that are distinguished either by their unusual nature or by the infrequency of their occurrence, or both. The following criteria should be met to classify an event or transaction as either unusual in nature or infrequent in occurrence:

a. *Unusual nature*—the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the government, taking into account the environment in which the government operates. (See paragraph 47.)
b. *Infrequency of occurrence*—the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the government operates. (See paragraph 48.)

47. *Unusual Nature.* The specific characteristics of the government, such as type and scope of operations and operating policies, should be considered in determining ordinary and typical activities of the government. The environment in which a government operates is a primary consideration in determining whether an underlying event or transaction is abnormal and significantly different from the ordinary and typical activities of the government. The environment of a government includes such factors as the characteristics of its business-type activities, the geographical location of its operations, and the nature

[23]For purposes of applying paragraphs 45–50, the term *flows statement* includes the government-wide statement of activities; the governmental fund statement of revenues, expenditures, and changes in fund balances; and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

and extent of governmental regulation. Thus, an event or transaction may be unusual in nature for one government but not for another because of differences in their respective environments. Unusual nature is not established by the fact that an event or transaction is beyond the control of management.

48. *Infrequency of Occurrence.* For purposes of applying paragraphs 45–50, an event or transaction of a type not reasonably expected to recur in the foreseeable future is considered to occur infrequently. Determining the probability of recurrence of a particular event or transaction in the foreseeable future should take into account the environment in which a government operates. Accordingly, a specific transaction of one government might meet that criterion, and a similar transaction of another government might not because of different probabilities of recurrence. The past occurrence of an event or transaction for a particular government provides evidence to assess the probability of recurrence of that type of event or transaction in the foreseeable future.

49. Certain gains and losses should not be reported as extraordinary items because they are usual in nature or may be expected to recur as a consequence of customary and continuing operations. Examples include:

a. Write-down or write-off of receivables, inventories, equipment leased to others, or intangible assets
b. Gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations
c. Other gains or losses from sale or abandonment of capital assets used in operations
d. Effects of a strike, including those against major suppliers
e. Adjustment of accruals on long-term contracts.

In rare situations, an event or transaction may occur that clearly meets both criteria specified in paragraph 46 and, thus, gives rise to an extraordinary gain or loss that includes one or more of the gains or losses enumerated above. In these circumstances, gains or losses such as (a) and (c), above, should be included in the extraordinary item if they are a direct result of a major casualty (such as an earthquake) or a prohibition under a newly enacted law or regulation that clearly meets both criteria specified in paragraph 46. However, any portion of such losses that would have resulted from a valuation of assets on a going-concern basis should not be included in the extraordinary items.

Adjustment of Amounts Reported in Prior Periods

50. Circumstances attendant to special or extraordinary items frequently require estimates, for example, of associated costs and occasionally of associated revenue, based on judgment and evaluation of the facts known at the time of first accounting for the event. Each adjustment in the current period of an element of an extraordinary or special item that was reported in a prior period should be separately disclosed as to year of origin, nature, and amount and classified separately in the current period in the same manner as the original item. If the adjustment is the correction of an error, the provisions of paragraphs 88 and 89 should be applied.

Comparative Financial Statements

51. Paragraphs 51–53 set forth general principles applicable to the presentation of a complete set of financial statements covering one or more preceding periods, along with the current period. Paragraphs 51–53 are not applicable to current-year financial statements that only include prior year summary financial information. For example, those paragraphs are not applicable to a general purpose government's current-year financial statements that include only a total column for the prior year's statement of net assets and a column for the prior year's "net (expense) revenue and changes in net assets" in the statement of activities.

52. If the statement of net assets[24] and the flows statement[25] are presented for one or more preceding periods, as well as the current period, the notes to the financial statements that were presented for the preceding periods should be repeated to the extent that they continue to be of significance. If, because of reclassifications or for other reasons, changes have occurred in the manner of or basis for presenting corresponding items for two or more periods, information should be furnished to explain the change.

53. It is necessary that prior-period figures shown for comparative purposes be, in fact, comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out as described in paragraphs 63–89.

Related Parties

54. Paragraphs 54–57 provide guidance on disclosures of transactions between **related parties.**[26] Examples of related party transactions include transactions (a) between a government and its related organizations, joint ventures, and jointly governed organizations; (b) between a government and its elected and appointed officials, **management,** or members of their **immediate families;** and (c) between a government and trusts for the benefit of employees, such as pension and other postemployment benefit trusts that are managed by or under the trusteeship of the government's management. Transactions between related parties commonly occur in the normal course of operations. Some examples of common types of transactions with related parties are sales, purchases,

[24]For purposes of applying paragraphs 51–53, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

[25]For purposes of applying paragraphs 51–53, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

[26]Terms defined in the glossary (see paragraph 57) are shown in **boldface type** the first time they appear in paragraphs 54–56.

and transfers of realty and personal property; services received or furnished, for example, accounting, management, engineering, and legal services; use of capital assets by lease or otherwise; borrowings and lendings; guarantees; and reimbursements based on allocations of common costs. Transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, a government may receive services from a related party without charge and not record receipt of the services.

Disclosures

55. Financial statements should include disclosures of related party transactions, other than compensation arrangements, expense/expenditure allowances, and other similar items in the ordinary course of operations. The disclosures should include:[27]

a. The nature of the relationship(s) involved
b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which financial statements are presented, and such other information deemed necessary to gain an understanding of the effects of the transactions on the financial statements
c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
d. Amounts due from or to related parties as of the date of each statement of net assets[28] presented and, if not otherwise apparent, the terms and manner of settlement.

56. Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, should not

[27]In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed.

[28]For purposes of applying paragraphs 54–57, the term *statement of net assets* includes the government-wide statement of net assets, the governmental fund balance sheet, and the proprietary fund statement of fund net assets.

imply that the related party transactions were consummated on terms equivalent to those that prevail in arm’s-length transactions unless such representations can be substantiated.

Glossary

57. This paragraph contains definitions of certain terms *as they are used in paragraphs 54–56;* the terms may have different meanings in other contexts.

Immediate Family(ies)

Family members whom an elected or appointed official or a member of management might influence or by whom they might be influenced because of the family relationship.

Management

Persons who are responsible for achieving the objectives of the government and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes the chief executive officer (for example, city manager), directors or secretaries in charge of principal government departments or functions (such as service provision administration or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management.

Related Parties

A government’s related organizations, joint ventures, and jointly governed organizations, as defined in Statement No. 14, *The Financial Reporting Entity,* as amended; elected and appointed officials of the government; its management; members of the immediate families of elected or appointed officials of the government and its management; and other parties with which the government may deal if one party can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties (for example, through imposition of will as discussed in Statement 14, as amended) or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Prior-Period Adjustments

58. Paragraphs 58–62 do not affect the manner of reporting accounting changes required or permitted by other provisions of this Statement and other authoritative pronouncements.[29]

59. Except as specified in paragraph 60, all increases and decreases in net assets recognized during a period, including accruals of estimated losses from loss contingencies, should be included in the change in net assets section of the flows statement[30] for that period.

60. A correction of an error in previously issued financial statements[31] should be accounted for and reported as a prior-period adjustment[32] and excluded from the change in net assets section of the flows statement for the current period.

[29]Accounting changes resulting in restatement of previously issued financial statements of prior periods include a change in accounting method permitted by a change in the reporting entity described in paragraph 86.

[30]For purposes of applying paragraphs 58–62, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

[31]*A correction of an error in previously issued financial statements* is used here as that term is defined in paragraph 72. That paragraph also describes the distinction between a correction of an error and a change in accounting estimate.

[32]The reporting of prior-period adjustments is described in paragraphs 61 and 62.

61. Those items that are reported as prior-period adjustments should, in single-period statements, be reflected as adjustments of the opening balance of net assets. When comparative statements are presented, corresponding adjustments should be made of the amounts reported in the flows statement and the statement of net assets[33] for all of the periods reported therein to reflect the retroactive application of the prior-period adjustments. (See paragraph 62 for required disclosures of prior-period adjustments.)

Disclosure of Prior-Period Adjustments and Restatements of Reported Changes in Net Assets

62. When prior-period adjustments are recorded, the resulting effects on the change in net assets of prior periods should be disclosed in the notes to the financial statements in the period in which the adjustments are made. When financial statements for a single period only are presented, the disclosure should indicate the effects of such restatement on the balance of net assets at the beginning of the period and on the change in net assets of the immediately preceding period. When financial statements for more than one period are presented, the disclosure should include the effects for each of the periods included in the statements. Disclosure of restatements in annual reports issued subsequent to the first such post-revision disclosure is not required.

Accounting Changes and Error Corrections

63. Paragraphs 63–89 define various types of accounting changes and establish guidance for determining the manner of reporting and disclosing each type. Those paragraphs also cover reporting a correction of an error in previously issued financial statements.

[33]For purposes of applying paragraphs 58–62, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

64. Each Statement and Interpretation of the GASB specifies its effective date and the manner of reporting a change to conform with the conclusions of that pronouncement. Other pronouncements of the GASB or other designated bodies as described in categories (b)–(d) in the hierarchy of generally accepted accounting principles (GAAP), described in Statement 55, also may establish the manner of reporting a change in accounting principle. Accordingly, the provisions of paragraphs 63–89 do not apply to changes made in conformity with such pronouncements issued in the past or in the future.

Types of Accounting Changes

65. The term *accounting change* as used in paragraphs 63–89 means a change in (a) an accounting principle, (b) an accounting estimate, or (c) the reporting entity (which is a special type of change in accounting principle classified separately for purposes of applying paragraphs 65–89). The correction of an error in previously issued financial statements is not an accounting change.

Change in Accounting Principle

66. A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes not only accounting principles and practices but also the methods[34] of applying them.

67. A characteristic of a change in accounting principle is that it concerns a choice from among two or more generally accepted accounting principles. However, neither (a) initial adoption of an accounting principle in recognition of events or transactions occurring for

[34]This provision does not apply to the term *method* when it is used in conjunction with depreciation, depletion, or amortization.

the first time or that previously were insignificant in their effect nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring is a change in accounting principle.

68. Changes in accounting principle are numerous and varied. They include, for example, a change in the policy for determining which short-term, highly liquid investments will be treated as cash equivalents. (Paragraph 70 covers a change in accounting principle to effect a change in estimate.)

Change in Accounting Estimate

69. Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements. Preparing financial statements requires estimating the effects of future events. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, and periods benefited by a deferred cost. Future events and their effects cannot be perceived with certainty; estimating, therefore, requires the exercise of judgment. Therefore, accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.

Change in estimate effected by a change in accounting principle

70. Distinguishing between a change in an accounting principle and a change in an accounting estimate is sometimes difficult. For example, a government may change from deferring and amortizing a cost to recording it as an expense when incurred because future benefits of the cost have become doubtful. The new accounting method is adopted, therefore, in partial or complete recognition of the change in estimated future benefits.

The effect of the change in accounting principle is inseparable from the effect of the change in accounting estimate. Changes of this type are often related to the continuing process of obtaining additional information and revising estimates and are, therefore, considered to be changes in estimates for purposes of applying paragraphs 65–89.

Change in the Reporting Entity

71. One special type of change in accounting principle results in financial statements that, in effect, are those of a different reporting entity. This type is limited mainly to changing the organizations included in a reporting entity's financial statements. A different group of organizations comprise the reporting entity after each change.

Correction of an Error in Previously Issued Financial Statements

72. Reporting a correction of an error in previously issued financial statements concerns factors similar to those relating to reporting an accounting change and is therefore discussed in paragraphs 65–89. Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and, accordingly, from better insight or improved judgment. Therefore, an error is distinguishable from a change in estimate. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error for purposes of applying paragraphs 63–89.

Justification for a Change in Accounting Principle

73. In the preparation of financial statements, there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type. Consistent use of accounting principles from one accounting period to

another enhances the utility of financial statements to users by facilitating analysis and understanding of comparative accounting data.

74. The presumption that a government should not change an accounting principle may be overcome only if the government justifies the use of an alternative acceptable accounting principle on the basis that it is preferable. However, a method of accounting that previously was adopted for a type of transaction or event that is being terminated or that was a single, nonrecurring event in the past should not be changed. For example, the method of accounting should not be changed for inventory that is being discontinued. This does not imply, however, that a change in the estimated period to be benefited for a deferred cost (if justified by the facts) should not be recognized as a change in accounting estimate. The issuance of a new pronouncement by the GASB or by other designated bodies as described in categories (a)–(d) of the GAAP hierarchy discussed in Statement 55 that creates a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle *may require* a government to adopt a change in accounting principle. The issuance of such a pronouncement is considered to constitute sufficient support for making a change in accounting principle provided that the hierarchy presented in Statement 55 is followed. The burden of justifying other changes rests with the government proposing the change.

General Disclosure—A Change in Accounting Principle

75. The nature of and justification for a change in accounting principle and its effect on beginning net assets/fund net assets should be disclosed in the financial statements of the period in which the change is made. The justification for the change should explain clearly why the newly adopted accounting principle is preferable.

Reporting a Change in Accounting Principle

76. Changes in accounting should be recognized by adjusting the beginning net assets/fund net assets in the period of the change for the cumulative effect of changing to a new accounting principle (paragraphs 77–82), but a change in reporting entity should be reported by restating the financial statements of prior periods (paragraphs 86 and 87).

77. For all changes in accounting principle except for a change in reporting entity described in paragraphs 86 and 87:

a. Financial statements for prior periods included for comparative purposes should be presented as previously reported.
b. The cumulative effect of changing to a new accounting principle on the amount of net assets/fund net assets at the beginning of the period in which the change is made should be reported as an adjustment to amounts previously reported.
c. The effect of adopting the new accounting principle on the change in net assets/fund net assets of the period of the change should be disclosed.
d. Changes in net assets/fund net assets computed on a pro forma basis should be shown on the face of the flows statements[35] for all periods presented as if the newly adopted accounting principle had been applied during all periods affected (paragraph 79).

Thus, the change in net assets/fund net assets (exclusive of the cumulative adjustment) for the period of the change should be reported on the basis of the newly adopted accounting principle. The conclusions in this paragraph are modified for various special situations, which are described in paragraphs 80 and 81.

Cumulative Effect of a Change in Accounting Principle

78. The adjustment to beginning net assets/fund net assets for the cumulative effect of changing to a new accounting principle is the difference between (a) the balance of net assets/fund net assets at the beginning of the period of a change and (b) the balance of net

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[35]For purposes of applying paragraphs 63–89, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

assets/fund net assets that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods that would have been affected.

Pro Forma Effects of Retroactive Application

79. Pro forma effects of retroactive application (paragraph 77d) should be shown on the face of the flows statement for the change in net assets/fund net assets. Pro forma amounts should be shown in both current and future reports for all periods presented that are prior to the change and that would have been affected. If a flows statement is presented for the current period only, the actual and the pro forma amounts for the immediately preceding period should be disclosed.

Pro Forma Amounts Not Determinable

80. In rare situations, the pro forma amounts described in paragraph 79 cannot be computed or reasonably estimated for individual prior periods, although the cumulative effect on net assets/fund net assets at the beginning of the period of change can be determined. The reason for not showing the pro forma amounts by periods should be explained because disclosing those amounts is otherwise required.

Cumulative Effect Not Determinable

81. Computing the effect on net assets/fund net assets at the beginning of the period in which a change in accounting principle is made may sometimes be impossible. In those rare situations, a government should disclose the effect of the change on the results of operations of the period of change and explain the reason for omitting accounting for the cumulative effect and disclosure of pro forma amounts for prior years. The principal

example of this type of accounting change is a change in inventory pricing method from first in, first out (FIFO) to last in, first out (LIFO).

Reporting Accounting Changes under Other Pronouncements

82. For purposes of applying paragraphs 65–89, a government making a change in accounting principle to conform with the recommendations of a GASB Technical Bulletin or an AICPA Statement of Position or Practice Bulletin, should report the change as specified in the pronouncement. If the pronouncement does not specify the manner of reporting a change in accounting principle to conform with its recommendations, a government making a change in accounting principle to conform with the recommendations of the pronouncement should report the change as specified by paragraphs 65–89.

Reporting a Change in Accounting Estimate

83. The effect of a change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.[36]

84. A change in accounting estimate that is recognized in whole or in part by a change in accounting principle should be reported as a change in an estimate because the cumulative effect attributable to the change in accounting principle cannot be separated from the current or future effects of the change in estimate (paragraph 70).

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[36]Specific guidance for reporting changes in estimates by municipal solid waste landfills is provided in paragraphs 13 and 14 of Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*.

Disclosure

85. The effect on the change in net assets/fund net assets of the current period should be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on the change in net assets/fund net assets is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence.

Reporting a Change in the Entity

86. Accounting changes that result in financial statements that are, in effect, the statements of a different reporting entity (paragraph 71) should be reported by restating the financial statements of all prior periods presented in order to show financial information for the new reporting entity for all periods.

Disclosure

87. The financial statements of the period of a change in the reporting entity should describe the nature of the change and the reason for it. In addition, the effect of the change on beginning net assets/fund net assets should be disclosed for all periods presented. Financial statements of subsequent periods need not repeat the disclosures.

Reporting a Correction of an Error in Previously Issued Financial Statements

88. Correction of an error in the financial statements of a prior period discovered subsequent to their issuance (paragraph 72) should be reported as a prior-period adjustment. (Paragraphs 61 and 62 cover the manner of reporting prior-period adjustments.)

Disclosure

89. The nature of an error in previously issued financial statements and the effect of its correction on the change in net assets/fund net assets should be disclosed in the period in which the error was discovered and corrected. Financial statements of subsequent periods need not repeat the disclosures.

Disclosure of Accounting Policies

90. The accounting policies of a government are the specific accounting principles and the methods of applying those principles that are judged by the management of the government to be the most appropriate in the circumstances to present fairly financial position and changes in financial position in conformity with GAAP and that, accordingly, have been adopted for preparing the financial statements.

91. The accounting policies adopted by a government can affect significantly the presentation of its financial position and changes in financial position. Accordingly, the usefulness of financial statements for purposes of making economic decisions about the government depends significantly upon the user's understanding of the accounting policies followed by the government.

92. Information about the accounting policies adopted by a government is essential for financial statement users. When financial statements are issued purporting to present fairly financial position and changes in financial position in conformity with GAAP, a description of all significant accounting policies of the government should be included as an integral part of the financial statements.

Content

93. Disclosure of accounting policies should identify and describe the accounting principles followed by the government and the methods of applying those principles that affect the determination of financial position and changes in financial position. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives
b. Principles and methods peculiar to the industry in which the government (for example, a special-purpose district) operates, even if such principles and methods are predominantly followed in that industry
c. Unusual or innovative applications of GAAP (and, as applicable, of principles and methods peculiar to the industry in which the government operates).

94. Financial statement disclosure of accounting policies should not duplicate details (for example, composition of inventories or of capital assets) presented elsewhere in the basic financial statements. In some cases, the disclosure of accounting policies should refer to related details presented elsewhere in the notes to the financial statements; for example, changes in accounting policies during the period should be described with cross-reference to the disclosure required by paragraphs 65–89 of the current effect of the change and of the pro forma effect of retroactive application.

Disclosure of Depreciation

95. Disclosure of accounting policies should identify and describe the method or methods used in computing depreciation with respect to major classes of depreciable assets.

Contingencies

96. For the purpose of applying paragraphs 96–113, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (referred to as a gain contingency) or loss[37] (referred to as a loss contingency) to a government that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

97. Not all uncertainties inherent in the accounting process give rise to contingencies as that term is used in paragraphs 96–113. Estimates are required in financial statements for many ongoing and recurring activities of a government. The mere fact that an estimate is involved does not, in and of itself, constitute the type of uncertainty referred to in the definition in paragraph 96. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by a government does not make depreciation a contingency; the eventual expiration of the utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency as defined in paragraph 96, nor are such matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. Also, amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred.

98. Risks of loss from the following kinds of events are included within the scope of paragraphs 96–113:

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[37]The term *loss* is used for convenience to include many decreases in net assets/fund balances that are commonly referred to as expenses/expenditures and others that are commonly referred to as losses.

a. Collectibility of receivables
b. Guarantees of indebtedness of others
c. Agreements to repurchase receivables (or to repurchase the related property) that have been sold
d. Claims for delays or inadequate specifications on contracts.

99. Risks of loss from the following kinds of events are *not* included within the scope of paragraphs 96–113:

a. Torts
b. Theft of, damage to, or destruction of assets
c. Business interruption
d. Errors or omissions
e. Job-related illnesses or injuries to employees
f. Acts of God
g. Pollution remediation obligations.[38]

Probability Classifications for Loss Contingencies

100. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. Paragraphs 96–113 use the terms *probable, reasonably possible,* and *remote* to identify three areas within that range, as follows:

a. *Probable.* The future event or events are likely to occur.
b. *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
c. *Remote.* The chance of the future event or events occurring is slight.

Accrual of Loss Contingencies

101. The conditions for accrual of loss contingencies in paragraph 102 do not amend any other present requirement in a pronouncement to accrue a particular type of loss or expense/expenditure.

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[38]The accounting and financial reporting standards for the risks of loss associated with items (a)–(f) in paragraph 99 are provided in Statement 10, as amended. The accounting and financial reporting standards for the risks of loss associated with item (g) are provided in Statement 49.

102. An estimated loss from a loss contingency (as defined in paragraph 96) should be accrued if both of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it should be probable that one or more future events will occur confirming the fact of the loss.
b. The amount of loss can be reasonably estimated.

103. The purpose of the two conditions in paragraph 102 is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. Condition (b) in paragraph 102, that the amount of loss can be reasonably estimated, does not delay accrual of a loss until only a single amount can be reasonably estimated. To the contrary, when condition (a) in paragraph 102 is met, that is, it is probable that an asset had been impaired or a liability had been incurred, and information available indicates that the estimated amount of loss is within a range of amounts, it follows that some amount of loss has occurred and can be reasonably estimated.

104. When condition (a) in paragraph 102 is met with respect to a particular loss contingency and the reasonable estimate of the loss is a range, condition (b) in paragraph 102 is met and an amount should be accrued for the loss. When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount should be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range should be accrued.[39] In addition, paragraph 106 may require disclosure of the nature and, in some circumstances, the amount accrued, and paragraph 107 requires disclosure of the nature of the

[39]Even though the minimum amount in the range is not necessarily the amount of loss that ultimately will be determined, it is not likely that the ultimate loss will be less than the minimum amount.

contingency and the additional exposure to loss if there is at least a reasonable possibility of loss in excess of the amount accrued.

105. As an example, assume that at December 31, 20XX, a government has an investment of $1,000,000 in the securities of an entity that has declared bankruptcy, and there is no quoted market price for the securities. Condition (a) in paragraph 102 has been met because information available indicates that the value of the investment has been impaired, and a reasonable estimate of loss is a range between $300,000 and $600,000. No amount of loss in that range appears at the time to be a better estimate of loss than any other amount. Paragraphs 96–113 require accrual of the $300,000 loss at December 31, 20XX, disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $300,000, and possibly disclosure of the amount of the accrual.

Disclosure of Loss Contingencies

106. Disclosure of the nature of an accrual[40] made pursuant to the provisions of paragraph 102, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

107. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 102 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 102, disclosure of the contingency should be made when there is at least a reasonable possibility that a loss or an additional loss may have

[40]Terminology used should be descriptive of the nature of the accrual.

been incurred.[41] The disclosure should indicate the nature of the contingency and should give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

108. After the date of a government's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements should indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements in which the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial

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[41]For example, disclosure should be made of any loss contingency that meets the condition in paragraph 102a but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 102b). Disclosure also is required of some loss contingencies that do not meet the condition in paragraph 102a—namely, those contingencies for which there is a reasonable possibility that a loss may have been incurred even though information may not indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.

statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a statement of net assets[42] only, in columnar form on the face of the historical financial statements.

109. Certain loss contingencies should be disclosed in financial statements even though the possibility of loss may be remote. The common characteristic of those contingencies is a guarantee, normally with a right to proceed against an outside party in the event that the guarantor is called upon to satisfy the guarantee. Examples include guarantees of indebtedness of others and guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned. Those loss contingencies, and others that in substance have the same characteristic, should be disclosed. The disclosure should include the nature and amount of the guarantee. Consideration should be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.

110. The term *guarantees of indebtedness of others* in paragraph 109 includes indirect guarantees of indebtedness of others. An indirect guarantee of the indebtedness of another arises under an agreement that obligates a government to transfer resources to another entity upon the occurrence of specified events, under conditions whereby (a) the resources are legally available to creditors of the second entity and (b) those creditors may enforce the second entity's claims against the government under the agreement. Examples of

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[42]For purposes of applying paragraphs 96–113, the term *statement of net assets* includes the government-wide statement of net assets, the governmental fund balance sheet, and the proprietary fund statement of fund net assets.

indirect guarantees include agreements to advance resources if a second entity's revenues, coverage of debt service, or net assets/fund balance fall below a specified minimum.[43]

General or Unspecified Operations Risks

111. General or unspecified operations risks do not meet the conditions for accrual in paragraph 102, and no accrual for loss should be made. No disclosure about these risks is required by paragraphs 96–113.

Gain Contingencies

112. Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization. Adequate disclosure should be made of contingencies that might result in gains, but care should be exercised to avoid misleading implications as to the likelihood of realization.

Other Disclosures

113. Unused letters of credit, long-term leases, assets pledged as security for loans, and commitments, such as an obligation to reduce debts, should be disclosed in notes to financial statements, and paragraphs 96–113 do not alter the present disclosure requirements with respect to those items.

Construction-Type Contracts—Long-Term

114. Paragraphs 114–123 establish standards of accounting and financial reporting for construction-type contracts by governments engaged in the contracting operations. Those paragraphs do not apply to cost-plus-fixed-fee contracts or contracts such as those for products or services customarily billed as shipped or rendered. In general, those paragraphs apply to contracts for construction of specific projects.

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[43]Disclosure of an indirect guarantee is not required by paragraphs 96–113 if it is otherwise disclosed in the financial statements.

115. Considerations other than those acceptable as a basis for the recognition of revenue frequently enter into the determination of the timing and amounts of interim billings on construction-type contracts. For this reason, revenue to be recognized on such contracts at the various stages of performance generally should not be measured by interim billings.

Generally Accepted Methods

Selection of Method

116. When estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method generally should be applied. However, when lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method generally should be applied. Disclosure of the method followed should be included in the notes to financial statements.

Percentage-of-Completion Method

117. The percentage-of-completion method recognizes revenue as work on a contract progresses. The recognized revenue should be that percentage of estimated total revenue that either:

a. Incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or
b. May be indicated by such other measure of progress toward completion as may be appropriate, having due regard to work performed.

Costs as used here may exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts.

118. Under this method, current assets may include costs and recognized revenue not yet billed, with respect to certain contracts; and liabilities, in most cases current liabilities,

may include billings in excess of costs and recognized revenue with respect to other contracts.

119. When the current estimate of total contract costs indicates a loss, in most circumstances, a provision should be made for the loss on the entire contract. If there is a close relationship between contracts resulting in gains and those resulting in losses, such as in the case of contracts that are part of the same project, the group may be treated as a unit in determining the necessity for a provision for loss.

Completed-Contract Method

120. The completed-contract method recognizes revenue only when the contract is completed, or substantially so. Accordingly, costs of contracts in process and current billings should be accumulated, but no interim revenue or expenses should be recognized other than provisions for losses. A contract should be regarded as substantially completed if remaining costs are not significant in amount.

121. When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs. However, there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process.

122. Although the completed-contract method does not permit the recording of any revenue prior to completion, a provision should be made for expected losses. If there is a close relationship between contracts resulting in gains and those resulting in losses, such as in the case of contracts that are part of the same project, the group may be treated as a unit in determining the necessity for a provision for losses.

123. When the completed-contract method is used, an excess of accumulated costs over related billings should be shown in the statement of net assets[44] as a current asset, and an excess of accumulated billings over related costs should be shown among the liabilities, in most cases as a current liability. If costs exceed billings on some contracts, and billings exceed costs on others, the contracts generally should be segregated so that the figures on the asset side include only those contracts on which costs exceed billings and those on the liability side include only those on which billings exceed costs. The asset item should be described as "costs of uncompleted contracts in excess of related billings" rather than as "inventory" or "work in process," and the item on the liability side should be described as "billings on uncompleted contracts in excess of related costs."

Extinguishments of Debt

124. Paragraphs 124–127 apply to all extinguishments of debt, whether early or not, except debt defeased by a current or advanced refunding and debt that is extinguished through a troubled debt restructuring.

Circumstances for an Extinguishment of Debt

125. A debtor should consider debt to be extinguished for financial reporting purposes in the following circumstances:

a. Using financial resources that did not arise from debt proceeds, the debtor pays the creditor and is relieved of all its obligations with respect to the debt. This includes the debtor's reacquisition of its outstanding debt securities in the public securities markets, regardless of whether the securities are cancelled or held as so-called treasury bonds.

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[44]For purposes of applying paragraphs 114–123, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

b. The debtor is legally released[45] from being the primary obligor under the debt, either judicially or by the creditor, and it is probable[46] that the debtor will not be required to make future payments with respect to that debt under any guarantees.

Accounting for Extinguishments of Debt

126. A **difference**[47] between the **reacquisition price** and the **net carrying amount** of the extinguished debt should be recognized in the flows statements[48] of the period of extinguishment as a loss or gain and identified as a separate item.[49] Gains and losses should not be amortized to future periods.

Glossary

127. This paragraph contains definitions of certain terms *as they are used in paragraph 126;* the terms may have different meanings in other contexts.

Difference

The excess of the reacquisition price over the net carrying amount or the excess of the net carrying amount over the reacquisition price.

Net Carrying Amount

The amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.

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[45]If nonrecourse debt (such as certain mortgages) is assumed by a third party in conjunction with the sale of an asset that serves as the sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller/debtor for purposes of applying paragraphs 124–127.

[46]*Probable* is used here, consistent with its use in paragraph 100, to mean that it is likely that no payments will be required.

[47]Terms defined in the glossary (see paragraph 127) are shown in **boldface type** the first time they appear in paragraph 126.

[48]For purposes of applying paragraphs 124–127, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

[49]If upon extinguishment of debt, the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges should be given appropriate accounting recognition.

Reacquisition Price

The amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities.

Troubled Debt Restructuring

128. Paragraphs 128–164 establish standards of accounting and financial reporting by the debtor and by the creditor for a troubled debt restructuring. Those paragraphs do not provide guidance for accounting for allowances for estimated uncollectible amounts and do not prescribe particular methods for estimating amounts of uncollectible receivables. Those paragraphs also do not provide accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code.

129. A restructuring of a debt constitutes a *troubled debt restructuring* for purposes of applying paragraphs 128–164 if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt

though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.[50]

130. Whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it.

131. In paragraphs 128–164, a *receivable* or *payable* (collectively referred to as *debt*) represents a contractual right to receive money or a contractual obligation to pay money on demand or on fixed or determinable dates that already is included as an asset or liability in the creditor's or debtor's statement of net assets[51] at the time of the restructuring. Receivables or payables involved in troubled debt restructurings commonly result from the lending or borrowing of cash, investing in debt securities that previously were issued, or selling or purchasing goods or services on credit. Examples are accounts receivable or payable, notes, debentures and bonds (whether those receivables or payables are secured or unsecured and whether they are convertible or nonconvertible), and related accrued interest, if any. Typically, each receivable or payable is negotiated separately, but sometimes two or more receivables or payables are negotiated together. For example, a debtor may negotiate with a group of creditors but sign separate debt instruments with each creditor. For purposes of applying paragraphs 128–164, restructuring of each receivable or payable, including those negotiated and restructured jointly, should be

[50]Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term *troubled debt restructuring* in paragraphs 128–164.

[51]For purposes of applying paragraphs 128–164, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

accounted for individually. The substance rather than the form of the receivable or payable should govern. For example, to a debtor, a bond constitutes one payable even though there are many bondholders.

132. A troubled debt restructuring may include one or a combination of the following:

a. Transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession)
b. Issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest
c. Modification of terms of a debt, such as one or a combination of:
   (1) Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt
   (2) Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk
   (3) Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement
   (4) Reduction (absolute or contingent) of accrued interest.

133. Troubled debt restructurings may occur before, at, or after the stated maturity of debt, and time may elapse between the agreement, court order, etc., and the transfer of assets or equity interest, the effective date of new terms, or the occurrence of another event that constitutes consummation of the restructuring. The date of consummation is the *time of the restructuring* in paragraphs 128–164.

134. A debt restructuring is not necessarily a troubled debt restructuring for purposes of applying paragraphs 128–164, even if the debtor is experiencing some financial difficulties. For example, a troubled debt restructuring is not involved if (a) the fair value of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the

receivable;[52] (b) the fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable; (c) the creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain resources from other sources at the current market interest rate; or (d) the debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors. In general, a debtor that can obtain resources from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. A debtor in a troubled debt restructuring can obtain resources from sources other than the existing creditor in the troubled debt restructuring, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them. Thus, in an attempt to protect as much of its investment as possible, the creditor in a troubled debt restructuring grants a concession to the debtor that it would not otherwise consider.

135. For purposes of applying paragraphs 128–164, troubled debt restructurings do not include changes in lease agreements (the accounting is prescribed by paragraphs 211–271) or employment-related agreements (for example, pension or other postemployment benefit plans and deferred compensation contracts). Nor do troubled debt restructurings include debtors' failures to pay trade accounts according to their terms or creditors' delays in

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[52]The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous direct write-down of the investment.

taking legal action to collect overdue amounts of interest and principal, unless they involve an agreement between debtor and creditor to restructure.

Accounting by Debtors

136. A debtor should account for a troubled debt restructuring according to the type of the restructuring as prescribed in the following paragraphs.

Transfer of Assets in Full Settlement

137. A debtor that transfers its receivables from third parties, real estate, or other assets to a creditor to settle fully a payable should recognize a gain on restructuring of payables. The gain should be measured by the excess of (a) the carrying amount of the payable settled (the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs) over (b) the fair value of the assets transferred to the creditor.[53] The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets should be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but does exist for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred.[54]

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[53]Paragraphs 137 and 142 indicate that the fair value of assets transferred or the fair value of an equity interest granted should be used in accounting for a settlement of a payable in a troubled debt restructuring. That guidance is not intended to preclude using the fair value of the payable settled if more clearly evident than the fair value of the assets transferred or of the equity interest granted in a full settlement of a payable (paragraph 137). However, in a partial settlement of a payable (paragraph 142), the fair value of the assets transferred or of the equity interest granted should be used in all cases to avoid the need to allocate the fair value of the payable between the part settled and the part still outstanding.

[54]Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 180–184 and paragraph 278.

138. A difference between the fair value and the carrying amount of assets transferred to a creditor to settle a payable is a gain or loss on transfer of assets.[55] The debtor should recognize that gain or loss in the period of transfer.

Modification of Terms

139. A debtor in a troubled debt restructuring involving only modification of terms of a payable—that is, not involving a transfer of assets—should account for the effects of the restructuring prospectively from the time of restructuring and should not change the carrying amount of the payable at the time of the restructuring unless the carrying amount exceeds the total future cash payments specified by the new terms.[56] That is, the effects of changes in the amounts or timing (or both) of future cash payments designated as either interest or face amount should be reflected in future periods.[57] Interest expense should be computed in a way that a constant effective interest rate is applied to the carrying amount of the payable at the beginning of each period between restructuring and maturity (in substance the "interest" method prescribed by paragraph 185). The new effective interest rate should be the discount rate that equates the present value of the future cash payments specified by the new terms (excluding amounts contingently payable) with the carrying amount of the payable.

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[55]The carrying amount of a receivable encompasses not only unamortized premium, discount, acquisition costs, and the like but also an allowance for uncollectible amounts and other "valuation" accounts, if any. A loss on transferring receivables to creditors may therefore have been wholly or partially recognized before the transfer and be wholly or partly a reduction of a valuation account rather than a gain or loss for the period of the transfer.

[56]In paragraphs 128–164, *total future cash payments* includes related accrued interest, if any, that continues to be payable under the new terms at the time of the restructuring.

[57]All or a portion of the carrying amount of the payable at the time of the restructuring may need to be reclassified in the statement of net assets because of changes in the terms, for example, a change in the amount of the payable due within one year after the date of the debtor's statement of net assets. A troubled debt restructuring of a short-term obligation after the date of a debtor's statement of net assets but before that statement of net assets is issued may affect the classification of that obligation in accordance with paragraphs 36–44.

140. If, however, the total future cash payments specified by the new terms of a payable, including both payments designated as interest and those designated as face amount, are less than the carrying amount of the payable, the debtor should reduce the carrying amount to an amount equal to the total future cash payments specified by the new terms and should recognize a gain on restructuring of payables equal to the amount of the reduction.[58] Thereafter, all cash payments under the terms of the payable should be accounted for as reductions of the carrying amount of the payable, and no interest expense should be recognized on the payable for any period between the restructuring and maturity of the payable.[59]

141. A debtor should not recognize a gain on a restructured payable involving indeterminate future cash payments as long as the maximum total future cash payments may exceed the carrying amount of the payable. Amounts designated either as interest or as face amount by the new terms may be payable contingent on a specified event or circumstance (for example, the debtor may be required to pay specified amounts if its financial condition improves to a specified degree within a specified period). To determine whether the debtor should recognize a gain according to the provisions of paragraphs 139 and 140, those contingent amounts should be included in the "total future cash payments specified by the new terms" to the extent necessary to prevent recognizing a gain at the time of restructuring that may be offset by future interest expense. Thus, the

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[58]If the carrying amount of the payable comprises several accounts (for example, face amount, accrued interest, and unamortized premium, discount, finance charges, and issue costs) that are to be continued after the restructuring, some possibly being combined, the reduction in carrying amount may need to be allocated among the remaining accounts in proportion to the previous balances. However, the debtor may choose to carry the amount designated as face amount by the new terms in a separate account and adjust another account accordingly.

[59]The only exception is to recognize interest expense in conformity with paragraph 144.

debtor should apply paragraph 112, in which probability of occurrence of a gain contingency is not a factor, and should assume that contingent future payments will have to be paid. The same principle applies to amounts of future cash payments that sometimes need to be estimated to apply the provisions of paragraphs 139 and 140. For example, if the number of future interest payments is flexible because the face amount and accrued interest is payable on demand or becomes payable on demand, estimates of total future cash payments should be based on the maximum number of periods possible under the restructured terms.

Combination of Types

142. A troubled debt restructuring may involve partial settlement of a payable by the debtor's transferring assets to the creditor and modification of terms of the remaining payable.[60] A debtor should account for a troubled debt restructuring involving a partial settlement and a modification of terms as prescribed in paragraphs 139–141 except that, first, assets transferred in that partial settlement should be measured as prescribed in paragraph 137, and the carrying amount of the payable should be reduced by the total fair value of those assets.[61] A difference between the fair value and the carrying amount of assets transferred to the creditor should be recognized as a gain or loss on transfer of assets. No gain on restructuring of payables should be recognized unless the remaining carrying amount of the payable exceeds the total future cash payments (including amounts contingently payable) specified by the terms of the debt remaining unsettled after the

[60]Even if the stated terms of the remaining payable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the transfer of assets, the restructuring should be accounted for as prescribed by paragraph 142.

[61]If cash is paid in a partial settlement of a payable in a troubled debt restructuring, the carrying amount of the payable should be reduced by the amount of cash paid.

restructuring. Future interest expense, if any, should be determined according to the provisions of paragraphs 139–141.

Related Matters

143. A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor or other transfer of assets to the creditor should be accounted for in conformity with the provisions of paragraphs 137, 138, and 142.

144. If a troubled debt restructuring involves amounts contingently payable, those contingent amounts should be recognized as a payable and as interest expense in future periods in accordance with paragraph 102. Thus, in general, interest expense for contingent payments should be recognized in each period in which (a) it is probable that a liability has been incurred and (b) the amount of that liability can be reasonably estimated. Before recognizing a payable and interest expense for amounts contingently payable, however, accrual or payment of those amounts should be deducted from the carrying amount of the restructured payable to the extent that contingent payments included in "total future cash payments specified by the new terms" prevented recognition of a gain at the time of restructuring (paragraph 141).

145. If amounts of future cash payments need to be estimated to apply the provisions of paragraphs 139–141 because future interest payments are expected to fluctuate—for example, the restructured terms may specify the stated interest rate to be the prime interest rate increased by a specified amount or proportion—estimates of maximum total future payments should be based on the interest rate in effect at the time of the restructuring. Fluctuations in the effective interest rate after the restructuring from changes in the prime rate or other causes should be accounted for as changes in estimates in the periods the

changes occur. However, the accounting for those fluctuations should not result in recognizing a gain on restructuring that may be offset by future cash payments (paragraphs 141 and 144). Rather, the carrying amount of the restructured payable should remain unchanged, and future cash payments should reduce the carrying amount until the time that any gain recognized cannot be offset by future cash payments.

146. All direct costs that a debtor incurs to effect a troubled debt restructuring should be deducted in measuring gain on restructuring of payables or should be included in expense for the period if no gain on restructuring is recognized.

Disclosure by Debtors

147. A debtor should disclose in the notes to financial statements, the following information about troubled debt restructurings that have occurred during a period for which financial statements are presented:

a. For each restructuring,[62] a description of the principal changes in terms, the major features of settlement, or both
b. Aggregate gain on restructuring of payables
c. Aggregate net gain or loss on transfers of assets recognized during the period (paragraphs 138 and 142).

148. A debtor should disclose in the notes to financial statements for periods after a troubled debt restructuring the extent to which amounts contingently payable are included in the carrying amount of restructured payables pursuant to the provisions of paragraph 141. If required by paragraphs 106–110, a debtor also should disclose total amounts that are contingently payable on restructured payables and the conditions under which those amounts would become payable or would be forgiven.

[62]Separate restructurings within a fiscal period for the same category of payables (for example, accounts payable or bonds) may be grouped for disclosure purposes.

Accounting by Creditors

149. A creditor should account for a troubled debt restructuring according to the type of the restructuring as prescribed in the following paragraphs. Paragraphs 150–164 do not apply to a receivable that the creditor is accounting for at fair value (for example, a marketable debt security).

Receipt of Assets in Full Satisfaction

150. A creditor that receives from a debtor in full satisfaction of a receivable either (a) receivables from third parties, real estate, or other assets or (b) shares of stock or other evidence of an equity interest in the debtor, or both, should account for those assets (including an equity interest) at their fair value at the time of the restructuring (see paragraph 137 for how to measure fair value).[63] The excess of (1) the recorded investment in the receivable[64] satisfied over (2) the fair value of assets received is a loss to be recognized according to paragraph 157.

151. After a troubled debt restructuring, a creditor should account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash.

Modification of Terms

152. A creditor in a troubled debt restructuring involving only modification of terms of a receivable—that is, not involving receipt of assets (including an equity interest in the

[63]Paragraphs 150 and 155 indicate that the fair value of assets received should be used in accounting for satisfaction of a receivable in a troubled debt restructuring. That guidance is not intended to preclude using the fair value of the receivable satisfied if more clearly evident than the fair value of the assets received in full satisfaction of a receivable (paragraph 150). However, in a partial satisfaction of a receivable (paragraph 155), the fair value of the assets received should be used in all cases to avoid the need to allocate the fair value of the receivable between the part satisfied and the part still outstanding.

[64]*Recorded investment in the receivable* is used in paragraphs 150–163 instead of *carrying amount of the receivable* because the latter is net of an allowance for estimated uncollectible amounts or other "valuation" account, if any, while the former is not. The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous direct write-down of the investment in the receivable.

debtor)—should account for the effects of the restructuring prospectively and should not change the recorded investment in the receivable at the time of the restructuring unless that amount exceeds the total future cash receipts specified by the new terms.[65] That is, the effects of changes in the amounts or timing (or both) of future cash receipts designated either as interest or as face amount should be reflected in future periods.[66] Interest revenue should be computed in a way that a constant effective interest rate is applied to the recorded investment in the receivable at the beginning of each period between restructuring and maturity (in substance the “interest” method prescribed by paragraph 185). The new effective interest rate should be the discount rate that equates the present value of the future cash receipts specified by the new terms (excluding amounts contingently receivable) with the recorded investment in the receivable.

153. If, however, the total future cash receipts specified by the new terms of the receivable, including both receipts designated as interest and those designated as face amount, are less than the recorded investment in the receivable before restructuring, the creditor should reduce the recorded investment in the receivable to an amount equal to the total future cash receipts specified by the new terms. The amount of the reduction is a loss to be recognized according to paragraph 157. Thereafter, all cash receipts by the creditor under the terms of the restructured receivable, whether designated as interest or as face amount, should be accounted for as recovery of the recorded investment in the receivable,

[65]In paragraphs 128–164, *total future cash receipts* includes related accrued interest, if any, that continues to be receivable under the new terms at the time of the restructuring. Uncertainty of collection of noncontingent amounts specified by the new terms (see paragraph 154 for inclusion of contingent amounts) is not a factor in applying paragraphs 152–154 but should be considered in accounting for allowances for uncollectible amounts.

[66]All or a portion of the recorded investment in the receivable at the time of restructuring may need to be reclassified in the statement of net assets because of changes in the terms.

and no interest revenue should be recognized on the receivable for any period between the restructuring and maturity of the receivable.[67]

154. A creditor should recognize a loss on a restructured receivable involving indeterminate future cash receipts unless the minimum future cash receipts specified by the new terms at least equal the recorded investment in the receivable. Amounts designated either as interest or as face amount that are receivable from the debtor may be contingent on a specified event or circumstance (for example, specified amounts may be receivable from the debtor if the debtor's financial condition improves to a specified degree within a specified period). To determine whether the creditor should recognize a loss according to the provisions of paragraphs 152 and 153, those contingent amounts should be included in the "total future cash receipts specified by the new terms" only if at the time of restructuring those amounts meet the conditions that would be applied under the provisions of paragraph 102 in accruing a loss. That is, a creditor should recognize a loss unless contingent future cash receipts needed to make total future cash receipts specified by the new terms at least equal to the recorded investment in the receivable both are probable and can be reasonably estimated. The same principle applies to amounts of future cash receipts that sometimes need to be estimated to apply the provisions of paragraphs 152 and 153. For example, if the number of interest receipts is flexible because the face amount and accrued interest is collectible on demand or becomes collectible on demand after a specified period, estimates of total future cash receipts should be based on the minimum number of periods possible under the restructured terms.

[67]The only exception is to recognize interest revenue in conformity with paragraph 158.

Combination of Types

155. A troubled debt restructuring may involve receipt of assets (including an equity interest in the debtor) in partial satisfaction of a receivable and a modification of terms of the remaining receivable.[68] A creditor should account for a troubled debt restructuring involving a partial satisfaction and modification of terms as prescribed in paragraphs 152–154 except that, first, the assets received should be accounted for at their fair values as prescribed in paragraph 150, and the recorded investment in the receivable should be reduced by the fair value of the assets received.[69] No loss on the restructuring should be recognized unless the remaining recorded investment in the receivable exceeds the total future cash receipts specified by the terms of the receivable remaining unsatisfied after the restructuring. Future interest revenue, if any, should be determined according to the provisions of paragraphs 152–154.

Related Matters

156. A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, should be accounted for according to the provisions of paragraphs 150 and 155 and, if appropriate, paragraph 161.

157. Losses determined by applying the provisions of paragraphs 150–156 should, to the extent that they are not offset against allowances for uncollectible amounts or other valuation accounts, be included in the period of restructuring. Although paragraphs 128–

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[68]Even if the stated terms of the remaining receivable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the receipt of assets (including an equity interest in the debtor), the restructuring should be accounted for as prescribed by paragraph 155.

[69]If cash is received in a partial satisfaction of a receivable, the recorded investment in the receivable should be reduced by the amount of cash received.

164 do not address questions concerning estimating uncollectible amounts or accounting for the related valuation allowance (paragraph 128), those paragraphs recognize that creditors use allowances for uncollectible amounts. Thus, a loss from reducing the recorded investment in a receivable may have been recognized before the restructuring by recognizing an expense for an estimate of uncollectible amounts and increasing an appropriate valuation allowance. If so, a reduction in the recorded investment in the receivable in a troubled debt restructuring is a deduction from the valuation allowance rather than a loss for the period of restructuring. A valuation allowance can also be used to recognize a loss determined by applying paragraphs 150–156 that has not been previously recognized. For example, a creditor with an allowance for uncollectible amounts pertaining to a group of receivables that includes the restructured receivable may deduct from the allowance the reduction of recorded investment in the restructured receivable and recognize the loss in the period of restructuring by estimating the appropriate allowance for remaining receivables, including the restructured receivable.

158. If a troubled debt restructuring involves amounts contingently receivable, those contingent amounts should not be recognized as interest revenue in future periods before they become receivable—that is, they should not be recognized as interest revenue before both the contingency has been removed and the interest has been earned.[70] Before recognizing those amounts as interest revenue, however, they should be deducted from the recorded investment in the restructured receivable to the extent that contingent receipts included in "total future cash receipts specified by the new terms" avoided recognition of a loss at the time of restructuring (paragraph 154).

[70]Paragraph 112 states, in part, "Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization."

159. If amounts of future cash receipts need to be estimated to apply the provisions of paragraphs 152–154 because future interest receipts are expected to fluctuate—for example, the restructured terms may specify the stated interest rate to be the prime interest rate increased by a specified amount or proportion—estimates of the minimum total future receipts should be based on the interest rate in effect at the time of restructuring. Fluctuations in the effective interest rate after the restructuring from changes in the prime rate or other causes should be accounted for as changes in estimates in the periods the changes occur except that a creditor should recognize a loss and reduce the recorded investment in a restructured receivable if the interest rate decreases to an extent that the minimum total future cash receipts determined using that interest rate fall below the recorded investment in the receivable at that time.

160. Legal fees and other direct costs incurred by a creditor to effect a troubled debt restructuring should be included in expense when incurred.

161. A receivable from the sale of assets previously obtained in a troubled debt restructuring should be accounted for according to paragraphs 173–187 regardless of whether the assets were obtained in satisfaction (full or partial) of a receivable to which those paragraphs do not apply. A difference, if any, between the amount of the new receivable and the carrying amount of the assets sold is a gain or loss on sale of assets.

Disclosure by Creditors

162. A creditor should disclose, in the notes to financial statements, the following information about troubled debt restructurings as of the date of each statement of net assets presented:

a. For outstanding receivables whose terms have been modified in troubled debt restructurings, by major category:[71] (1) the aggregate recorded investment; (2) the gross interest revenue that would have been recorded in the period then ended if those receivables had been current in accordance with their original terms and had been outstanding throughout the period or since origination, if held for part of the period; and (3) the amount of interest revenue on those receivables that was included in changes in net assets for the period. A receivable whose terms have been modified need not be included in that disclosure if, subsequent to restructuring, its effective interest rate (paragraph 152) has been equal to or greater than the rate that the creditor was willing to accept for a new receivable with comparable risk.
b. The amount of commitments, if any, to lend additional resources to debtors owing receivables whose terms have been modified in troubled debt restructurings.

163. A creditor may disclose the information prescribed by paragraph 162, by major category, for the aggregate of outstanding reduced-earning and nonearning receivables rather than separately for outstanding receivables whose terms have been modified in troubled debt restructurings.

Substitution or Addition of Debtors

164. A troubled debt restructuring may involve substituting debt of a private-sector entity, individual, or another government unit for that of the troubled debtor or adding another debtor (for example, as a joint debtor). That kind of restructuring should be accounted for according to its substance. For example, a restructuring in which the substitute or additional debtor and original debtor are related after the restructuring by an agency, trust, or other relationship that in substance earmarks certain of the original debtor's resources for the creditor although payments to the creditor may be made by the substitute or additional debtor is an example of one that should be accounted for by the creditor according to the provisions of paragraphs 152–154. In contrast, a restructuring in which the substitute or additional debtor and the original debtor do not have any of the

[71]The appropriate major categories depend on various factors, including the industry or industries in which the creditor is involved.

relationships described above after the restructuring should be accounted for by the creditor according to the provisions of paragraphs 150 and 155.

Foreign Currency Transactions

165. Paragraphs 165–172 establish standards of accounting and financial reporting for **foreign currency transactions.**[72]

166. Foreign currency transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid. A change in exchange rates between the U.S. dollar and the currency in which a transaction is denominated increases or decreases the expected amount of U.S. dollar cash flows upon settlement of the transaction. That increase or decrease in expected U.S. dollar cash flows is a foreign currency **transaction gain or loss** that generally should be recognized in the period in which the exchange rate changes. Likewise, a transaction gain or loss (measured from the **transaction date** or the most recent intervening financial statement date, whichever is later) realized upon settlement of a foreign currency transaction generally should be recognized in the period in which the transaction is settled. The exceptions to this requirement for recognition of transaction gains and losses pertain to transactions that are designated as, and effective as, hedges of net investments and foreign currency commitments in conformity with Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*.

[72]Terms defined in the glossary (see paragraph 172) are shown in **boldface type** the first time they appear in paragraphs 165–171.

167. For other than forward exchange contracts that meet the definition of a derivative,[73] the following applies to all foreign currency transactions of a government:

a. At the date the transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction should be measured and recorded in U.S. dollars by use of the exchange rate in effect at that date (paragraphs 168 and 169).
b. At each financial statement date, recorded balances that are denominated in a currency other than the U.S. dollar should be adjusted to reflect the current exchange rate.

Exchange Rates

168. The exchange rate is the ratio of a unit of one currency to the amount of another currency for which that unit can be exchanged at a particular time. If exchangeability between two currencies is temporarily lacking at the transaction date or the date of the financial statements, the first subsequent rate at which exchanges could be made should be used for purposes of applying paragraphs 165–172.

169. The exchange rate to be used to translate and record foreign currency transactions is the applicable rate at which a particular transaction could be settled at the transaction date. At subsequent financial statement dates, the current rate is that rate at which the related receivable or payable could be settled at that date.

Disclosure

170. The aggregate transaction gain or loss recognized in the period should be disclosed in the notes to financial statements.

171. A government's financial statements should not be adjusted for a rate change that occurs after the date of the financial statements. However, disclosure of the rate change

[73]Forward exchange contracts that meet the definition of derivative instruments in Statement 53 should be reported in accordance with that Statement.

and its effects on unsettled balances pertaining to foreign currency transactions may be necessary.

Glossary

172. This paragraph contains definitions of certain terms *as they are used in paragraphs 165–171;* the terms may have different meanings in other contexts.

Foreign Currency Transactions

Transactions whose terms are denominated in a currency other than the U.S. dollar. Foreign currency transactions arise when a government (a) buys or sells on credit goods or services whose prices are denominated in a foreign currency, (b) borrows or lends resources and the amounts payable or receivable are denominated in a foreign currency, or (c) for other reasons, acquires or disposes of assets, or incurs or settles liabilities denominated in a foreign currency.

Transaction Date

The date at which a transaction (for example, a sale or purchase of merchandise or services) is recorded in accounting records in conformity with GAAP. A long-term commitment may have more than one transaction date (for example, the due date of each progress payment under a construction contract is an anticipated transaction date).

Transaction Gain or Loss

Transaction gains or losses result from a change in exchange rates between the U.S. dollar and the currency in which a foreign currency transaction is denominated. They represent an increase or decrease in (a) the actual U.S. dollar cash flows realized upon settlement of foreign currency transactions and (b) the expected U.S. dollar cash flows on unsettled foreign currency transactions.

Interest Costs—Imputation

173. The principles discussed in paragraphs 173–187 are applicable to receivables and payables that represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest, except as stated in paragraphs 174 and 175. Such receivables and payables are collectively referred to in paragraphs 173–187 as "notes." Examples are secured and unsecured notes, bonds, mortgage notes, equipment obligations, and some accounts receivable and payable.

174. Paragraph 187, covering financial statement presentation of discount and premium, is applicable in all circumstances. However, paragraphs 173–186 do not apply to the following:

a. Receivables and payables arising from transactions with customers or suppliers in the normal course of operations, which are due in customary trade terms not exceeding approximately one year
b. Amounts that do not require repayment in the future but, rather, will be applied to the purchase price of the property, goods, or service involved (for example, deposits or progress payments on construction contracts and advance payments for acquisition of resources and raw materials)
c. Amounts intended to provide security for one party to an agreement (for example, security deposits and retainages on contracts)
d. The customary cash lending activities and demand or savings deposit activities of business-type activities whose primary purpose is lending money
e. Transactions in which interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (for example, industrial revenue bonds, tax-exempt obligations, and government-guaranteed obligations)
f. Low-interest loans issued by governments to carry out governmental objectives
g. Transactions between a primary government and its component units or between component units of the same reporting entity.

175. Paragraphs 173–187 also do not apply to the application of the present value measurement (valuation) technique to estimates of contractual or other obligations

assumed in connection with sales of property, goods, or services, for example, a warranty for product performance.

Note Exchanged for Cash

176. The total amount of interest during the entire period of a cash loan generally should be measured by the difference between the actual amount of cash received by the borrower and the total amount agreed to be repaid to the lender. Frequently, the stated or coupon interest rate may differ from the prevailing rate applicable to similar notes, and the proceeds of the note may differ from its face amount. Such differences are related to differences between the present value upon issuance and the face amount of the note. The difference, if any, between the face amount and the proceeds upon issuance should be shown as either a discount or premium, which should be amortized over the life of the note.[74]

177. When a note is received or issued solely for cash and no other right or privilege is exchanged, the present value at issuance should be measured by the cash proceeds exchanged. If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges should be given accounting recognition as described in paragraph 178.

Unstated Rights or Privileges

178. A note issued solely for cash equal to its face amount is presumed to earn the stated rate of interest. However, in some cases, the parties also may exchange unstated (or

[74]For example, if a bond is issued at a discount or premium, that discount or premium should be recognized in accounting for the original issue. The coupon or stated interest rate should not be regarded as the effective yield or market rate. Moreover, if a long-term non-interest-bearing note or bond is issued, its net proceeds are less than face amount, and an effective interest rate should be based on its market value upon issuance. The coupon or stated rate of interest and the face amount of a note or bond may not be the appropriate bases for valuation. The presumption that market values provide the evidence for valuation should be overcome before using coupon or stated rates and face or maturity amounts as the bases for accounting.

stated) rights or privileges, which should be given accounting recognition by establishing a note discount or premium account. In such instances, the effective interest rate differs from the stated rate.

Note Exchanged for Property, Goods, or Services

179. A note exchanged for property, goods, or services represents two elements, which may or may not be stipulated in the note: (a) the principal amount, equivalent to the bargained exchange price of the property, goods, or services as established between the supplier and the purchaser and (b) an interest factor to compensate the supplier over the life of the note for the use of resources they would have received in a cash transaction at the time of the exchange. Notes exchanged for property, goods, or services should be valued and accounted for at the present value of the consideration exchanged between the contracting parties at the date of the transaction in a manner similar to that followed for a cash transaction. The difference between the face amount and the present value upon issuance should be shown as either discount or premium and amortized over the life of the note.

180. When a note is exchanged for property, goods, or services in a bargained transaction entered into at arm's length, the rate of interest stipulated by the parties to the transaction represents fair and adequate compensation to the supplier for the use of the related resources unless (a) interest is not stated, (b) the stated interest rate is unreasonable (paragraphs 183 and 184), or (c) the stated face amount of the note is significantly different from the current cash sales price for the same or similar items or from the market value of the note at the date of the transaction. In these circumstances, the note, the sales price, and the cost of the property, goods, or services exchanged for the note should be

recorded at the fair value of the property, goods, or services or at an amount that reasonably approximates the market value of the note, whichever is the more clearly determinable amount. That amount may or may not be the same as its face amount, and any resulting discount or premium should be accounted for as an element of interest over the life of the note (paragraph 185). In the absence of established exchange prices for the related property, goods, or services or evidence of the market value of the note (paragraph 181), the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable should be determined by discounting all future payments on the notes using an imputed rate of interest as described in paragraphs 183 and 184. This determination should be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates should be ignored.

Determining Present Value

181. If determinable, the established exchange price (which, presumably, is the same as the price for a cash sale) of property, goods, or services acquired or sold in consideration for a note should be used to establish the present value of the note. When notes are traded in an open market, the market rate of interest and market value of the notes should provide the evidence of the present value.

182. If an established exchange price is not determinable and if the note has no ready market, to estimate the present value of a note, an applicable interest rate should be approximated, which may differ from the stated or coupon rate. This process of approximation frequently is called imputation, and the resulting rate is often called an imputed interest rate.

Determining an Appropriate Interest Rate

183. The variety of transactions encountered precludes any specific interest rate from being applicable in all circumstances. However, the following general guide should be considered. The choice of a rate may be affected by the credit standing of the issuer, restrictive covenants, collateral, payment, and other terms pertaining to the debt. The prevailing rates for similar instruments of issuers with similar credit ratings will normally help determine the appropriate interest rate for determining the present value of a specific note at its date of issuance. In any event, the rate used for valuation purposes should be the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction. The objective should be to approximate the rate that would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase, which bears the prevailing rate of interest to maturity.

184. The selection of a rate may be affected by many considerations. For instance, where applicable, the choice of a rate may be influenced by (a) an approximation of the prevailing market rates for the source of credit that would provide a market for sale or assignment of the note; (b) the prime or higher rate for notes that are discounted with banks, giving due weight to the credit standing of the maker; (c) published market rates for similar quality bonds; and (d) the current rate charged by investors for first or second mortgage loans on similar property.

Amortization of Discount and Premium

185. With respect to a note, which, by the provisions of paragraphs 173–187 requires the imputation of interest, the difference between the present value and the face amount should be treated as discount or premium and amortized as interest expense or revenue over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the interest method.

186. The objective of the interest method is to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period. The difference between the periodic interest cost so calculated and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization.

Financial Statement Presentation of Discount and Premium

187. The discount or premium resulting from the determination of present value in cash or noncash transactions is not an asset or liability separable from the note that gives rise to it. Therefore, the discount or premium should be reported in the statement of net assets[75] as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit. The description of the note should include the effective interest rate; the face amount also should be disclosed in the notes to the financial statements. Amortization of discount or premium should be reported as

[75]For purposes of applying paragraphs 173–187, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

interest in the flows statement.[76] Issue costs should be reported in the statement of net assets as deferred charges.

Inventory

188. Paragraphs 188–201 set forth the general principles applicable to the pricing of inventories of business-type activities.

Definition of Inventory

189. The term *inventory* is used in paragraphs 188–201 to designate the aggregate of those items of tangible personal property that (a) are held for sale in the ordinary course of operations, (b) are in process of production for such sale, or (c) are to be currently consumed in the production of goods or services to be available for sale. Operating materials and supplies (for example, property held for installation or use in the provision of services) of certain business-type activities usually are treated as inventory.

190. This definition of inventory excludes long-term assets subject to depreciation accounting, or goods that, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be ultimately absorbed in the production process does not require separate classification.

[76]For purposes of applying paragraphs 173–187, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

Accounting for Inventories

Cost Basis

191. Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as average cost, FIFO, and LIFO); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic cost.

192. The cost to be charged to operations from a sale may not be the identified cost of the specific item which is sold, especially in cases in which similar goods are purchased at different times and at different prices. Several assumptions with respect to the flow of cost factors provide practical bases for the measurement of periodic cost.[77] In some situations, a business-type activity may use a reversed mark-up procedure of inventory pricing, such as the retail inventory method. The operations of a business-type activity may apply one of the acceptable methods of determining cost to one portion of the inventory or components thereof and another of the acceptable methods to other portions of the inventory.

193. General and administrative expenses should be included as period charges, except for the portion of such expenses that may be clearly related to production and thus constitute a part of inventory costs (product charges). Selling expenses constitute no part of inventory costs.

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[77]Standard costs are acceptable if adjusted at reasonable intervals to reflect current conditions so that at the date of the financial statements, standard costs reasonably approximate costs computed under one of the recognized bases. In such cases, descriptive language should be used that would express this relationship as, for instance, “approximate costs determined on the FIFO basis,” or “standard costs, approximating average costs.”

Lower of Cost or Market Basis

194. A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. A loss should be recognized and accounted for in the current period whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. Such losses should be measured by applying the method of pricing inventories at *cost or market, whichever is lower.*

195. As used in the phrase *lower of cost or market,*[78] the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:

a. Market should not exceed the net realizable value (that is, estimated selling price in the ordinary course of operations less reasonably estimable costs of completion and disposal)
b. Market should not be less than net realizable value reduced by an allowance for a normally expected gain.

196. Depending on the character and composition of the inventory, the method of cost or market, whichever is lower may be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category). The method should be that which most clearly reflects periodic costs.

197. Generally, the lower of cost or market method should be applied separately to each item of the inventory. However, if there is only one end-product category, the method may be applied to the inventory in its entirety. Similarly, if more than one major product or operational category exists, the application of the cost or market, whichever is lower

[78]The terms *cost or market, whichever is lower* and *lower of cost or market* are used synonymously in general practice and in paragraphs 188–201.

method to the total of the items included in such major categories may result in the most useful determination of periodic costs.

198. To the extent, however, that the stocks of particular materials or components are excessive in relation to others, the more widely recognized procedure of applying the lower of cost or market to the individual items constituting the excess should be followed.

Stating Inventories above Cost

199. Inventories should not be stated above cost unless stating at net realizable value is justifiable by the inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Stating inventories at quoted market price is not uncommon for inventories representing agricultural, mineral, and other products. If such inventories are stated at sales prices, they should be reduced by outlays to be incurred in disposal. If goods are stated above cost, this fact should be disclosed.

Net Losses on Firm Purchase Commitments

200. The recognition in a current period of losses arising from the decline in the utility of inventory is equally applicable to similar losses that are expected to arise from firm, uncancelable, and unhedged commitments for the future purchase of inventory items. The net loss on such commitments should be measured in the same way as are inventory losses and should be separately recognized in the flows statement.[79] The utility of such commitments is not impaired, and, therefore, there is no loss when the amounts to be realized from the disposition of the future inventory items are adequately protected by

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[79]For purposes of applying paragraphs 188–201, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

firm sales contracts or when there are other circumstances that reasonably assure continuing sales without price decline.

Disclosure

201. For the various classifications of inventory items, the basis upon which their amounts are stated and, where practicable, indication of the method of determining the cost, for example, average cost, FIFO, and LIFO, should be disclosed in the notes to the financial statements.

Investments in Common Stock

202. Paragraphs 202–210 establish accounting and financial reporting standards for investments in common stock. Those paragraphs do not apply to investments in common stock held by (a) governmental external investment pools, (b) defined benefit pension or other postemployment benefit plans, or (c) Internal Revenue Code Section 457 deferred compensation plans. Paragraphs 202–210 also do not apply to investments in joint ventures or component units as provided in Statement 14, as amended. Paragraphs 202–210 also do not apply to investments in common stock other than those described in those paragraphs.

203. A summary of the two methods of accounting for the investments in common stock discussed in paragraphs 202–210 are as follows:

a. *The cost method.* An investor records an investment in the stock of an investee at cost and recognizes as revenue dividends received that are distributed from net accumulated earnings of the investee since the date of acquisition by the investor. The net accumulated earnings of an investee subsequent to the date of investment are recognized by the investor only to the extent distributed by the investee as dividends. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and should accordingly be recognized.

b. *The equity method.* An investor initially records an investment in the stock of an investee at cost and adjusts the carrying amount of the investment to recognize the investor's share of the earnings or losses of the investee after the date of acquisition. The amount of the adjustment is included in the determination of the changes in net assets by the investor. Such amount reflects adjustments including adjustments to eliminate inter-entity gains and losses, and to amortize, if appropriate, any difference between investor cost and underlying equity in net assets of the investee at the date of investment. The investment of an investor is also adjusted to reflect the investor's share of changes in the investee's capital. Dividends received from an investee reduce the carrying amount of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and that should be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.

204. Investments in common stock that do not have readily determinable fair values and that do not meet the criteria in paragraphs 205–208 for applying the equity method should be accounted for using the cost method. Statement 31 should be applied to investments in common stock that do not meet the criteria for applying the equity method and that have readily determinable fair values as described in that Statement.

Criteria for Applying the Equity Method

205. The equity method of accounting for an investment in common stock should be followed by a government whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the government holds 50 percent or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the governing body, participation in policy making processes, significant intra-entity transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by a government in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence

by the government. Determining the ability of a government to exercise such influence is not always clear, and applying judgment is necessary to assess the status of each investment. An investment (direct or indirect) of 20 percent or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary, a government has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20 percent of the voting stock of an investee should lead to a presumption that a government does not have the ability to exercise significant influence unless that ability can be demonstrated.[80]

206. A government's *voting-stock interest* in an investee should be based on those currently outstanding securities whose holders have present voting privileges. Potential voting privileges that may become available to holders of securities of an investee should be disregarded.

207. Evidence that a government owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the government has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary.

[80]The equity method should not be applied to an investment if the government's ability to exercise influence over the investee is likely to be temporary or if it does not rest with the government (as, for instance, if the investee is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the government's ability to exercise influence over the investee).

208. Examples of indications that a government may be unable to exercise significant influence over the operating and financial policies of an investee include:

a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the government's ability to exercise significant influence.
b. The government and investee sign an agreement under which the government surrenders significant rights as a shareholder.
c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the government.
d. The government needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the government wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.
e. The government tries and fails to obtain representation on the investee's board of directors.

This list is illustrative and is not all-inclusive. None of the individual circumstances is necessarily conclusive that the government is unable to exercise significant influence over the investee's operating and financial policies. However, if any of these or similar circumstances exists, a government with ownership of 20 percent or more should evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the government has the ability to exercise significant influence over the investee's operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

Applying the Equity Method

209. The procedures set forth below should be followed by a government in applying the equity method of accounting to investments in common stock that qualify for the equity method:

a. Intra-entity profits and losses should be eliminated until realized by the government or investee.

b. A difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as goodwill and amortized in a systematic and rational manner.

c. The investment(s) in common stock should be shown in the statement of net assets[81] of a government as a single amount, and the government's share of earnings or losses of an investee(s) should be shown in the flows statement[82] as a single amount except for the extraordinary items as specified in (d) below.

d. The government's share of special and extraordinary items and its share of prior-period adjustments reported in the financial statements of the investee should be classified in conformity with Statement 34, paragraph 55, and paragraphs 45–50 and 58–62 of this Statement, respectively.

e. Sales of stock of an investee by a government should be accounted for as gains or losses equal to the difference at the time of sale between selling price and carrying amount of the stock sold.

f. If financial statements of an investee are not sufficiently timely for an investor to apply the equity method currently, the government should record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting should be consistent from period to period.

g. A loss in value of an investment that is other than a temporary decline should be recognized the same as a loss in value of other long-term assets. Evidence of a loss in value might include, but would not necessarily be limited to, absence of an ability to recover the carrying amount of the investment or inability of the investee to sustain an earnings capacity that would justify the carrying amount of the investment. A current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors that should be evaluated.

h. A government's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. The government should discontinue applying the equity method when the investment (and net advances) is reduced to zero and should not recognize additional losses unless the government has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee.[83] If the investee subsequently reports net income, the government should resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended.

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[81]For purposes of applying paragraphs 202–210, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

[82]For purposes of applying paragraphs 202–210, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

[83]A government should, however, provide for additional losses when the imminent return to profitable operations by an investee appears to be assured. For example, a nonrecurring loss of an isolated nature may reduce an investment below zero even though the underlying profitable operating pattern of an investee is unimpaired.

i. When an investee has outstanding cumulative preferred stock, a government should compute its share of earnings (losses) after deducting the investee's preferred dividends, whether or not such dividends are declared.

j. An investment in voting stock of an investee company may fall below the level of ownership described in paragraph 205 from sale of a portion of an investment by the government, sale of additional stock by an investee, or other transaction, and the government may thereby lose the ability to influence policy, as described in that paragraph. A government should discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. The earnings or losses that relate to the stock retained by the government and that previously were accrued should remain as a part of the carrying amount of the investment. The investment account should not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the government in subsequent periods that exceed its share of earnings for such periods should reduce the carrying amount of the investment (see paragraph 203a).

k. An investment in common stock of an investee that previously was accounted for by other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 205 (that is, acquisition of additional voting stock by the government, acquisition or retirement of voting stock by the investee, or other transactions). When an investment qualifies for use of the equity method, the government should adopt the equity method of accounting.

l. The carrying amount of an investment in common stock of an investee that qualifies for the equity method of accounting as described in subparagraph (k) may differ from the underlying equity in net assets of the investee. The difference should be accounted for as goodwill and amortized in a systematic and rational manner.

Disclosures

210. The significance of an investment to the government's financial position and results of operations should be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. If the government has more than one investment in common stock, disclosures wholly or partly on a combined basis may be appropriate. The following disclosures generally are applicable to the equity method of accounting for investments in common stock:

a. Financial statements of a government should disclose in the notes to financial statements: (1) the name of each investee and percentage of ownership of common stock, (2) the accounting policies of the government with respect to investments in common stock,[84] and (3) the difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference.

b. For those investments in common stock for which a quoted market price is available, the aggregate value of each identified investment based on the quoted market price should be disclosed.

c. When investments in common stock accounted for under the equity method are, in the aggregate, significant in relation to the financial position or results of operations of a government, it may be necessary for summarized information about assets, liabilities, and results of operations of the investees to be presented in the notes to the financial statements either individually or in groups, as appropriate.

d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants, and other contingent issuances of an investee may have a significant effect on a government's share of reported earnings or losses. Accordingly, significant effects of possible conversions, exercises, or contingent issuances should be disclosed in notes to the financial statements of a government.

Leases

211. Paragraphs 211–271 establish standards of financial accounting and reporting for leases by lessees and lessors. For purposes of applying those paragraphs, a lease is defined as an agreement conveying the right to use capital assets (land and/or depreciable assets) usually for a stated period of time. It includes agreements that, although not nominally identified as leases, meet the above definition, such as a "heat supply contract" for nuclear fuel.[85] This definition does not include agreements that are contracts for services that do not transfer the right to use capital assets from one contracting party to the other. On the other hand, agreements that do transfer the right to use capital assets meet the definition of a lease for purposes of applying paragraphs 211–271 even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance

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[84]Disclosure should include (a) the names of any significant investee corporations in which the government holds 20 percent or more of the voting stock, but the common stock is not accounted for by the equity method, together with the reasons why the equity method is not considered appropriate and (b) the names of any significant investee corporations in which the government holds less than 20 percent of the voting stock and the common stock is accounted for by the equity method, together with the reasons why the equity method is considered appropriate.

[85]Heat supply (also called "burn-up") contracts usually provide for payments by the user-lessee based upon nuclear fuel utilization in the period plus a charge for the unrecovered cost base. The residual value usually accrues to the lessee, and the lessor furnishes no service other than the financing.

of such assets. Paragraphs 211–271 do not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor do those paragraphs apply to licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights.

Classification of Leases

212. For purposes of applying the accounting and financial reporting standards of paragraphs 211–271, leases are classified as follows:

a. Classifications from the standpoint of the lessee:
   (1) *Capital leases.* Leases that meet one or more of the criteria in paragraph 213.
   (2) *Operating leases.* All other leases.
b. Classifications from the standpoint of the lessor:
   (1) *Sales-type leases.* Leases that give rise to gain (or loss) (for example, the **fair value of the leased property**[86] at the **inception of the lease** is greater or less than its cost or carrying amount, if different) and that meet one or more of the criteria in paragraph 213 and both of the criteria in paragraph 214, except as indicated in the following sentence. A lease involving real estate should be classified as a sales-type lease only if it meets the criterion in paragraph 213a, in which case the criteria in paragraph 214 do not apply. Leases involving lessors that primarily are engaged in financing operations will not normally be sales-type leases if they qualify under paragraphs 213 and 214 but most often will be direct financing leases, described in paragraph 212b(2), below. If a lessor leases an asset that at the inception of the lease has a fair value that is greater or less than its cost or carrying amount, if different, such a transaction is a sales-type lease, assuming the criteria referred to are met. A renewal or extension[87] of an existing sales-type or direct financing lease that otherwise qualifies as a sales-type lease should be classified as a direct financing lease unless the renewal or extension occurs at or near the end of the original term[88] specified in the existing lease, in which case it should be classified as a sales-type lease. (See paragraph 224f.)
   (2) *Direct financing leases.* Leases other than leveraged leases that do not give rise to a gain (or loss) to the lessor but that meet one or more of the criteria in paragraph 213 and both of the criteria in paragraph 214. In such leases, the cost or carrying amount, if different, and fair value of the leased property are

[86]Terms defined in the glossary (see paragraph 271) are shown in **boldface type** the first time they appear in paragraphs 212–271.

[87]As used here, *renewal* or *extension* includes a new lease under which the lessee continues to use the same property.

[88]A renewal or extension that occurs in the last few months of an existing lease is considered to have occurred at or near the end of the existing lease term.

the same at the inception of the lease. An exception arises when an existing sales-type or direct financing lease is renewed or extended[89] during the term of the existing lease. In such cases, the fact that the carrying amount of the property at the end of the original **lease term** is different from its fair value at that date should not preclude the classification of the renewal or extension as a direct financing lease. (See paragraph 224f.)

(3) *Leveraged leases.* Leases that meet the criteria of paragraph 265.

(4) *Operating leases.* All other leases, including leases that involve real estate and give rise to a gain (or loss) to the lessor but do not meet the criterion in paragraph 213a.

Criteria for Classifying Leases (Other Than Leveraged Leases)

213. If at its inception a lease meets one or more of the following four criteria, the lease should be classified as a capital lease by the lessee. Otherwise, it should be classified as an operating lease.

a. The lease transfers ownership of the property to the lessee by the end of the lease term.[90]

b. The lease contains a **bargain purchase option.**

c. The lease term is equal to 75 percent or more of the **estimated economic life of the leased property.** However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion should not be used for purposes of classifying the lease.

d. The present value at the beginning of the lease term of the **minimum lease payments,** excluding that portion of the payments representing executory costs such as insurance and maintenance to be paid by the lessor, including any gain thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by and expected to be realized by the lessor. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion should not be used for purposes of classifying the lease. A lessor should compute the present value of the minimum lease payments using the **interest rate implicit in the lease.** A lessee should compute the present value of the minimum lease payments using its incremental borrowing rate, unless (1) it is practicable to obtain the implicit rate computed by the lessor and (2) the implicit rate computed by the lessor is less than the **lessee's incremental borrowing rate.** If both of those conditions are met, the lessee should use the implicit rate.

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[89]See footnote 87.

[90]This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title.

214. From the standpoint of the lessor, a lease involving real estate should be classified as a sales-type lease only if it meets the criterion in paragraph 213a as appropriate under paragraph 212b(1). Otherwise, if the lease at inception meets any one of the four criteria in paragraph 213 and in addition meets both of the following criteria, it should be classified as a sales-type lease, a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 212b. If the lease does not meet any of the criteria of paragraph 213 or both of the following criteria, the lease should be classified as an operating lease.

a. Collectibility of the minimum lease payments is reasonably predictable. A lessor should not be precluded from classifying a lease as a sales-type lease, a direct financing lease, or a leveraged lease simply because the receivable is subject to an estimate of uncollectibility based on experience with groups of similar receivables.
b. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.[91] Important uncertainties might include commitments by the lessor to guarantee performance of the leased property in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the leased property. However, the necessity of estimating executory costs such as insurance and maintenance to be paid by the lessor (see paragraphs 224a and 226a) should not by itself constitute an important uncertainty as referred to herein.

215. If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 213 and 214 had the changed terms been in effect at the inception of the lease, the revised agreement should be considered a new agreement over its term, and the criteria in paragraphs 213 and 214 should be applied for purposes of classifying the new lease. Likewise, except when a guarantee or **penalty** is rendered inoperative as described in paragraphs 218 and 224e, any

[91]If the property covered by the lease is yet to be constructed or has not been acquired by the lessor at the inception of the lease, the classification criterion of paragraph 214b should be applied at the date that construction of the property is completed or the property is acquired by the lessor.

action that extends the lease beyond the expiration of the existing lease term, such as the exercise of a lease renewal option other than those already included in the lease term, should be considered a new agreement, which should be classified according to the provisions of paragraphs 212–214. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, should not give rise to a new classification of a lease for accounting purposes.

Accounting and Reporting by Lessees

Capital Leases

216. The lessee should record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance and maintenance to be paid by the lessor, together with any gain thereon. However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation should be the fair value.[92] If the portion of the minimum lease payments representing executory costs, including gain thereon, is not determinable from the provisions of the lease, an estimate of the amount should be made. The discount rate to be used in determining present value of the minimum lease payments should be that prescribed for the lessee in paragraph 213d.

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[92] If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred should be considered in the determination of “fair value of the leased property at the inception of the lease” for purposes of applying this paragraph.

217. Except as provided in paragraphs 233 and 234 with respect to leases involving land, the asset recorded under a capital lease should be amortized as follows:

a. If the lease meets the criterion of either paragraph 213a or 213b, the asset should be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets.
b. If the lease does not meet either criterion 213a or 213b, the asset should be amortized in a manner consistent with the lessee's normal depreciation policy except that the period of amortization should be the lease term. The asset should be amortized to its expected value, if any, to the lessee at the end of the lease term. As an example, if the lessee guarantees a residual value at the end of the lease term and has no interest in any excess which might be realized, the expected value of the leased property to the lessee is the amount that can be realized from it up to the amount of the guarantee.

218. During the lease term, each minimum lease payment should be allocated between a reduction of the obligation and interest expense/expenditure so as to produce a constant periodic rate of interest on the remaining balance of the obligation.[93] In leases containing a residual guarantee by the lessee or a penalty for failure to renew the lease at the end of the lease term,[94] following the above method of amortization will result in a balance of the obligation at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension of the lease term or a new lease under which the lessee continues to lease the same property renders the guarantee or penalty inoperative, the asset and the obligation under the lease should be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised agreement should be computed using the rate of interest used to record the lease initially.

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[93]This is the "interest" method described in paragraphs 185 and 186.

[94]Residual guarantees and termination penalties that serve to extend the lease term are excluded from minimum lease payments and are thus distinguished from those guarantees and penalties referred to in this paragraph.

In accordance with paragraph 215, other renewals and extensions of the lease term should be considered new agreements, which should be accounted for in accordance with the provisions of paragraph 219. **Contingent rentals** should be included in the flows statement[95] when accruable.

219. Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a capital lease (see paragraph 221), a change in the provisions of a lease, a renewal or extension[96] of an existing lease, and a termination of a lease prior to the expiration of the lease term should be accounted for as follows:

a. If the provisions of the lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (1) does not give rise to a new agreement under the provisions of paragraph 215 or (2) does give rise to a new agreement but such agreement is also classified as a capital lease, the present balances of the asset and the obligation should be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised or new agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised or new agreement should be computed using the rate of interest used to record the lease initially. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the asset and obligation under the lease should be removed, a gain or loss should be recognized for the difference, and the new lease agreement should thereafter be accounted for as any other operating lease.
b. Except when a guarantee or penalty is rendered inoperative as described in paragraph 218, a renewal or an extension[97] of an existing lease should be accounted for as follows:
    (1) If the renewal or extension is classified as a capital lease, it should be accounted for as described in subparagraph (a) above.

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[95]For purposes of applying paragraphs 211–271, the term *flows statement* includes the government-wide statement of activities, the governmental fund statement of revenues, expenditures, and changes in fund balances, and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

[96]See footnote 87.

[97]See footnote 87.

(2) If the renewal or extension is classified as an operating lease, the existing lease should continue to be accounted for as a capital lease to the end of its original term, and the renewal or extension should be accounted for as any other operating lease.

c. A termination of a capital lease should be accounted for by removing the asset and obligation, with a gain or loss recognized for the difference.

220. The termination of a capital lease that results from the purchase of a leased asset by the lessee is not the type of transaction contemplated by paragraph 219c but rather is an integral part of the purchase of the leased asset. The purchase by the lessee of property under a capital lease should be accounted for like a renewal or extension of a capital lease that, in turn, is classified as a capital lease. That is, any difference between the purchase price and the carrying amount of the lease obligation should be recorded as an adjustment of the carrying amount of the asset.

221. If prior to the expiration of the lease term a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a capital lease by the lessee, the change should be accounted for as follows:

a. If a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding that results in a defeasance of debt, the lessee should adjust the lease obligation to the present value of the future minimum lease payments under the revised lease using the effective interest rate applicable to the revised agreement and should defer the resulting gain or loss and amortize it as a component of interest expense/expenditure in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter.

b. If the provisions of a lease are changed in connection with an advance refunding by the lessor of tax-exempt debt that results in a defeasance of debt at the date of the advance refunding and the lessee is obligated to reimburse the lessor for any costs related to the debt to be refunded that have been or will be incurred, such as unamortized discount or issue costs or a call premium, the lessee should accrue those costs by the "interest" method[98] over the remaining life of the old debt or the life of the new debt, whichever is shorter.

Operating Leases

222. Normally, rental on an operating lease should be charged to expense/expenditure over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense/expenditure nevertheless should be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis should be used.

Disclosures

223. The following information with respect to leases should be disclosed in the notes to the lessee's financial statements.

a. For capital leases:
   (1) The gross amount of assets recorded under capital leases as of the date of each set of financial statements presented by major classes according to nature or function. This information may be combined with the comparable information for owned assets.
   (2) The total of minimum sublease rentals to be received in the future under noncancelable subleases as of the date of the latest financial statements presented.
   (3) Total contingent rentals actually incurred for each period for which a flows statement is presented.
   (4) Assets recorded under capital leases and the accumulated amortization thereon. Unless the expense resulting from amortization of assets recorded under capital leases is included with depreciation expense and the fact that it is so included is disclosed, the amortization expense should be disclosed in the notes to the financial statements.
b. For operating leases having initial or remaining noncancelable lease terms in excess of one year, the total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest financial statements presented.
c. For all operating leases, rental expense/expenditure for each period for which a flows statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.

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[98]See paragraph 218 and footnote 93 thereto.

d. A general description of the lessee's leasing arrangements including, but not limited to, the following:
   (1) The basis on which contingent rental payments are determined
   (2) The existence and terms of renewal or purchase options and escalation clauses
   (3) Restrictions imposed by lease agreements, such as those concerning additional debt and further leasing.

Accounting and Reporting by Lessors

Sales-Type Leases

224. Sales-type leases should be accounted for by the lessor as follows:

a. The minimum lease payments (net of amounts, if any, included therein with respect to executory costs such as insurance and maintenance to be paid by the lessor, together with any gain thereon) plus the **unguaranteed residual value** accruing to the benefit of the lessor should be recorded as the gross investment in the lease. The **estimated residual value** used to compute the unguaranteed residual value accruing to the benefit of the lessor generally should not exceed the amount estimated at the inception of the lease.[99] However, if the sales-type lease involves real estate, the lessor should account for the transaction under the provisions of paragraphs 282–349 in the same manner as a seller of the same property.
b. The difference between the gross investment in the lease in (a) above and the sum of the present values of the two components of the gross investment should be recorded as a liability. The discount rate to be used in determining the present values should be the interest rate implicit in the lease. The net investment in the lease should consist of the gross investment less the related liability. The liability should be recognized as revenue over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.[100] The net investment in the lease should be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified statement of net assets. Contingent rentals should be included in the flows statement when accruable.
c. The present value of the minimum lease payments (net of executory costs, including any gain thereon), computed at the interest rate implicit in the lease, should be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any **initial direct costs,** less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, should be recognized in the same period.
d. The estimated residual value should be reviewed at least annually. If the review results in a lower estimate than had been previously established, a determination

[99]If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred should be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of applying this paragraph.

[100]See footnote 93.

should be made as to whether the decline in estimated residual value is other than temporary. If the decline in estimated residual value is judged to be other than temporary, the accounting for the transaction should be revised using the changed estimate. The resulting reduction in the net investment should be recognized as a loss in the period in which the estimate is changed. An upward adjustment of the estimated residual value should not be made.

e. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,[101] following the method of amortization described in (b) above will result in a balance of minimum lease payments receivable at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension[102] of the lease term renders the guarantee or penalty inoperative, the existing balances of the minimum lease payments receivable and the estimated residual value should be adjusted for the changes resulting from the revised agreement (subject to the limitation on the residual value imposed by subparagraph (d) above), and the net adjustment should be charged or credited to a liability.

f. Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a direct financing lease (see paragraph 225), a change in the provisions of a lease, a renewal or extension[103] of an existing lease, and a termination of a lease prior to the expiration of the lease term should be accounted for as follows:

(1) If the provisions of a lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (a) does not give rise to a new agreement under the provisions of paragraph 215 or (b) does give rise to a new agreement but such agreement is classified as a direct financing lease, the balance of the minimum lease payments receivable and the estimated residual value, if affected, should be adjusted to reflect the change (subject to the limitation on the residual value imposed by subparagraph (d) above), and the net adjustment should be charged or credited to a liability. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the remaining net investment should be removed from the accounts, the leased asset should be recorded as an asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment should be charged to revenue in the period. The new lease should thereafter be accounted for as any other operating lease.

(2) Except when a guarantee or penalty is rendered inoperative as described in subparagraph (e) above, a renewal or an extension[104] of an existing lease should be accounted for as follows:

[101]See footnote 94.

[102]See footnote 87.

[103]See footnote 87.

[104]See footnote 87.

(a) If the renewal or extension is classified as a direct financing lease, it should be accounted for as described in subparagraph (f)(1) above.

(b) If the renewal or extension is classified as an operating lease, the existing lease should continue to be accounted for as a sales-type lease to the end of its original term, and the renewal or extension should be accounted for as any other operating lease.

(c) If a renewal or extension that occurs at or near the end of the term[105] of the existing lease is classified as a sales-type lease, the renewal or extension should be accounted for as a sales-type lease.

(3) A termination of the lease should be accounted for by removing the net investment from the accounts, recording the leased asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment should be charged to revenue in the period.

225. If prior to the expiration of the lease term a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a direct financing lease by the lessor, the change should be accounted for as follows:

a. If a change in the provisions of a lease results from a refunding of tax-exempt debt, including an advance refunding that results in a defeasance of debt, the lessor should adjust the balance of the minimum lease payments receivable and the estimated residual value (that is, the gross investment in the lease), if affected in accordance with the requirements of paragraphs 226c and 224f(1). The adjustment of the liability should be the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement. The combined adjustment resulting from applying the two preceding sentences should be recognized as a gain or loss over the remaining life of the old debt or the life of the new debt, whichever is shorter.

b. If a change in the provisions of a lease results from an advance refunding that results in a defeasance of debt, the lessor should systematically recognize, as revenue, any reimbursements to be received from the lessee for costs related to the debt to be refunded, such as unamortized discount or issue costs or a call premium, over the remaining life of the old debt or the life of the new debt, whichever is shorter.

Direct Financing Leases

226. Direct financing leases should be accounted for by the lessor as follows:

[105]See footnote 88.

a. The sum of (1) the minimum lease payments (net of amounts, if any, included therein with respect to executory costs, such as insurance and maintenance, to be paid by the lessor, together with any gain thereon) and (2) the unguaranteed residual value accruing to the benefit of the lessor should be recorded as the gross investment in the lease. The estimated residual value used to compute the unguaranteed residual value accruing to the benefit of the lessor should not exceed the amount estimated at the inception of the lease.[106]
b. The difference between the gross investment in the lease in (a) above and the cost or carrying amount, if different, of the leased property should be recorded as a liability. The net investment in the lease should consist of the gross investment plus any unamortized initial direct costs less the related liability. The liability and initial direct costs should be amortized to revenue over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.[107] The net investment in the lease should be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified statement of net assets. Contingent rentals should be included in the determination of the change in net assets as accruable.
c. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,[108] the lessor should follow the accounting procedure described in paragraph 224e. The accounting provisions of paragraph 224f with respect to renewals and extensions not dealt with in paragraph 224e, terminations, and other changes in lease provisions also should be followed with respect to direct financing leases.
d. The estimated residual value should be reviewed at least annually and, if necessary, adjusted in the manner prescribed in paragraph 224d.

Operating Leases

227. Operating leases should be accounted for by the lessor as follows:

a. The leased property should be included with or near capital assets in the statement of net assets. The property should be depreciated following the lessor's normal depreciation policy, and in the statement of net assets, the accumulated depreciation should be deducted from the investment in the leased property.
b. Rent should be reported as revenue over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the revenue should be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis should be used.
c. Initial direct costs should be deferred and allocated over the lease term in proportion to the recognition of rental revenue.

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[106]See footnote 99.

[107]See footnote 93.

[108]See footnote 94.

d. If, at the inception of the lease, the fair value of the property in an operating lease involving real estate that would have been classified as a sales-type lease except that it did not meet the criterion in paragraph 213a is less than its cost or carrying amount, if different, then a loss equal to that difference should be recognized at the inception of the lease.

Participation by Third Parties

228. The sale or assignment of a lease or of property subject to a lease that was accounted for as a sales-type lease or direct financing lease should not negate the original accounting treatment accorded the lease. Any gain or loss on the sale or assignment should be recognized at the time of the transaction except that (a) if the sale or assignment is between related parties, the provisions of paragraphs 239 and 240 should be applied or (b) if the sale or assignment is with recourse, it should be accounted for in accordance with Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.*

229. The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third-party purchaser to another party, should not be treated as a sale if the seller or any party related to the seller retains substantial risks of ownership in the leased property. A seller may by various arrangements assure recovery of the investment by the third-party purchaser in some operating lease transactions and thus retain substantial risks in connection with the property. For example, in the case of default by the lessee or termination of the lease, the arrangements may involve a formal or informal commitment by the seller to (a) acquire the lease or the property, (b) substitute an existing lease, or (c) secure a replacement lessee or a buyer for the property under a remarketing agreement. However, a remarketing agreement by itself should not disqualify accounting for the transaction as a sale if the seller (i) will receive a reasonable fee

commensurate with the effort involved at the time of securing a replacement lessee or buyer for the property and (ii) is not required to give priority to the re-leasing or disposition of the property owned by the third-party purchaser over similar property owned or produced by the seller. (For example, a FIFO remarketing arrangement is considered to be a priority.)

230. If a sale to a third party of property subject to an operating lease or of property that is leased by or intended to be leased by the third-party purchaser to another party is not to be recorded as a sale because of the provisions of paragraph 229 above, the transaction should be accounted for as a borrowing. (Transactions of these types are in effect collateralized borrowings.) The proceeds from the "sale" should be recorded as an obligation on the books of the "seller." Until that obligation has been amortized under the procedure described herein, rental payments made by the lessee(s) under the operating lease or leases should be recorded as revenue by the seller, even if such rentals are paid directly to the third-party purchaser. A portion of each rental should be recorded by the seller as interest expense/expenditure, with the remainder to be recorded as a reduction of the obligation. The interest expense/expenditure should be calculated by application of a rate determined in accordance with the provisions of paragraphs 183 and 184. The leased property should be accounted for as prescribed in paragraph 227a for an operating lease, except that the term over which the asset is depreciated should be limited to the estimated amortization period of the obligation. The sale or assignment by the lessor of lease payments due under an operating lease should be accounted for as a borrowing as described above.

Disclosures

231. When leasing, exclusive of leveraged leasing, is a significant part of the lessor's activities, the following information with respect to leases should be disclosed in the notes to financial statements:

a. For sales-type and direct financing leases:
   (1) The components of the net investment in sales-type and direct financing leases as of the date of each set of financial statements presented:
      (a) Future minimum lease payments to be received, with separate deductions for (i) amounts representing executory costs, including any gain thereon, included in the minimum lease payments and (ii) the accumulated allowance for uncollectible minimum lease payments receivable
      (b) The unguaranteed residual values accruing to the benefit of the lessor
      (c) For direct financing leases only, initial direct costs
      (d) Related liability (see paragraphs 224b and 226b).
   (2) Future minimum lease payments to be received for each of the five succeeding fiscal years as of the date of the latest financial statements presented.
   (3) Total contingent rentals included in the flows statement for each period presented.
b. For operating leases:
   (1) The cost and carrying amount, if different, of property on lease or held for leasing by major classes of property, and the amount of accumulated depreciation in total as of the date of the latest financial statements presented.
   (2) Minimum future rentals on noncancelable leases as of the date of the latest financial statements presented, in the aggregate and for each of the five succeeding fiscal years.
   (3) Total contingent rentals included in the flows statement for each period presented.
c. A general description of the lessor's leasing arrangements.

Leases Involving Real Estate

232. For purposes of applying paragraphs 211–271, leases involving real estate can be divided into four categories: (a) leases involving land only, (b) leases involving land and building(s), (c) leases involving equipment as well as real estate, and (d) leases involving only part of a building.

Leases Involving Land Only

233. If land is the sole item of property leased and the criterion in either paragraph 213a or 213b is met, the lessee should account for the lease as a capital lease, otherwise, as an operating lease. If the lease gives rise to a gain (or loss) and the criterion of paragraph 213a is met, the lessor should classify the lease as a sales-type lease as appropriate under paragraph 212b(1) and account for the transaction under the provisions of paragraphs 282–349 in the same manner as a *seller* of the same property. If the lease does not give rise to a gain (or loss) and the criterion of paragraph 213a and both criteria of paragraph 214 are met, the lessor should account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 212b. If the criterion of paragraph 213b and both criteria of paragraph 214 are met, the lessor should account for the lease as a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 212b. If the lease does not meet the criteria of paragraph 214, the lessor should account for the lease as an operating lease. Criteria 213c and 213d are not applicable to land leases. Because ownership of the land is expected to pass to the lessee if either criterion 213a or 213b is met, the asset recorded under the capital lease normally would not be amortized.

Leases Involving Land and Building(s)

234. Leases involving both land and building(s) should be accounted for as follows:

a. The lease meets either criterion 213a or 213b:

   (1) Lessee's accounting: If either criterion (a) or (b) of paragraph 213 is met, the land and building should be separately capitalized by the lessee. For this purpose, the present value of the minimum lease payments after deducting executory costs, including any gain thereon, should be allocated between the two elements in proportion to their fair values at the inception of the lease.[109]

[109]See footnote 92.

The building should be amortized in accordance with the provisions of paragraph 217a. As stated in paragraph 233, land capitalized under a lease that meets criterion (a) or (b) of paragraph 213 would not normally be amortized.

(2) Lessor's accounting if the lease meets criterion 213a: If the lease gives rise to a gain (or loss), the lessor should classify the lease as a sales-type lease as appropriate under paragraph 212b(1) and account for the lease as a single unit under the provisions of paragraphs 282–349 in the same manner as a *seller* of the same property. If the lease does not give rise to a gain (or loss) and meets both criteria of paragraph 214, the lessor should account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 212b(2) or 212b(3). If the lease does not give rise to a gain (or loss) and does not meet both criteria of paragraph 214, the lessor should account for the lease as an operating lease.

(3) Lessor's accounting if the lease meets criterion 213b: If the lease gives rise to a gain (or loss), the lessor should classify the lease as an operating lease as appropriate under paragraph 212b(4). If the lease does not give rise to a gain (or loss) and meets both criteria of paragraph 214, the lessor should account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 212b(2) or 212b(3). If the lease does not give rise to a gain (or loss) and does not meet both criteria of paragraph 214, the lessor should account for the lease as an operating lease.

b. The lease meets neither criterion 213a nor 213b:

(1) If the fair value of the land is less than 25 percent of the total fair value of the leased property at the inception of the lease, both the lessee and the lessor should consider the land and the building as a single unit for purposes of applying the criteria of paragraphs 213c and 213d. For purposes of applying the criterion of paragraph 213c, the estimated economic life of the building should be considered the estimated economic life of the unit.

(a) Lessee's accounting: If either criterion (c) or (d) of paragraph 213 is met, the lessee should capitalize the land and building as a single unit and amortize it in accordance with the provisions of paragraph 217b; otherwise, the lease should be accounted for as an operating lease.

(b) Lessor's accounting: If either criterion (c) or (d) of paragraph 213 and both criteria of paragraph 214 are met, the lessor should account for the lease as a single unit, a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 212b. If the lease meets neither criterion (c) nor (d) of paragraph 213 or does not meet both criteria of paragraph 214, the lease should be accounted for as an operating lease.

(2) If the fair value of the land is 25 percent or more of the total fair value of the leased property at the inception of the lease, both the lessee and lessor should consider the land and the building separately for purposes of applying the criteria of paragraphs 213c and 213d. The minimum lease payments after deducting executory costs, including any gain thereon, applicable to the land and the building should be separated both by the lessee and the lessor by determining the fair value of the land and applying the lessee's incremental

borrowing rate to it to determine the annual minimum lease payments applicable to the land element; the remaining minimum lease payments should be attributed to the building element.

(a) Lessee's accounting: If the building element of the lease meets criterion (c) or (d) of paragraph 213, the building element should be accounted for as a capital lease and amortized in accordance with the provisions of paragraph 217b. The land element of the lease should be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph 213, both the building element and the land element should be accounted for as a single operating lease.

(b) Lessor's accounting: If the building element of the lease meets either criterion (c) or (d) of paragraph 213 and both criteria of paragraph 214, the building element should be accounted for as a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 212b. The land element of the lease should be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph 213 or does not meet the criteria of paragraph 214, both the building element and the land element should be accounted for as a single operating lease.

Leases Involving Equipment as Well as Real Estate

235. If a lease involving real estate also includes equipment, the portion of the minimum lease payments applicable to the equipment element of the lease should be estimated by whatever means are appropriate in the circumstances. The equipment should be considered separately for purposes of applying the criteria in paragraphs 213 and 214 and should be accounted for separately according to its classification by both lessees and lessors.

Leases Involving Only Part of a Building

236. When the leased property is part of a larger whole, its cost (or carrying amount) and fair value may not be objectively determinable, as for example, when an office or floor of

a building is leased.[110] If the cost and fair value of the leased property are objectively determinable, both the lessee and the lessor should classify and account for the lease according to the provisions of paragraph 234. Unless both the cost and the fair value are objectively determinable, the lease should be classified and accounted for as follows:

a. Lessee:
   (1) If the fair value of the leased property is objectively determinable, the lessee should classify and account for the lease according to the provisions of paragraph 234.
   (2) If the fair value of the leased property is not objectively determinable, the lessee should classify the lease according to the criterion of paragraph 213c only, using the estimated economic life of the building in which the leased premises are located. If that criterion is met, the leased property should be capitalized as a unit and amortized in accordance with the provisions of paragraph 217b.
b. Lessor: If either the cost or the fair value of the property is not objectively determinable, the lessor should account for the lease as an operating lease.

Because of special provisions normally present in leases involving terminal space and other airport facilities owned by a governmental unit or authority, the economic life of such facilities for purposes of classifying the lease is essentially indeterminate. Likewise, the concept of fair value is not applicable to such leases. Because such leases also do not provide for a transfer of ownership or a bargain purchase option, they should be classified as operating leases. Leases of other facilities owned by a governmental unit or authority wherein the rights of the parties are essentially the same as in a lease of airport facilities

[110]Information providing a basis for a reasonable estimate of fair value might be obtained through an appraisal or other similar valuation. That kind of information should be obtained whenever possible if (a) classification as a capital lease seems likely and (b) the effects of capital lease classification would be significant to the financial statements of a lessee. Also, a lessee's ability to make a reasonable estimate of the leased property's fair value will vary depending on the size of the leased property in relation to the entire facility. For example, obtaining a meaningful appraisal of an office or a floor of a multi-story building may not be possible whereas similar information may be readily obtainable if the leased property is a major part of that facility. For leases involving only part of a building, other evidence may provide a basis for an objective determination of fair value even if there are no sales of property similar to the leased property. For example, reasonable estimates of the leased property's fair value might be objectively determined by referring to an independent appraisal of the leased property or to estimated replacement cost information.

described above also should be classified as operating leases. Examples of such leases may be those involving facilities at ports and bus terminals.

237. The provisions of paragraph 236 stating that certain leases should be classified as operating leases are intended to apply to leases only if all of the following conditions are met:

a. The leased property is owned by a governmental unit or authority.
b. The leased property is part of a larger facility, such as an airport, operated by or on behalf of the lessor.
c. The leased property is a permanent structure or a part of a permanent structure, such as a building, that normally could not be moved to a new location.
d. The lessor, or in some cases a higher governmental authority, has the explicit right under the lease agreement or existing statutes or regulations applicable to the leased property to terminate the lease at any time during the lease term, such as by closing the facility containing the leased property or by taking possession of the facility.
e. The lease neither transfers ownership of the leased property to the lessee nor allows the lessee to purchase or otherwise acquire ownership of the leased property.
f. The leased property or equivalent property in the same service area[111] cannot be purchased nor can such property be leased from a nongovernmental unit or authority.

238. Leases of property not meeting all of the conditions of paragraph 237 are subject to the same criteria for classifying leases under paragraphs 211–271 that are applicable to leases not involving government-owned property.

Leases between Related Parties

239. Except as noted below, leases between related parties should be classified in accordance with the criteria in paragraphs 213 and 214. Insofar as the separate financial statements of the related parties are concerned, the classification and accounting should be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the lessee

[111]As used here, *equivalent property in the same service area* is property that would allow continuation of essentially the same service or activity as afforded by the leased property without any appreciable difference in economic results to the lessee.

and lessor are related. In such cases, the classification and accounting should be modified as necessary to recognize economic substance rather than legal form. The nature and extent of leasing transactions with related parties should be disclosed.

240. In financial statements for which an interest in an investee is accounted for using the equity method, any gain or loss on a leasing transaction with the related party should be accounted for in accordance with the principles set forth in paragraphs 202–210.

Sale-Leaseback Transactions

241. Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life should be accounted for by the seller-lessee in accordance with the provisions of paragraph 242 and should be accounted for by the buyer-lessor in accordance with the provisions of paragraph 243.

242. If the lease meets one of the criteria for treatment as a capital lease (see paragraph 213), the seller-lessee should account for the lease as a capital lease; otherwise as an operating lease. Any gain or loss on the sale[112] should be deferred and amortized in proportion to the amortization of the leased asset,[113] if a capital lease, or in proportion to the related gross rental charged to expense/expenditure over the lease term, if an operating lease, unless:

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[112]*Gain or loss on the sale* is used in this paragraph to refer to the gain or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to paragraphs 282–349, the gain on the sale to be deferred and amortized in proportion to the leaseback would be the gain that could otherwise be recognized in accordance with those paragraphs.

[113]If the leased asset is land only, the amortization should be on a straight-line basis over the lease term.

a. The seller-lessee relinquishes the right to *substantially all* of the remaining use of the property sold (retaining only a *minor* portion of such use),[114] in which case the sale and the leaseback should be accounted for as separate transactions based on their respective terms. However, if the amount of rentals called for by the lease is unreasonable under market conditions at the inception of the lease, an appropriate amount should be deferred or accrued, by adjusting the gain or loss on the sale, and amortized as specified in the introduction of this paragraph to adjust those rentals to a reasonable amount.

b. The seller-lessee retains more than a minor part but less than substantially all[115] of the use of the property through the leaseback and realizes a gain on the sale[116] in excess of (1) the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease, or (2) the recorded amount of the leased asset, if the leaseback is classified as a capital lease. In that case, the gain on the sale in excess of either the present value of the minimum lease payments or the recorded amount of the leased asset, whichever is appropriate, should be recognized at the date of the sale. For purposes of applying this provision, the present value of the minimum lease payments for an operating lease should be computed using the interest rate that would be used to apply the 90 percent recovery criterion of paragraph 213d.

c. The fair value of the property at the time of the transaction is less than its undepreciated cost, in which case a loss should be recognized immediately up to the amount of the difference between undepreciated cost and fair value.

243. If the lease meets the criteria in paragraphs 213 and 214, the buyer-lessor should record the transaction as a purchase and a direct financing lease; otherwise, the transaction should be recorded as a purchase and an operating lease.

Sale-Leaseback Transactions Involving Real Estate

244. Paragraphs 244–256 establish standards of accounting and financial reporting by a seller-lessee for sale-leaseback transactions involving real estate, including real estate with equipment, such as power plants and office buildings with furniture and fixtures. Under

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[114]*Substantially all* and *minor* are used here in the context of the concepts underlying the classification criteria of paragraphs 211–271. In that context, a test based on the 90 percent recovery criterion of those paragraphs could be used as a guideline; that is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the purchaser-lessor the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use.

[115]*Substantially all* is used here in the context of the concepts underlying the classification criteria of paragraphs 211–271. In that context, if a leaseback of *the entire property sold* meets the criteria of those paragraphs for classification as a capital lease, the seller-lessee would be presumed to have retained substantially all of the remaining use of the property sold.

[116]See footnote 112.

those paragraphs, a sale-leaseback transaction involving real estate with equipment includes any sale-leaseback transaction in which the equipment and the real estate are sold and leased back as a package, irrespective of the relative value of the equipment and the real estate. Paragraphs 244–256 also address sale-leaseback transactions in which the seller-lessee sells property improvements or integral equipment[117] to a buyer-lessor and leases them back while retaining the underlying land.[118] In addition, paragraphs 244–256 apply to sale-leaseback transactions involving real estate with equipment that include separate sale and leaseback agreements (a) with the same entity or related parties and (b) that are consummated at or near the same time, suggesting that they were negotiated as a package. Except as specified in this paragraph, paragraphs 244–256 do not address sale-leaseback or other leasing transactions involving only equipment.

Criteria for Sale-Leaseback Accounting

245. Sale-leaseback accounting should be used by a seller-lessee only if a sale-leaseback transaction includes all of the following:

a. A normal leaseback as described in paragraph 246
b. Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property (refer to paragraphs 289–297)
c. Payment terms and provisions that transfer *all* of the other risks and rewards of ownership as demonstrated by the absence of *any* other continuing involvement by the seller-lessee described in paragraphs 249–251, 306–319, and 321–323.

[117]The terms *property improvements* or *integral equipment* as used in paragraphs 244–256 refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost. Examples include an office building and a power plant.

[118]Paragraphs 318 and 319 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph 318 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. It is not the intent of paragraphs 244–256 to modify paragraph 318; thus, it does not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph 318. However, paragraphs 244–256 do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph 319.

246. A normal leaseback is a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee,[119] and excludes other continuing involvement provisions or conditions described in paragraphs 249–251. The phrase *active use of the property by the seller-lessee* refers to the use of the property during the lease term in the seller-lessee's operations, provided that subleasing of the leased back property is minor.[120] If the present value of a reasonable amount of rental for that portion of the leaseback that is subleased is not more than 10 percent of the fair value of the asset sold, the leased back property under sublease is considered minor. Active use of the property may involve the providing of services where the occupancy of the property is generally transient or short-term and is integral to the ancillary services being provided. Those ancillary services include, but are not limited to, housekeeping, inventory control, entertainment, bookkeeping, and food services. Thus, the use of property by a seller-lessee engaged in the hotel or bonded warehouse operation or the operation of a golf course or a parking lot, for example, is considered active use.

Terms of the Sale-Leaseback Transaction

247. Terms of the sale-leaseback transaction that are substantially different from terms that an independent third-party lessor or lessee would accept represent an exchange of some stated or unstated rights or privileges. Those rights or privileges should be considered in evaluating the continuing involvement provisions in paragraphs 249–251. Those terms or conditions include, but are not limited to, the sales price, the interest rate,

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[119]Paragraphs 244–256 distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor. The latter type of contingent rental is addressed in paragraph 250e.

[120]*Minor* is used in paragraphs 244–256 in the context of the definition in paragraph 242a and footnote 114.

and other terms of any loan from the seller-lessee to the buyer-lessor. The fair value of the property used in making that evaluation should be based on objective evidence, for example, an independent third-party appraisal or recent sales of comparable property.

Continuing Involvement

248. A sale-leaseback transaction that does not qualify for sale-leaseback accounting because of any form of continuing involvement by the seller-lessee other than a normal leaseback should be accounted for by the deposit method or as a financing, whichever is appropriate under paragraphs 282–349. The provisions or conditions described in paragraphs 249–251 are examples of continuing involvement for the purpose of applying paragraphs 244–256.

249. Paragraphs 306–319 and 321–323 describe forms of continuing involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessor. Two examples of continuing involvement specified in those paragraphs that are frequently found in sale-leaseback transactions are provisions or conditions in which:

a. The seller-lessee has an obligation or an option[121] to repurchase the property or the buyer-lessor can compel the seller-lessee to repurchase the property.
b. The seller-lessee guarantees the buyer-lessor's investment or a return on that investment for a limited or extended period of time.

250. Other provisions or conditions that are guarantees and that do not transfer all of the risks of ownership should constitute continuing involvement for the purpose of applying paragraphs 244–256 to sale-leaseback transactions and include, but are not limited to, the following:

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[121] A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase.

a. The seller-lessee is required to pay the buyer-lessor at the end of the lease term for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.
b. The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.
c. The seller-lessee is not relieved of the obligation under any existing debt related to the property.
d. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment.
e. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessor.[122]

251. The following provisions or conditions also should be considered examples of continuing involvement for the purpose of applying paragraphs 244–256 to sale-leaseback transactions:

a. The seller-lessee enters into a sale-leaseback transaction involving property improvements or integral equipment[123] without leasing the underlying land to the buyer-lessor.[124]
b. The buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property.
c. Any other provision or circumstance that allows the seller-lessee to participate in any future gains of the buyer-lessor or the appreciation of the leased property, for example, a situation in which the seller-lessee owns or has an option to acquire any interest in the buyer-lessor.

Sale-Leaseback Transactions by Regulated Enterprises

252. The provisions of paragraphs 252–254 apply to sale-leaseback transactions of a regulated enterprise subject to paragraphs 476–500. That accounting may result in a difference between the timing of revenue and expense recognition required by paragraphs 244–256 and the timing of revenue and expense recognition for rate-making purposes.

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[122]See footnote 119.

[123]See footnote 117.

[124]See footnote 118.

The timing of revenue and expense recognition related to the sale-leaseback transaction should be modified as necessary to conform to paragraphs 476–500. That modification required for a transaction that is accounted for by the deposit method or as a financing is further described in paragraphs 253 and 254.

253. If a sale-leaseback transaction is accounted for by the deposit method but the sale is recognized for rate-making purposes, the amortization of the asset should be modified to equal the total of the rental expense and the gain or loss allowable for rate-making purposes. Similarly, if the sale-leaseback transaction is accounted for as a financing and the sale is recognized for rate-making purposes, the total of interest imputed under the interest method for the financing and the amortization of the asset should be modified to equal the total rental expense and the gain or loss allowable for rate-making purposes.

254. The difference between the amount of revenue or expense recognized for a transaction that is accounted for by the deposit method or as a financing under paragraphs 244–256 and the amount of revenue or expense included in allowable cost for rate-making purposes should be capitalized or accrued as a separate regulatory-created asset or liability, as appropriate, if that difference meets the criteria of paragraphs 476–500.

Financial Statement Presentation and Disclosure

255. In addition to the disclosure requirements in paragraphs 223, 231, 239, and 270, the notes to financial statements of a seller-lessee should include a description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee’s continuing involvement.

256. The notes to financial statements of a seller-lessee that has accounted for a sale-leaseback transaction by the deposit method or as a financing according to the provisions of paragraphs 244–254 also should disclose the total minimum sublease rentals, if any, to be received in the future under noncancelable subleases in the aggregate and for each of the five succeeding fiscal years.

Accounting and Reporting for Subleases and Similar Transactions

257. Paragraphs 257–263 deal with the following types of leasing transactions:

a. The leased property is re-leased by the original lessee to a third party, and the lease agreement between the two original parties remains in effect (a sublease).
b. A new lessee is substituted under the original lease agreement. The new lessee becomes the primary obligor under the agreement, and the original lessee may or may not be secondarily liable.
c. A new lessee is substituted through a new agreement, with cancellation of the original lease agreement.

Accounting by the Original Lessor

258. If the original lessee enters into a sublease or the original lease agreement is sold or transferred by the original lessee to a third party, the original lessor should continue to account for the lease as before.

259. If the original lease agreement is replaced by a new agreement with a new lessee, the lessor should account for the termination of the original lease as provided in paragraph 224f and should classify and account for the new lease as a separate transaction.

Accounting by the Original Lessee

260. If the nature of the transaction is such that the original lessee is relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraphs 257b and 257c, the termination of the original lease agreement should be accounted for as follows:

a. If the original lease was a capital lease, the asset and obligation representing the original lease should be removed from the accounts, a gain or loss should be recognized for the difference, and, if the original lessee is secondarily liable, the loss contingency should be treated as provided by paragraphs 96–113. Any consideration paid or received upon termination should be included in the determination of the gain or loss to be recognized.
b. If the original lease was an operating lease and the original lessee is secondarily liable, the loss contingency should be treated as provided by paragraphs 96–113.

261. If the nature of the transaction is such that the original lessee is not relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraph 257a, the original lessee, as sublessor, should account for the transaction as follows:

a. If the original lease met either criterion (a) or (b) of paragraph 213, the original lessee should classify the new lease in accordance with the criteria of paragraphs 213 and 214. If the new lease meets one of the criteria of paragraph 213 and both of the criteria of paragraph 214, it should be accounted for as a sales-type or direct financing lease, as appropriate, and the unamortized balance of the asset under the original lease should be treated as the cost of the leased property. If the new lease does not qualify as a sales-type or direct financing lease, it should be accounted for as an operating lease. In either case, the original lessee should continue to account for the obligation related to the original lease as before.
b. If the original lease met either criterion (c) or (d) but not criterion (a) or (b) of paragraph 213, the original lessee should, with one exception, classify the new lease in accordance with the criteria of paragraphs 213c and 214 only. If it meets those criteria, it should be accounted for as a direct financing lease, with the unamortized balance of the asset under the original lease treated as the cost of the leased property; otherwise, as an operating lease. In either case, the original lessee should continue to account for the obligation related to the original lease as before. The one exception arises when the timing and other circumstances surrounding the sublease are such as to suggest that the sublease was intended as an integral part of an overall transaction in which the original lessee serves only as an intermediary. In that case, the sublease should be classified according to the criteria of paragraphs 213c and 213d, as well as the criteria of paragraph 214. In applying the criterion of paragraph 213d, the fair value of the leased property should be the fair value to the original lessor at the inception of the original lease.
c. If the original lease is an operating lease, the original lessee should account for both it and the new lease as operating leases.

262. Paragraph 261 does not prohibit the recognition of a loss by an original lessee who disposes of leased property or mitigates the cost of an existing lease commitment by subleasing the property.

Accounting by the New Lessee

263. The new lessee should classify the lease in accordance with the criteria of paragraph 213 and account for it accordingly.

Accounting and Reporting for Leveraged Leases

264. From the standpoint of the lessee, leveraged leases should be classified and accounted for in the same manner as nonleveraged leases. Paragraphs 264–270 deal with leveraged leases from the standpoint of the lessor.

265. For purposes of applying paragraphs 211–271, a leveraged lease is defined as one having all of the following characteristics:

a. Except for the exclusion of leveraged leases from the definition of a direct financing lease as set forth in paragraph 212b(2), it otherwise meets that definition. Leases that meet the definition of sales-type leases set forth in paragraph 212b(1) should not be accounted for as leveraged leases but should be accounted for as prescribed in paragraph 224.
b. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).
c. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of the financing is sufficient to provide the lessor with substantial "leverage" in the transaction.
d. The lessor's net investment, as defined in paragraph 266, declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

A lease meeting the preceding definition should be accounted for by the lessor using the method described in paragraphs 266–270. A lease not meeting the definition of a leveraged lease should be accounted for in accordance with its classification under paragraph 212b.

266. The lessor should record an investment in a leveraged lease net of the nonrecourse debt. The net of the balances of the following accounts should represent the initial and continuing investment in leveraged leases:

a. Rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt
b. The estimated residual value of the leased asset. The estimated residual value generally should not exceed the amount estimated at the inception of the lease.[125]

267. Given the original investment and using the projected cash receipts and disbursements over the term of the lease, the rate of return on the net investment in the years[126] in which it is positive should be computed. The rate is that rate which when applied to the net investment in the years in which the net investment is positive will distribute the revenue to those years and is distinct from the interest rate implicit in the lease. In each year, whether positive or not, the difference between the net cash flow and the amount of revenue recognized, if any, should serve to increase or reduce the net investment balance.

268. If the projected net cash receipts[127] over the term of the lease are less than the lessor's initial investment, the deficiency should be recognized as a loss at the inception of the lease. Likewise, if at any time during the lease term the application of the method prescribed in paragraphs 266 and 267 would result in a loss being allocated to future

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[125]See footnote 99.

[126]The use of the term *years* is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods.

[127]For purposes of applying this paragraph, net cash receipts should be gross cash receipts less gross cash disbursements exclusive of the lessor's initial investment.

years, that loss should be recognized immediately. This situation might arise in cases in which one of the important assumptions affecting revenue is revised (see paragraph 269).

269. Any estimated residual value and all other important assumptions affecting estimated total revenue from the lease should be reviewed at least annually. If during the lease term the estimate of the residual value is determined to be excessive and the decline in the residual value is judged to be other than temporary or if the revision of another important assumption changes the estimated total revenue from the lease, the rate of return and the allocation of revenue to positive investment years should be recalculated from the inception of the lease following the method described in paragraph 267 and using the revised assumption. The accounts constituting the net investment balance should be adjusted to conform to the recalculated balances, and the change in the net investment should be recognized as a gain or loss in the year in which the assumption is changed. An upward adjustment of the estimated residual value should not be made.

Disclosures

270. When leveraged leasing is a significant part of the lessor's operations, the components of the net investment balance in leveraged leases as set forth in paragraph 266 should be disclosed in the notes to the financial statements.

Glossary

271. This paragraph contains definitions of certain terms *as they are used in paragraphs 212–271;* the terms may have different meanings in other contexts.

Bargain Purchase Option

A provision allowing the lessee the option to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable such that exercise of the option appears, at the inception of the lease, to be reasonably assured.

Bargain Renewal Option

A provision allowing the lessee the option to renew the lease for a rental sufficiently lower than the fair rental[128] of the property at the date the option becomes exercisable such that exercise of the option appears, at the inception of the lease, to be reasonably assured.

Contingent Rentals

The increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based, except as provided in the following sentence. Any escalation of minimum lease payments relating to increases in construction or acquisition cost of the leased property or for increases in some measure of cost or value during the construction or pre-construction period should be excluded from contingent rentals. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, should be included in minimum lease payments based on the index or rate existing at the inception of the lease; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of revenue or expense/expenditure as accruable.

[128] *Fair rental* in this context means the expected rental for equivalent property under similar terms and conditions.

Estimated Economic Life of Leased Property

The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term.

Estimated Residual Value of Leased Property

The estimated fair value of the leased property at the end of the lease term.

Fair Value of the Leased Property

The price for which the property could be sold in an arm's-length transaction between willing parties, that is, other than in a forced or liquidation sale. The following are examples of the determination of fair value:

a. The fair value of the property at the inception of the lease, in some cases, will be its normal selling price, reflecting any volume or trade discounts that may be applicable. However, the determination of fair value should be made in light of market conditions prevailing at the time, which may indicate that the fair value of the property is less than the normal selling price and, in some instances, less than the cost of the property.
b. The fair value of the property at the inception of the lease, in some cases, will be its cost, reflecting any volume or trade discounts that may be applicable. However, when there has been a significant lapse of time between the acquisition of the property by the lessor and the inception of the lease, the determination of fair value should be made in light of market conditions prevailing at the inception of the lease, which may indicate that the fair value of the property is greater or less than its cost or carrying amount, if different. (See paragraph 212b.)

Inception of the Lease

The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment should be in writing, signed by the parties in interest to the transaction, and should specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

Initial Direct Costs[129]

Only those costs incurred by the lessor that are (1) costs to originate a lease incurred in transactions with independent third parties that (a) result directly from and are essential to acquire that lease and (b) would not have been incurred had that leasing transaction not occurred and (2) certain costs directly related to specified activities performed by the lessor for that lease. Those activities are evaluating the prospective lessee's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating lease terms; preparing and processing lease documents; and closing the transaction. The costs directly related to those activities should include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs should not include costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Initial direct costs should not include administrative costs, rent, depreciation, any other occupancy and equipment costs and employees' compensation and fringe benefits related to activities described in the previous sentence, unsuccessful origination efforts, and idle time.

Interest Rate Implicit in the Lease

The discount rate that, when applied to (1) the minimum lease payments, excluding that portion of the payments representing executory costs to be paid by the lessor, together

[129]Initial direct costs should be offset by nonrefundable fees that are yield adjustments as prescribed in paragraphs 431–451.

with any gain thereon, and (2) the unguaranteed residual value accruing to the benefit of the lessor,[130] causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property to the lessor at the inception of the lease, minus any investment tax credit retained by and expected to be realized by the lessor. (This definition does not necessarily include all factors that a lessor might recognize in determining the lessor's rate of return. For an example, see paragraph 267.)

Lease Term

The fixed noncancelable[131] term of the lease plus (1) all periods, if any, covered by **bargain renewal options,** (2) all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured, (3) all periods, if any, covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property[132] is expected to be in effect or a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding, (4) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable, and (5) all periods, if any, representing renewals or extensions of the lease at the lessor's option; however, in no case should the lease term be assumed to extend beyond the date a bargain purchase option becomes exercisable. A

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[130]If the lessor is not entitled to any excess of the amount realized on disposition of the property over a guaranteed amount, no unguaranteed residual value would accrue to the lessor's benefit.

[131]See paragraphs 18–21 of NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments,* regarding fiscal funding and cancellation clauses.

[132]The phrase *indirectly related to the leased property* is used in this paragraph to describe provisions or conditions that in substance are guarantees of the lessor's debt or loans to the lessor by the lessee that are related to the leased property but are structured in such a manner that they do not represent a direct guarantee or loan. Examples include a party related to the lessee guaranteeing the lessor's debt on behalf of the lessee, or the lessee financing the lessor's purchase of the leased asset using collateral other than the leased property.

lease that is cancelable (a) only upon the occurrence of some remote contingency, (b) only with the permission of the lessor, (c) only if the lessee enters into a new lease with the same lessor, or (d) only if the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured should be considered "noncancelable" for purposes of this definition.

Lessee's Incremental Borrowing Rate

The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the resources necessary to purchase the leased asset.

Minimum Lease Payments

a. From the standpoint of the lessee: The payments that the lessee is obligated to make or can be required to make in connection with the leased property.[133] However, a guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance and maintenance in connection with the leased property should be excluded. If the lease contains a bargain purchase option, only the minimum rental payments over the lease term and the payment called for by the bargain purchase option should be included in the minimum lease payments. Otherwise, minimum lease payments include the following:
   (1) The minimum rental payments called for by the lease over the lease term.
   (2) Any guarantee by the lessee[134] of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property.[135] When the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount should be considered a lessee guarantee. When the lessee

[133]Contingent rentals as defined in this glossary should be excluded from minimum lease payments. Contingent rentals should be recognized as period costs when incurred (or revenue when receivable). (See paragraphs 218, 224b, and 226b.)

[134]A guarantee by a third party related to the lessee should be considered a lessee guarantee.

[135]A guarantee of the residual value obtained by the lessee from an unrelated third party for the benefit of the lessor should not be used to reduce the amount of the lessee's minimum lease payments under paragraphs 211–271 except to the extent that the lessor explicitly releases the lessee from obligation, including secondary obligation if the guarantor defaults, to make up a residual value deficiency. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and should not be included in the lessee's minimum lease payments.

agrees to make up any deficiency[136] below a stated amount in the lessor's realization of the residual value, the guarantee to be included in the minimum lease payments should be the stated amount,[137] rather than an estimate of the deficiency to be made up.

(3) Any payment that the lessee is required to make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the leased property. In this connection, it should be noted that the definition of lease term includes "all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured." If the lease term has been extended because of that provision, the related penalty should not be included in minimum lease payments.

b. From the standpoint of the lessor: The payments described in (a) above plus any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee[138] or the lessor,[139] provided the third party is financially capable of discharging the obligations that may arise from the guarantee.

Penalty

Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider when determining if an economic detriment may be incurred include, but are not limited to, the uniqueness

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[136]A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to contingent rentals in that the amount is not determinable at the inception of the lease. Such a provision does not constitute a lessee guarantee of the residual value for purposes of applying paragraphs 211–271.

[137] If a lease limits the amount of the lessee's obligation to make up a residual value deficiency to an amount less than the stipulated residual value of the leased property at the end of the lease term, the amount of the lessee's guarantee to be included in minimum lease payments under paragraphs 211–271 should be limited to the specified maximum deficiency the lessee can be required to make up. In other words, the "stated amount" referred to in paragraphs 211–271 is the specified maximum deficiency that the lessee is obligated to make up. If that maximum deficiency clearly exceeds any reasonable estimate of a deficiency that might be expected to arise in normal circumstances, the lessor's risk associated with the portion of the residual in excess of the maximum may appear to be negligible. However, the fact remains that the lessor should look to the resale market or elsewhere rather than to the lessee to recover the unguaranteed portion of the stipulated residual value of the lease property. The lessee has not guaranteed full recovery of the residual value, and the parties should not base their accounting on the assumption that the lessee has guaranteed it. The 90 percent test specified in criterion (d) of paragraph 213 is stated as a lower limit rather than as a guideline.

[138]See footnote 134.

[139]If the guarantor is related to the lessor, the residual value should be considered unguaranteed.

of purpose or location of the property, the availability of a comparable replacement property, the relative importance or significance of the property to the continuation of the lessee's operations or service to its customers, the existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property, adverse tax consequences, and the ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property.

Unguaranteed Residual Value

The estimated residual value of the leased property exclusive of any portion guaranteed by the lessee[140] or by a third party unrelated to the lessor.[141]

Nonmonetary Transactions

272. Some transactions involve an **exchange**[142] with another entity (reciprocal transfer) that involves principally **nonmonetary assets or liabilities.** Exchanges that involve little or no **monetary assets or liabilities** are referred to in paragraphs 272–281 as nonmonetary transactions.

273. Paragraphs 272–281 do not apply to the following transactions:

a. A government combination
b. A transfer of nonmonetary assets solely between reporting units within the same reporting entity, such as between a primary government and its component units or between two component units of the same reporting entity, or between a joint venture and its owners or participating governments[143]
c. Nonexchange transactions.

[140]See footnote 134.

[141]See footnote 139.

[142]Terms defined in the glossary (see paragraph 281) are shown in **boldface type** the first time they appear in paragraphs 272–280.

[143]The accounting and reporting standards for intra-entity transactions are provided in Statement 48.

Some exchanges of nonmonetary assets involve a small monetary consideration, referred to as "boot," even though the exchange is essentially nonmonetary. Paragraphs 272–281 also apply to those transactions. For purposes of applying those paragraphs, events and transactions in which nonmonetary assets are involuntarily converted (for example, as a result of total or partial destruction, theft, seizure, or condemnation) to monetary assets that are then reinvested in other nonmonetary assets are monetary transactions because the recipient is not obligated to reinvest the monetary consideration in other nonmonetary assets.

Basic Principle

274. In general, accounting for nonmonetary transactions should be based on the fair values[144] of the assets (or services) involved, which is the same basis as that used in monetary transactions. Therefore, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered.

Modifications of the Basic Principle

Fair Value Not Determinable

275. Accounting for a nonmonetary transaction should not be based on the fair values of the assets transferred unless those fair values are determinable within reasonable limits (paragraph 278).

[144]See paragraph 278 for determination of fair value.

Exchanges

276. If the exchange is not essentially the culmination of an earning process, accounting for an exchange of a nonmonetary asset between a government and another entity should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset relinquished. The following two types of nonmonetary exchange transactions do not culminate in an earning process:

a. An exchange of a product or property held for sale in the ordinary course of operations for a product or property to be sold in the same function to facilitate sales to customers other than the parties to the exchange, and
b. An exchange of a **productive asset** not held for sale in the ordinary course of operations for a **similar productive asset** or an equivalent interest in the same or similar productive asset.

277. The exchanges of nonmonetary assets that otherwise would be based on recorded amounts (paragraph 276) may include an amount of monetary consideration. The recipient of the monetary consideration has realized a gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. The government paying the monetary consideration should not recognize any gain on a transaction covered in paragraph 276 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraph 276, the entire indicated loss on the exchange should be recognized.

Applying the Basic Principle

278. Fair value of a nonmonetary asset transferred to or from a government in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

279. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value. An exchange involving parties with essentially opposing interests is not considered a prerequisite to determining a fair value of a nonmonetary asset transferred; nor does an exchange insure that a fair value for accounting purposes can be ascertained within reasonable limits. If neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the government may be the only available measure of the transaction.

Disclosure

280. A government that engages in one or more nonmonetary transactions during a period should disclose in financial statements for the period the nature of the transactions, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.

Glossary

281. This paragraph contains definitions of certain terms *as they are used in paragraphs 272–280;* the terms may have different meanings in other contexts.

Exchange (or Exchange Transaction)

A reciprocal transfer between a government and another entity that results in the government acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.

Monetary Assets and Liabilities

Assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash, short- or long-term accounts and notes receivable in cash, and short- or long-term accounts and notes payable in cash.

Nonmonetary Assets and Liabilities

Assets and liabilities other than monetary ones. Examples are inventories, investments in common stocks, capital assets, and liabilities for rent collected in advance.

Productive Assets

Assets held for or used in the production of goods or services by the government. Productive assets include an investment in another entity if the investment is accounted for by the equity method but exclude an investment not accounted for by that method.

Similar Productive Assets

Productive assets that are of the same general type, that perform the same function, or that are employed in the same line of operations.

Sales of Real Estate

282. Paragraphs 282–349 establish standards for recognition of gain on all real estate sales transactions. Those paragraphs distinguish between retail land sales and other sales

of real estate because differences in terms of sales and selling procedures lead to different gain recognition criteria and methods. Accounting for real estate sales transactions that are not retail land sales is specified in paragraphs 284–323. Accounting for retail land sales transactions is specified in paragraphs 324–330. Paragraphs 282–349 do not cover exchanges of real estate for other real estate, the accounting for which is covered in paragraphs 272–281.

283. The general requirements for recognizing all of the gain on a nonretail land sale at the date of sale are set forth in paragraphs 284–286. Paragraphs 287–299 elaborate on those general provisions. Paragraphs 300–323 provide more detailed guidance for a variety of more complex transactions.

Real Estate Sales Other Than Retail Land Sales

Recognition of Gain by the Full Accrual Method

284. Gain should be recognized in full when real estate is sold, provided (a) the gain is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale. Unless both conditions exist, recognition of all or part of the gain should be postponed. Recognition of all of the gain at the time of sale or at some later date when both conditions exist is referred to as the *full accrual method* in paragraphs 282–349.

285. In accounting for sales of real estate, collectibility of the sales price is demonstrated by the buyer’s commitment to pay, which in turn is supported by substantial initial and continuing investments that give the buyer a stake in the property sufficient that the risk of loss through default motivates the buyer to honor its obligation to the seller. Collectibility

also should be assessed by considering factors such as the credit standing of the buyer, the age and location of the property, and the adequacy of cash flow from the property.

286. Gain on real estate sales transactions[145] should not be recognized by the full accrual method until all of the following criteria are met:

a. A sale is consummated (paragraph 287).
b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property (paragraphs 289–297).
c. The seller's receivable is not subject to future subordination (paragraph 298).
d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property (paragraph 299).

Paragraphs 300–323 describe appropriate accounting if the above criteria are not met.

Consummation of a Sale

287. A sale should not be considered consummated until (a) the parties are bound by the terms of a contract, (b) all consideration has been exchanged, (c) any permanent financing for which the seller is responsible has been arranged, and (d) all conditions[146] precedent to closing have been performed. Usually, those four conditions are met at the time of closing or after closing, not when an agreement to sell is signed or at a preclosing.

Buyer's Initial and Continuing Investment

288. "Sales value" should be determined by:

a. Adding to the stated sales price the proceeds from the issuance of a real estate option that is exercised and other payments that are in substance additional sales proceeds. These nominally may be management fees, points, or prepaid interest or fees that are required to be maintained in an advance status and applied against the amounts due to the seller at a later date.
b. Subtracting from the sale price a discount to reduce the receivable to its present value and by the net present value of services that the seller commits to perform

[145]Gain on a sale of a partial interest in real estate should be subject to the same criteria for gain recognition as a sale of a whole interest.

[146]Paragraph 301 provides an exception to this requirement if the seller is constructing office buildings, apartments, or similar structures.

without compensation or by the net present value of the services in excess of the compensation that will be received. Paragraph 312 specifies appropriate accounting if services are to be provided by the seller without compensation or at less than prevailing rates.

289. Adequacy of a buyer's initial investment should be measured by (a) its composition (paragraphs 290 and 291) and (b) its size compared with the sales value of the property (paragraph 292).

290. The buyer's initial investment should include only (a) cash paid as a down payment, (b) the buyer's notes supported by irrevocable letters of credit from an independent established lending institution,[147] (c) payments by the buyer to third parties to reduce existing indebtedness on the property, and (d) other amounts paid by the buyer that are part of the sales value. Other consideration received by the seller, including other notes of the buyer, should be included as part of the buyer's initial investment only when that consideration is sold or otherwise converted to cash without recourse to the seller.

291. The initial investment should not include:

a. Payments by the buyer to third parties for improvements to the property
b. A permanent loan commitment by an independent third party to replace a loan made by the seller
c. Any resources that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller or loans guaranteed or collateralized by the seller for the buyer.[148]

292. The buyer's initial investment should be adequate to demonstrate the buyer's commitment to pay for the property and should indicate a reasonable likelihood that the seller will collect the receivable. Lending practices of independent established lending

[147]An *independent established lending institution* is an unrelated institution such as a commercial bank unaffiliated with the seller.

[148]As an example, if unimproved land is sold for $100,000, with a down payment of $50,000 in cash, and the seller plans to loan the buyer $35,000 at some future date, the initial investment is $50,000 minus $35,000, or $15,000.

institutions provide a reasonable basis for assessing the collectibility of receivables from buyers of real estate. Therefore, to qualify, the initial investment should be equal to at least a major part of the difference between usual loan limits and the sales value of the property.

293. The buyer's continuing investment in a real estate transaction should not qualify unless the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that debt and interest on the unpaid balance over no more than (a) 20 years for debt for land and (b) the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate. For this purpose, contractually required payments by the buyer on its debt should be in the forms specified in paragraph 290 as acceptable for an initial investment. Except as indicated in the following sentence, resources to be provided directly or indirectly by the seller (paragraph 291c) should be subtracted from the buyer's contractually required payments in determining whether the initial and continuing investments are adequate. If the proceeds of a future loan are conditional on use for specified development of or construction on the property, the loan need not be subtracted in determining the buyer's investment.

Release Provisions

294. An agreement to sell property (usually land) may provide that part or all of the property may be released from liens securing related debt by payment of a release price or that payments by the buyer may be assigned first to released property. If either of those conditions is present, a buyer's initial investment is sufficient both to pay release prices on property released at the date of sale and to constitute an adequate initial investment on

property not released or not subject to release at that time in order to meet the criterion of an adequate initial investment for the property as a whole.

295. If the release conditions described in paragraph 294 are present, the buyer's investment is sufficient, after the released property is paid for, to constitute an adequate continuing investment on property not released in order to meet the criterion of an adequate continuing investment for the property as a whole (paragraph 293).

296. If the amounts applied to unreleased portions do not meet the initial and continuing-investment criteria as applied to the sales value of those unreleased portions, a gain should be recognized on each released portion when it meets the criteria in paragraph 286 as if each release were a separate sale.

297. Tests of adequacy of a buyer's initial and continuing investments described in paragraphs 289–296 should be applied cumulatively when the sale is consummated and annually afterward. If the initial investment exceeds the minimum prescribed, the excess should be applied toward the required annual increases in the buyer's investment.

Future Subordination

298. The seller's receivable should not be subject to future subordination. This restriction should not apply if (a) a receivable is subordinate to a first mortgage on the property existing at the time of sale or (b) a future loan, including an existing permanent loan commitment, is provided for by the terms of the sale and the proceeds of the loan will be applied first to the payment of the seller's receivable.

Continuing Involvement without Transfer of Risks and Rewards

299. If a seller is involved with a property after it is sold in any way that results in retention of substantial risks or rewards of ownership, except as indicated in paragraph 323, the absence-of-continuing-involvement criterion has not been met. Forms of involvement that result in retention of substantial risks or rewards by the seller, and accounting therefor, are described in paragraphs 306–322.

Recognition of Gain When the Full Accrual Method Is Not Appropriate

300. If a real estate sales transaction does not satisfy the criteria in paragraphs 284–299 for recognition of gain by the full accrual method, the transaction should be accounted for as specified in paragraphs 301–323.

Sale Not Consummated

301. The deposit method of accounting described in paragraphs 341–343 should be used until a sale has been consummated (paragraph 287). "Consummation" usually requires that all conditions precedent to closing have been performed, including that the building be certified for occupancy. However, because of the length of the construction period of office buildings, apartments, and similar structures, such sales and the related revenue may be recognized during the process of construction, subject to the criteria in paragraphs 321 and 322, even though a certificate of occupancy, which is a condition precedent to closing, has not been obtained.

302. If the net carrying amount of the property exceeds the sum of the deposit received, the fair value of the unrecorded note receivable, and the debt assumed by the buyer, the

seller should recognize the loss at the date the agreement to sell is signed.[149] If a buyer defaults, or if circumstances after the transaction indicate that it is probable the buyer will default and the property will revert to the seller, the seller should evaluate whether the circumstances indicate a decline in the value of the property for which an allowance for loss should be provided.

Initial or Continuing Investments Do Not Qualify

303. If the buyer's initial investment does not meet the criteria specified in paragraphs 289–292 for recognition of gain by the full accrual method and if recovery of the cost of the property is reasonably assured if the buyer defaults, the installment method described in paragraphs 332–337 should be used. If recovery of the cost of the property is not reasonably assured if the buyer defaults or if cost has already been recovered and collection of additional amounts is uncertain, the cost recovery method (described in paragraphs 338–340) or the deposit method (described in paragraphs 341–343) should be used. The cost recovery method may be used to account for sales of real estate for which the installment method would be appropriate.

304. If the initial investment meets the criteria in paragraphs 289–292 but the continuing investment by the buyer does *not* meet the criteria in paragraphs 293 and 297, the seller should recognize a gain by the reduced gain method described in paragraph 344 at the time of sale if payments by the buyer each year will at least cover both of the following:

a. The interest and principal amortization on the maximum first mortgage loan that could be obtained on the property
b. Interest, at an appropriate rate,[150] on the excess of the aggregate actual debt on the property over such a maximum first mortgage loan.

[149] Paragraph 372 specifies the accounting for an excess of costs over net realizable value for property that has not yet been sold.

[150] Paragraphs 183 and 184 provide criteria for selecting an appropriate rate for present-value calculations.

If the criteria specified in this paragraph for use of the reduced gain method are not met, the seller may recognize a gain by the installment method (paragraphs 332–337) or the cost recovery method (paragraphs 338–340).

Receivable Subject to Future Subordination

305. If the seller's receivable is subject to future subordination as described in paragraph 298, a gain should be recognized by the cost recovery method (paragraphs 338–340).

Continuing Involvement without Transfer of Risks and Rewards

306. If the seller has some continuing involvement with the property and does not transfer substantially all of the risks and rewards of ownership, a gain should be recognized by a method determined by the nature and extent of the seller's continuing involvement. Generally, a gain should be recognized at the time of sale if the amount of the seller's loss of gain because of continued involvement with the property is limited by the terms of the sales contract. The gain recognized should be reduced by the maximum exposure to loss. Paragraphs 307–323 describe some common forms of continuing involvement and specify appropriate accounting if those forms of involvement are present. If the seller has some other form of continuing involvement with the property, the transaction should be accounted for according to the nature of the involvement.

307. *The seller has an obligation to repurchase the property, or the terms of the transaction allow the buyer to compel the seller or give an option*[151] *to the seller to repurchase the property*. The transaction should be accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale.

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[151]A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase.

308. *The seller is a general partner in a limited partnership that acquires an interest in the property sold (or has an extended, noncancelable management contract requiring similar obligations) and holds a receivable from the buyer for a significant*[152] *part of the sales price*. The transaction should be accounted for as a financing, leasing, or profit-sharing arrangement.

309. *The seller guarantees*[153] *the return of the buyer's investment or a return on that investment for a limited or extended period*. For example, the seller guarantees cash flows, subsidies, or net tax benefits. If the seller guarantees return of the buyer's investment or if the seller guarantees a return on the investment for an extended period, the transaction should be accounted for as a financing, leasing, or profit-sharing arrangement. If the guarantee of a return on the investment is for a limited period, the deposit method should be used until operations of the property cover all operating expenses, debt service, and contractual payments. At that time, a gain should be recognized on the basis of performance of the services required.

310. *The seller is required to initiate or support operations or continue to operate the property at its own risk, or may be presumed to have such a risk, for an extended period, for a specified limited period, or until a specified level of operations has been obtained,*

[152]For this purpose, a significant receivable is a receivable in excess of 15 percent of the maximum first-lien financing that could be obtained from an independent established lending institution for the property. It would include:

a. A construction loan made or to be made by the seller to the extent that it exceeds the minimum funding commitment for permanent financing from a third party that the seller will not be liable for
b. An all-inclusive or wraparound receivable held by the seller to the extent that it exceeds prior-lien financing for which the seller has no personal liability
c. Other resources provided or to be provided directly or indirectly by the seller to the buyer
d. The present value of a land lease when the seller is the lessor (footnote 156).

[153]Guarantees by the seller may be limited to a specified period of time.

for example, until rentals of a property are sufficient to cover operating expenses and debt service. If support is required or presumed to be required[154] for an extended period of time, the transaction should be accounted for as a financing, leasing, or profit-sharing arrangement. If support is required or presumed to be required for a limited time, a gain on the sale should be recognized on the basis of performance of the services required. Performance of those services should be measured by the costs incurred and to be incurred over the period during which the services are performed. A gain should begin to be recognized when there is reasonable assurance that future rent receipts will cover operating expenses and debt service including payments due the seller under the terms of the transaction. Reasonable assurance that rentals will be adequate would be indicated by objective information regarding occupancy levels and rental rates in the immediate area. In assessing whether rentals will be adequate to justify recognition of a gain, total estimated future rent receipts of the property should be reduced by one-third as a reasonable safety factor unless the amount so computed is less than the rents to be received from signed leases. In this event, the rents from signed leases should be substituted for the computed amount.

311. If the sales contract does not stipulate the period during which the seller is obligated to support operations of the property, support should be presumed for at least two years from the time of initial rental unless actual rental operations cover operating expenses,

[154]Support should be presumed to be required if (a) a seller obtains an interest as a general partner in a limited partnership that acquires an interest in the property sold; (b) a seller retains an equity interest in the property, such as an undivided interest or an equity interest in an entity that holds an interest in the property; (c) a seller holds a receivable from a buyer for a significant part of the sales price and collection of the receivable depends on the operation of the property; or (d) a seller agrees to manage the property for the buyer on terms not usual for the services to be rendered, and the agreement is not terminable by either the seller or the buyer.

debt service, and other contractual commitments before that time. If the seller is contractually obligated for a longer time, gain recognition should continue on the basis of performance until the obligation expires.

312. If the sales contract requires the seller to provide management services relating to the property after the sale without compensation or at compensation less than prevailing rates for the service required (paragraph 288) or on terms not usual for the services to be rendered (footnote 154d), compensation should be imputed when the sale is recognized and should be recognized in revenue as the services are performed over the term of the management contract.

313. *The transaction is merely an option to purchase the property*. For example, undeveloped land may be "sold" under terms that call for a very small initial investment by the buyer and postponement of additional payments until the buyer obtains zoning changes or building permits or other contingencies specified in the sales agreement are satisfactorily resolved. Proceeds from the issuance of the option by a property owner should be accounted for as a deposit (paragraphs 341–343). A gain should not be recognized until the option either expires or is exercised. When an option to purchase real estate is sold by an option holder,[155] the seller of the option should recognize revenue by the cost recovery method (paragraphs 338–340) to the extent nonrefundable cash proceeds exceed the seller's cost of the option if the buyer's initial and continuing investments are not adequate for gain recognition by the full accrual method (paragraphs 288–297).

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[155]When an option to purchase real estate is sold by an option holder, the sales value includes the exercise price of the option and the sales price of the option. For example, if the option is sold for $150,000 ($50,000 cash and a $100,000 note) and the exercise price is $500,000, the sales value is $650,000.

314. *The seller has made a partial sale*. A sale is a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. A gain (the difference between the sales value and the proportionate cost of the partial interest sold) should be recognized at the date of sale if:

a. The buyer is independent of the seller.
b. Collection of the sales price is reasonably assured (paragraph 285).
c. The seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.

315. If the buyer is not independent of the seller, for example, if the seller holds or acquires an equity interest in the buyer, the seller should recognize the part of the gain proportionate to the outside interests in the buyer at the date of sale. If the buyer and seller are part of the same financial reporting entity, the sale should be accounted for as an intra-entity transfer of assets under paragraph 15 of Statement 48.

316. If collection of the sales price is not reasonably assured, the cost recovery or installment method of recognizing a gain should be used.

317. If the seller is required to support the operations of the property after the sale, the accounting should be based on the nature of the support obligation. For example, the seller may retain an interest in the property sold and the buyer may receive preferences as to gains, cash flows, return on investment, and so forth. If the transaction is in substance a sale, the seller should recognize a gain to the extent that proceeds from the sale, including receivables from the buyer, exceed all of the seller's costs related to the entire property. Other examples of support obligations are described in paragraphs 310–312.

318. *The seller sells property improvements and leases the underlying land to the buyer of the improvements*. In these circumstances, the transactions are interdependent and it is

impracticable to distinguish between a gain on the sale of the improvements and a gain under the related lease. The transaction should be accounted for as a lease of both the land and improvements if the term of the land lease to the buyer from the seller of the improvements either (a) does not cover substantially all of the economic life of the property improvements, thus strongly implying that the transaction is in substance a lease of both land and improvements, or (b) is not for a substantial period, for example, 20 years.

319. If the land lease described in paragraph 318 covers substantially all of the economic life of the improvements and extends for at least 20 years, the gain to be recognized on the sale of the improvements at the time of sale should be (a) the present value of the rental payments[156] not in excess of the seller's cost of the land plus (b) the sales value of the improvements minus (c) the carrying value of the improvements and the land. A gain on (1) the buyer's rental payments on the land in excess of the seller's cost of the land and (2) the rent to be received on the land after the maturity of the primary indebtedness on the improvements or other customary amortization term should be recognized when the land is sold or the rents in excess of the seller's cost of the land are accrued under the lease.

320. *The sale of the property is accompanied by a leaseback to the seller of all or any part of the property for all or part of its remaining economic life*. Real estate sale and leaseback transactions should be accounted for in accordance with paragraphs 244–256.

[156]The present value of the specified rental payments is the present value of the lease payments specified in the lease over the term of the primary indebtedness, if any, on the improvements, or over the customary amortization term of primary debt instruments on the type of improvements involved. The present value is computed at an interest rate appropriate for (a) primary debt if the lease is not subordinated or (b) secondary debt if the lease is subordinated to loans with prior liens.

321. *The sales contract or an accompanying agreement requires the seller to develop the property in the future, to construct facilities on the land, or to provide off-site improvements or amenities*. The seller is involved with future development or construction work if the buyer is unable to pay amounts due for that work or has the right under the terms of the arrangement to defer payment until the work is done. If future costs of development can be reasonably estimated at the time of sale, a gain allocable to (a) performance before the sale of the land and (b) the sale of the land should be recognized when the sale of the land meets the criteria in paragraph 286. A gain allocable to performance after the sale should be recognized by the percentage-of-completion method as development and construction proceed, provided that cost and gain can be reasonably estimated from the seller's previous experience.

322. The gain should be allocated to the sale of the land and the later development or construction work on the basis of estimated costs of each activity; the same rate of gain should be attributed to each activity. No gain should be recognized at the time of sale if future costs of development cannot be reasonably estimated at that time.

323. *The seller will participate in future gains from the property without risk of loss (such as participation in operating income or residual values without further obligation)*. If the transaction otherwise qualifies for recognition of gain by the full accrual method, the transfer of risks and rewards of ownership and absence-of-continuing-involvement criterion should be considered met. The contingent future gains should be recognized

when they are realized.[157] All the costs of the sale should be recognized at the time of sale; none should be deferred to periods when the contingent gains are recognized.

Retail Land Sales

324. A single method of recognizing gain should be applied to all sales transactions within a project[158] that have been consummated.[159] That method of recognizing gain should be changed when certain conditions are met for the entire project (paragraph 329).

Recognition of Gain

325. The full accrual method of accounting described in paragraphs 284–299 should be applied to a sale if all of the following conditions are met:

a. *Expiration of refund period*. The buyer has made the down payment and each required subsequent payment until the period of cancellation with refund has expired. That period should be the longest period of those required by local law, established by the seller's policy, or specified in the contract.
b. *Sufficient cumulative payments*. The cumulative payments of principal and interest equal or exceed 10 percent of the contract sales price.
c. *Collectibility of receivables*. Collection experience for the project in which the sale is made or for the seller's prior projects indicates that at least 90 percent of the contracts in the project in which the sale is made that are in force 6 months after the criteria in paragraph 326 are met will be collected in full.[160] The collection experience with the seller's prior projects may be applied to a new project if the prior projects:
   (1) Had predominantly the same characteristics (type of land, environment, clientele, contract terms, sales methods)[161] as the new project.
   (2) Had a sufficiently long collection period to indicate the percentage of current sales of the new project that will be collected to maturity.

   A down payment of at least 20 percent should be an acceptable indication of collectibility.
d. *Nonsubordination of receivables*. The receivable from the sale is not subject to subordination to new loans on the property except that subordination by an

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[157]Paragraph 112 addresses accounting for gain contingencies.

[158]A retail land sales "project" is a homogeneous, reasonably contiguous area of land that may, for development and marketing, be subdivided in accordance with a master plan.

[159]Retail land sales should be considered consummated when all of the criteria in paragraph 327 are met.

[160]The six-month period is solely a test of eligibility for the accrual method and is not intended to restrict the recognition of gain before the six-month period expires.

[161]Examples of sales methods include telephone sales, broker sales, and site-visitation sales.

individual lot buyer for home construction purposes is permissible if the collection experience on those contracts is the same as on contracts not subordinated.

e. *Completion of development*. The seller is not obligated to complete improvements of lots sold or to construct amenities or other facilities applicable to lots sold.

Paragraphs 326–329 specify accounting methods that should be used if the above criteria are not met.

326. The percentage-of-completion method of accounting should be applied to a sale that meets all of the following criteria:

a. *The period of cancellation with refund has expired* (paragraph 325a).
b. *Cumulative payments equal or exceed 10 percent* (paragraph 325b).
c. *Receivables are collectible* (paragraph 325c).
d. *Receivables are not subject to subordination* (paragraph 325d).
e. *There has been progress on improvements*. The project's improvements have progressed beyond preliminary stages, and there are indications that the work will be completed according to plan. Some indications of progress are:
   (1) The disbursement of resources on the proposed improvements
   (2) Initiation of work on the improvements
   (3) Existence of engineering plans and work commitments relating to lots sold
   (4) Completion of access roads and amenities such as golf courses, clubs, and swimming pools.

   In addition, there should be no indication of significant delaying factors, such as the inability to obtain permits, contractors, personnel, or equipment, and estimates of costs to complete and extent of progress toward completion should be reasonably dependable.
f. *Development is practical*. There is a reasonable expectation that the land can be developed for the purposes represented and the properties will be useful for those purposes at the end of the normal payment period. For example, it should be expected that legal restrictions, including environmental restrictions, will not seriously hamper development and that improvements such as access roads, water supply, and sewage treatment or removal are feasible within a reasonable period of time.

Paragraphs 327 and 328 specify accounting methods that should be used if the above criteria are not met.

327. The installment method of accounting described in paragraphs 332–337 should be applied to a sale that meets all of the following criteria:

a. *The period of cancellation with refund has expired* (paragraph 325a).
b. *Cumulative payments equal or exceed 10 percent* (paragraph 325b).
c. *The seller is financially capable.* The seller is clearly capable of providing both land improvements and off-site facilities promised in the contract and of meeting all other representations it has made. It is financially capable of funding or bonding the planned improvements in the project when required. That capability may be indicated by the seller's financial position, its borrowing capacity, or its positive cash flow from operations.

328. If a retail land sale transaction does not meet the criteria for accounting by the methods described in paragraphs 325–327, that transaction should be accounted for as a deposit as described in paragraphs 341–343.

Change from Installment to Percentage-of-Completion Method

329. When all of the conditions in paragraph 326 are satisfied on a retail land sales project originally reported by the installment method, the percentage-of-completion method of accounting may be adopted for the entire project (current and prior sales) and the effect accounted for as a change in accounting estimate.[162]

Disclosures

330. In addition to disclosures otherwise required by GAAP, the financial statements of business-type activities with retail land sales operations should disclose:

a. Maturities of accounts receivable for each of the five years following the date of the financial statements
b. Delinquent accounts receivable and the method(s) for determining delinquency
c. The weighted average and range of stated interest rates of receivables
d. Estimated total costs and estimated dates of outlays for improvements for major areas from which sales are being made over each of the five years following the date of the financial statements
e. Recorded obligations for improvements.

[162]The adjustment to the flows statement resulting from the change is the gain not yet recognized less (a) a discount, if required, to reduce the receivable balances to their present values at the date of change to the percentage-of-completion method (using the appropriate interest rates, as specified in paragraphs 183 and 184, in effect at the time of the original sales) and (b) the liability (also discounted) for remaining future performance.

Description of Certain Methods of Accounting for Real Estate Sales Transactions

331. Paragraphs 331–349 describe several of the methods of gain recognition that are provided for by paragraphs 282–329.

Installment Method

332. The installment method apportions each cash receipt and principal payment by the buyer on debt assumed between cost recovered and gain. The apportionment should be in the same ratio as total cost and total gain bear to the sales value.

333. If the stated interest rate is equal to or less than an appropriate interest rate, the receivable should not be reduced to its present value.

334. Under the installment method, the receivable less the unrecognized gain should not exceed what the property value would have been if the property had not been sold.

335. The notes to the financial statements for the period including the date of sale should disclose the sales value, the unrecognized gain, and the total cost of the sale. Revenue and cost of sales should be reported as separate items on the flows statement[163] or should be disclosed in the notes to the financial statements when a gain is recognized as earned.

336. Paragraph 348 describes accounting for obligations for future improvement costs under the percentage-of-completion method. That description applies as well to accounting for those obligations under the installment method.

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[163]For purposes of applying paragraphs 282–349, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

337. If after adoption of the installment method the transaction meets the requirements for the full accrual method (specified in paragraphs 284–299) for recognizing the gain on real estate sales other than retail land sales, the seller should then change to the full accrual method. The remaining unrecognized gain should be recognized at that time.

Cost Recovery Method

338. Under the cost recovery method, no gain should be recognized until cash payments by the buyer, including principal and interest on debt due to the seller and on existing debt assumed by the buyer, exceed the seller's cost of the property sold.[164] The receivable less the unrecognized gain, if any, should not exceed what the depreciated property value would have been if the property had not been sold.

339. The flows statement for the period including the date of sale should report the sales value, the unrecognized gain, and the total cost of the sale. The unrecognized gain should be offset against the related receivable on the statement of net assets.[165] Principal collections should reduce the related receivable, and interest collections on such receivables should increase the unrecognized gain on the statement of net assets. The gain should be reported as a separate item when it is recognized as earned.

340. If, after the adoption of the cost recovery method, the transaction meets the requirements for the full accrual method specified in paragraphs 284–299, the seller should change to the full accrual method. The remaining unrecognized gain should be recognized at that time.

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[164]For an all-inclusive or "wrap-around" receivable held by the seller, interest collected should be recognized to the extent of, and as an appropriate offset to, interest expense on prior-lien financing for which the seller remains responsible.

[165]For purposes of applying paragraphs 282–349, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

Deposit Method

341. Under the deposit method, the seller should not recognize any gain, should not record notes receivable, should continue to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer, and should disclose that those items are subject to a sales contract. The seller should continue to recognize depreciation expense for the property for which deposits have been received. Cash received from the buyer, including the initial investment and subsequent collections of principal and interest, should be reported as a deposit on the contract except that, for sales that are not retail land sales, portions of cash received that are designated by the contract as interest and are not subject to refund should offset carrying charges (for example, interest on existing debt) on the property. Interest collected that is subject to refund and is included in the deposit account before a sale is consummated should be accounted for as part of the buyer's initial investment (paragraph 288) at the time the sale is consummated.

342. When a contract is canceled without a refund, deposits forfeited should be recognized in the flows statement. When deposits on retail land sales are ultimately recognized as sales, the interest portion should be recognized as interest revenue.

343. The seller should report nonrecourse debt assumed by the buyer among the liabilities; the debt assumed should not be offset against the related property. The seller should report the buyer's principal payments on mortgage debt assumed as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.

Reduced Gain Method

344. A reduced gain should be determined by discounting the receivable from the buyer to the present value of the lowest level of annual payments required by the sales contract

over the maximum period specified in paragraph 293 and excluding requirements to pay lump sums. The present value should be calculated using an appropriate interest rate,[166] but not less than the rate stated in the sales contract.

Full Accrual Method—Retail Land Sales

345. Revenues and costs should be accounted for under the full accrual method as follows:

a. The net receivable should be discounted to the present value of the payments required. The present value should be determined using an appropriate interest rate,[167] not less than the rate stated in the sales contract.
b. An allowance should be provided for receivables that are not expected to be collected because of cancellation in subsequent periods. Receivable balances applicable to canceled contracts should be charged in their entirety to the allowance for contract cancellations when those contracts are canceled.
c. Costs of sales (land and improvement costs incurred, carrying costs, and so forth) should be based on sales net of those sales expected to be canceled in future periods.

Percentage-of-Completion Method—Retail Land Sales

346. The amount of revenue recognized (the discounted contract price) at the time a sale is recognized should be measured by the relationship of costs already incurred to total estimated costs to be incurred, including costs of the marketing effort. If performance[168] is incomplete, the portion of revenue related to costs not yet incurred should be recognized as the costs are incurred.

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[166]See footnote 150.

[167]See footnote 150.

[168]*Performance* means completion of the improvements required under the sales contract by either the seller or contractors retained by the seller. However, payments made to municipalities or other governmental organizations not in the reporting entity of the seller or a joint venture in which the seller participates constitute performance by the seller if those organizations are not financed solely by liens on property in the project and they undertake to complete the improvements without further risk or obligation of the seller.

347. The costs already incurred and total costs to be incurred should include land cost, costs previously charged to expense, such as interest and project carrying costs incurred prior to sale, and selling costs[169] directly associated with a project.

348. If there is an obligation for future improvement costs that is recognized under the percentage-of-completion method:

a. Estimates should be based on costs generally expected in the construction industry locally.
b. Unrecoverable costs of off-site improvements, utilities, and amenities should be provided for. In determining the amount of unrecoverable costs, estimates of amounts to be recovered from future sale of the improvements, utilities, and amenities should be discounted to present value as of the date the net unrecoverable costs are recognized.

349. Estimates of future improvement costs should be reviewed at least annually. Changes in those estimates should not lead to adjustment of revenue applicable to future improvements that has been previously recorded unless the adjusted total estimated cost exceeds the applicable revenue. When cost estimates are revised, the relationship of the two elements included in the unrecognized revenue, costs and gain, should be recalculated on a cumulative basis to determine future revenue recognition as performance takes place. If the adjusted total estimated cost exceeds the applicable revenue previously recognized, the total anticipated loss should be recognized when it meets the criteria in paragraph 102. When anticipated losses on lots sold are recognized, the business-type activity also should consider recognizing a loss on land and improvements not yet sold.

Costs and Initial Rental Operations of Real Estate Projects

350. Paragraphs 350–373 establish accounting and reporting standards for acquisition, development, construction, selling, and rental costs associated with real estate projects.

[169]Accounting for selling costs is addressed in paragraphs 350–373.

Those paragraphs also provide guidance for the accounting for initial rental operations and criteria for determining when a rental project is substantially completed and held available for occupancy.

351. Paragraphs 350–373 do not apply to:

a. Real estate developed by a government for use in its own operations,[170] other than for sale or rental
b. "Initial direct costs" of sales-type, operating, and other types of leases, which are defined in and accounted for under the provisions of paragraphs 211–271
c. Costs directly related to service activities as distinguished from real estate activities.

Paragraphs 368–371 do not apply to real estate rental activity in which the predominant rental period is less than one month.

352. Paragraphs 353–372 specify the accounting for the following as they relate to real estate projects: (a) **preacquisition costs,**[171] (b) insurance, (c) **project costs,** (d) **amenities,** (e) **incidental operations,** (f) allocation of capitalized costs to components of a real estate project, (g) revisions of estimates, (h) abandonments and changes in use, (i) selling costs, (j) rental costs, and (k) costs in excess of estimated **net realizable value.**

Acquisition, Development, and Construction Costs

Preacquisition Costs

353. Payments to obtain an option to acquire real property should be capitalized as incurred. All other costs related to a property that are incurred before the government acquires the property, or before the government obtains an option to acquire it, should be

[170]In this context, *real estate developed by a government for use in its own operations* includes real estate developed by a component unit in a reporting entity for use in the operations of another organization in the same reporting entity (for example, a facility developed by a state building authority for a state university, when both are component units of the state's reporting entity).

[171]Terms defined in the glossary (see paragraph 373) are shown in **boldface type** the first time they appear in paragraphs 352–372.

capitalized if all of the following conditions are met and otherwise should be charged to expense as incurred:

a. The costs are directly identifiable with the specific property.
b. The costs would be capitalized if the property already were acquired.
c. Acquisition of the property or of an option to acquire the property is probable.[172]
d. This condition requires that the prospective purchaser is actively seeking to acquire the property and has the ability to finance or obtain financing for the acquisition and that there is no indication that the property is not available for sale.

354. Capitalized preacquisition costs (a) should be included as project costs upon the acquisition of the property or (b) to the extent not recoverable by the sale of the options, plans, etc., should be charged to expense when it is probable that the property will not be acquired.

Insurance

355. Costs incurred on real estate for insurance should be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress.[173] Costs incurred for such items after the property is substantially complete and ready for its intended use[174] should be charged to expense as incurred.

Project Costs

356. Project costs clearly associated with the acquisition, development, and construction of a real estate project should be capitalized as a cost of that project. **Indirect project costs** that relate to several projects should be capitalized and allocated to the projects to which the costs relate. Indirect costs that do not clearly relate to projects under

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[172]*Probable* is defined in paragraph 100 as "likely to occur" and is used in the same sense in paragraphs 350–373.

[173]The phrase *activities necessary to get the property ready for its intended use are in progress* is used here with the same meaning as it has for interest capitalization in paragraph 16.

[174]The phrase *substantially complete and ready for its intended use* is used here with the same meaning as it has for interest capitalization in paragraph 17.

development or construction, including general and administrative expenses, should be charged to expense as incurred.

Amenities

357. Accounting for costs of amenities should be based on management's plans for the amenities in accordance with the following:

a. If an amenity is to be sold or transferred in connection with the sale of individual units, costs in excess of anticipated proceeds should be allocated as **common costs** because the amenity is clearly associated with the development and sale of the project. The common costs include expected future operating costs to be borne by the developer until they are assumed by buyers of units in a project.
b. If an amenity is to be sold separately or retained by the developer, capitalizable costs of the amenity in excess of its estimated **fair value** as of the expected date of its substantial physical completion should be allocated as common costs. For the purpose of determining the amount to be capitalized as common costs, the amount of cost previously allocated to the amenity should not be revised after the amenity is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value as of the date of substantial physical completion, less any accumulated depreciation, results in a gain or loss that should be recognized in the period in which the sale occurs.

Costs of amenities should be allocated among land parcels[175] benefited and for which development is probable.

358. Before an amenity is substantially completed and available for use, operating income (or loss) of the amenity should be included as a reduction of (or an addition to) common costs. When an amenity to be sold separately or retained by the developer is substantially completed and available for use, current operating income and expenses of the amenity should be included in current operating results.

Incidental Operations

359. **Incremental revenue from incidental operations** in excess of **incremental costs of incidental operations** should be accounted for as a reduction of capitalized project

[175] A land parcel may be considered to be an individual lot or unit, an amenity, or a **phase.**

costs. Incremental costs in excess of incremental revenue should be charged to expense as incurred, because the incidental operations did not achieve the objective of reducing the costs of developing the property for its intended use.

Allocation of Capitalized Costs to the Components of a Real Estate Project

360. The capitalized costs of real estate projects should be assigned to individual components of the project based on specific identification. If specific identification is not practicable, capitalized costs should be allocated as follows:

a. Land cost and all other common costs[176] (prior to construction) should be allocated to each land parcel benefited. Allocation should be based on the **relative fair value before construction.**
b. Construction costs should be allocated to individual units in the phase on the basis of relative sales value of each unit.

If allocation based on relative value also is impracticable, capitalized costs should be allocated based on area methods (for example, square footage) or other value methods as appropriate under the circumstances.

Revisions of Estimates

361. Estimates and cost allocations should be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Costs should be revised and reallocated as necessary for changes on the basis of current estimates.[177] Changes in estimates should be reported in accordance with paragraph 83.

Donations and Changes in Use

362. Real estate donated to other entities for uses that will benefit the project should be allocated as a common cost of the project.

[176]These include the costs of amenities to be allocated as common costs (paragraphs 357 and 358).

[177]Paragraph 349 discusses revisions of estimates relating to retail land sales accounted for by the percentage-of-completion method.

363. Changes in the use of real estate comprising a project or a portion of a project may arise after significant development and construction costs have been incurred. If the change in use is made pursuant to a formal plan for a project that is expected to produce a higher economic yield (as compared to its yield based on use before the change), the development and construction costs to be charged to expense should be limited to the amount by which the capitalized costs incurred and to be incurred exceed the estimated value of the revised project when it is substantially complete and ready for its intended use.

364. In the absence of a formal plan for a project that is expected to produce a higher economic yield, the project costs to be charged to expense should be limited to the amount by which total project costs exceed the estimated net realizable value of the property determined on the assumption it will be sold in its present state.

Costs Incurred to Sell and Rent Real Estate Projects, Including Initial Rental Operations

Costs Incurred to Sell Real Estate Projects

365. **Costs incurred to sell real estate projects** should be capitalized if they (a) are reasonably expected to be recovered from the sale of the project or from incidental operations and (b) are incurred for (1) tangible assets that are used directly throughout the selling period to aid in the sale of the project or (2) services that have been performed to obtain regulatory approval of sales. Examples of costs incurred to sell real estate projects that generally meet the criteria for capitalization are costs of model units and their furnishings, sales facilities, legal fees for preparation of prospectuses, and semipermanent signs.

366. Other costs incurred to sell real estate projects should be capitalized as prepaid costs if they are directly associated with and their recovery is reasonably expected from sales that are being accounted for under a method other than full accrual.[178] Costs that do not meet the criteria for capitalization should be expensed as incurred.

367. Capitalized selling costs should be charged to expense in the period in which the related revenue is recognized as earned. When a sales contract is canceled (with or without refund) or the related receivable is written off as uncollectible, the related unrecoverable capitalized selling costs should be charged to expense or an allowance previously established for that purpose.

Costs Incurred to Rent Real Estate Projects

368. If **costs incurred to rent real estate projects,** other than initial direct costs,[179] under operating leases are related to and their recovery is reasonably expected from future rental operations, they should be capitalized. Examples of such costs are costs of model units and their furnishings, rental facilities, semipermanent signs, "grand openings," and unused rental brochures. Costs that do not meet the criteria for capitalization should be expensed as incurred, for example, rental overhead.

369. Capitalized rental costs directly related to revenue from a specific operating lease should be amortized over the lease term. Capitalized rental costs not directly related to revenue from a specific operating lease should be amortized over the period of expected benefit. The amortization period should begin when the project is substantially completed

[178]Paragraphs 282–349 discuss the circumstances under which the appropriate methods are to be applied, including the full accrual method.

[179]*Initial direct costs* is defined in and accounted for under the provisions of paragraphs 211–271.

and held available for occupancy.[180] Estimated unrecoverable amounts of unamortized capitalized rental costs associated with a lease or group of leases should be charged to expense when it becomes probable that the lease(s) will be terminated.

Initial Rental Operations

370. When a real estate project is substantially completed and held available for occupancy, rental revenues and operating costs should be recognized as they accrue, all carrying costs should be charged to expense when incurred, depreciation on the cost of the project should be provided, and costs to rent the project should be amortized in accordance with paragraph 369. 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 one year from cessation of major construction activity (as distinguished from activities such as routine maintenance and cleanup).

371. If portions of a rental project are substantially completed and occupied by tenants or held available for occupancy and other portions have not yet reached that stage, the substantially completed portions should be accounted for as a separate project. Costs incurred should be allocated between the portions under construction and the portions substantially completed and held available for occupancy.

Recoverability

372. The carrying amount of a real estate project, or parts thereof, held for sale or development and sale should not exceed net realizable value. If costs exceed net realizable value, capitalization of costs associated with development and construction of a property should not cease; rather, an allowance should be provided to reduce the carrying amount

[180] Refer to paragraph 370 for the definition of *substantially completed and held available for occupancy*.

to estimated net realizable value, determined on the basis of an evaluation of individual projects. An individual project, for this purpose, consists of components that are relatively homogeneous, integral parts of a whole (for example, individual houses in a residential tract, individual units in a condominium complex, and individual lots in a subdivision and amenities). Therefore, a multiphase development consisting of a tract of single-family houses, a condominium complex, and a lot subdivision generally would be evaluated as three separate projects.

Glossary

373. This paragraph contains definitions of certain terms *as they are used in paragraphs 352–372;* the terms may have different meaning in other contexts.

Amenities

Examples of amenities include golf courses, utility plants, clubhouses, swimming pools, tennis courts, indoor recreational facilities, and parking facilities.

Common Costs

Costs that relate to two or more units within a real estate project.

Costs Incurred to Rent Real Estate Projects

Examples of such costs include costs of model units and their furnishings, rental facilities, semipermanent signs, rental brochures, advertising, “grand openings,” and rental overhead including rental salaries.

Costs Incurred to Sell Real Estate Projects

Examples of such costs include costs of model units and their furnishings, sales facilities, sales brochures, legal fees for preparation of prospectuses, semipermanent signs, advertising, “grand openings,” and sales overhead including sales salaries.

Fair Value

The amount in cash or cash equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (selling price), that is, other than in a forced or liquidation sale. The fair value of a parcel is affected by its physical characteristics, its probable ultimate use, and the time required for the buyer to make such use of the property considering access, development plans, zoning restrictions, and market absorption factors.

Incidental Operations

Revenue-producing activities engaged in during the holding or development period to reduce the cost of developing the property for its intended use, as distinguished from activities designed to generate income or a return from the use of the property.

Incremental Costs of Incidental Operations

Costs that would not be incurred except in relation to the conduct of incidental operations. Interest, insurance, security, and similar costs that would be incurred during the development of a real estate project regardless of whether incidental operations were conducted are not incremental costs.

Incremental Revenues from Incidental Operations

Revenues that would not be produced except in relation to the conduct of incidental operations.

Indirect Project Costs

Costs incurred after the acquisition of the property, such as construction administration (for example, the costs associated with a field office at a project site and the administrative personnel that staff the office), legal fees, and various office costs, that clearly relate to projects under development or construction. Examples of office costs that may be considered indirect project costs are cost accounting, design, and other departments providing services that are clearly related to real estate projects.

Net Realizable Value

The estimated selling price in the ordinary course of operations less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal.

Phase

A parcel on which units are to be constructed concurrently.

Preacquisition Costs

Costs related to a property that are incurred for the express purpose of, but prior to, obtaining that property. Examples of preacquisition costs may be costs of surveying, zoning or traffic studies, or payments to obtain an option on the property.

Project Costs

Costs clearly associated with the acquisition, development, and construction of a real estate project.

Relative Fair Value before Construction

The fair value of each land parcel in a real estate project in relation to the fair value of the other parcels in the project, exclusive of value added by on-site development and construction activities.

Research and Development Arrangements

374. Paragraphs 374–384 establish standards of accounting and financial reporting for a government that is a party to a research and development arrangement through which it can obtain the results of research and development funded partially or entirely by others. Those paragraphs apply whether the research and development is performed by the

government, the funding parties, or a third party. Paragraphs 374–384 only apply to research and development arrangements that are exchange or exchange-like transactions. Also, those paragraphs do not apply to government-sponsored research and development arrangements.

375. A government should determine the nature of the obligation it incurs when it enters into an arrangement with other parties who fund its research and development. The factors discussed in paragraphs 376–382 and other factors that may be present and relevant to a particular arrangement should be considered when determining the nature of the government's obligation.

Obligation Is a Liability to Repay the Other Parties

376. If the government is obligated to repay any of the resources provided by the other parties regardless of the outcome of the research and development, the government should estimate and recognize that liability. This requirement applies whether the government may settle the liability by paying cash or by some other means.

377. To conclude that a liability does not exist, the transfer of the financial risk involved with research and development from the government to the other parties should be substantive and genuine. To the extent that the government is committed to repay any of the resources provided by the other parties regardless of the outcome of the research and development, all or part of the risk has not been transferred. The following are some examples in which the government is committed to repay:

a. The government guarantees, or has a contractual commitment that assures, repayment of the resources provided by the other parties regardless of the outcome of the research and development.
b. The other parties can require the government to purchase their interest in the research and development regardless of the outcome.

378. Even though the written agreements or contracts under the arrangement do not require the government to repay any of the resources provided by the other parties, surrounding conditions might indicate that the government is likely to bear the risk of failure of the research and development. If those conditions suggest that it is probable[181] that the government will repay any of the resources regardless of the outcome of the research and development, there is a presumption that the government has an obligation to repay the other parties. That presumption can be overcome only by substantial evidence to the contrary.

379. Examples of conditions leading to the presumption that the government will repay the other parties include the following:

a. The government has indicated an intent to repay all or a portion of the resources provided regardless of the outcome of the research and development.
b. A significant related party[182] relationship between the government and the parties funding the research and development exists at the time the government enters into the arrangement.
c. The government has essentially completed the project before entering into the arrangement.

380. A government that incurs a liability to repay the other parties should capitalize or recognize as an expense, as appropriate, the research and development costs[183] as incurred. The amount of resources provided by the other parties might exceed the government's liability. That might be the case, for example, if license agreements or partial buy-out provisions permit the government to use the results of the research and development or to reacquire certain basic technology or other assets for an amount that is less than the resources provided. Those agreements or provisions might limit the extent to which the

[181]*Probable* is used here consistent with its use in paragraph 100 to mean that repayment is likely.

[182]*Related parties* is defined in paragraphs 54–57.

[183]Governments should apply the requirements in Statement No. 51, *Accounting and Financial Reporting for Intangible Assets,* where appropriate, for capitalization or expense of research and development costs.

government is economically compelled to buy out the other parties regardless of the outcome. In those situations, the liability to repay the other parties might be limited to a specified price for licensing the results or for purchasing a partial interest in the results. If the government's liability is less than the resources provided, the government should capitalize or recognize as an expense, as appropriate, its portion of the research and development costs[184] in the same manner as the liability is incurred. For example, the liability might arise as the initial resources are expended, or the liability might arise on a pro rata basis.

Obligation Is to Perform Contractual Services

381. To the extent that the financial risk associated with the research and development has been transferred because repayment of any of the resources provided by the other parties depends solely on the results of the research and development having future economic benefit, the government should account for its obligation as a contract to perform research and development for others.

382. If the government's obligation is to perform research and development for others and the government subsequently decides to exercise an option to purchase the other parties' interests in the research and development arrangement or to obtain the exclusive rights to the results of the research and development, the nature of those results and their future use should determine the accounting for the purchase transaction.

Loan or Advance to the Other Parties

383. If repayment to the government of any loan or advance by the government to the other parties depends solely on the results of the research and development having future

[184]See footnote 183.

economic benefit, the loan or advance should be accounted for as costs incurred by the government. The costs should be capitalized or recognized as an expense, as appropriate, as research and development costs[185] unless the loan or advance to the other parties can be identified as relating to some other activity, for example, marketing or advertising, in which case the costs should be accounted for according to their nature.

Disclosure

384. A government that under the provisions of paragraphs 374–383 accounts for its obligation under a research and development arrangement as a contract to perform research and development for others should disclose[186] the following:[187]

a. The terms of significant agreements under the research and development arrangement (including royalty arrangements, purchase provisions, license agreements, and commitments to provide additional funding) as of the date of the financial statements
b. The amount of compensation earned and costs incurred under such contracts for each period for which financial statements are presented.

Broadcasters

385. Paragraphs 385–388 address accounting and financial reporting standards for **broadcasters.**[188]

License Agreements for Program Material

Financial Statement Presentation

386. A licensee should report the asset and liability for a broadcast license agreement either (a) at the present value of the liability calculated in accordance with the provisions

[185]See footnote 183.

[186]Paragraphs 54–57 specify additional disclosure requirements for related party transactions and certain relationships.

[187]A government that is a party to more than one research and development arrangement need not separately disclose each arrangement unless separate disclosure is necessary to understand the effects on the financial statements. Aggregation of similar arrangements by type may be appropriate.

[188]Terms defined in the glossary (see paragraph 388) are shown in **boldface type** the first time they appear in paragraphs 385–387.

of paragraphs 173–187 or (b) at the gross amount of the liability. If the present value approach is used, the difference between the gross and net liability should be accounted for as interest in accordance with paragraphs 173–187.

Barter Transactions

387. Broadcasters may **barter** unsold advertising time for products or services. All barter transactions except those involving the exchange of advertising time for network programming[189] should be reported at the estimated fair value of the product or service received, in accordance with the provisions of paragraph 278. Barter revenue should be reported when commercials are broadcast, and merchandise or services received should be reported when received or used. If merchandise or services are received prior to the broadcast of the commercial, a liability should be reported. Likewise, if the commercial is broadcast first, a receivable should be reported.

Glossary

388. This paragraph contains definitions of certain terms *as they are used in paragraphs 385–387;* the terms may have different meanings in other contexts.

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.

[189]As the definition of **network affiliation agreement** in the glossary to paragraphs 385–387 describes in further detail, a network affiliate does not incur program costs for network programming it carries; likewise, it does not sell the related advertising time but instead receives compensation from the network.

Broadcaster

An entity or an affiliated group of entities that transmits radio or television 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, generally are lower for a network affiliate than for an independent station because an affiliate does not incur program costs for network programs.

Cable Television Systems

389. Paragraphs 389–399 establish financial accounting and reporting standards for certain transactions related to governments operating cable television systems.

Prematurity Period

390. Before revenue is earned from the first subscriber, management should establish the beginning and end of the **prematurity period**,[190] subject to a presumption that the prematurity period usually will not exceed two years. The prematurity period frequently will be shorter than two years; a longer period may be reasonably justified only in major urban markets. After the prematurity period is established by management, it should not be changed except as a result of highly unusual circumstances.

[190]Terms defined in the glossary (see paragraph 399) are shown in **boldface type** the first time they appear in paragraphs 390–398.

391. A portion of a cable television system that is in the prematurity period and can be clearly distinguished from the remainder of the system should be accounted for separately. Such a portion would have most of the following characteristics:

a. Geographical differences, such as coverage of a noncontiguous or separately awarded franchise area
b. Mechanical differences, such as a separate head-end[191]
c. Timing differences, such as starting construction or marketing at a significantly later date
d. Investment decision differences, such as separate break-even and return-on-investment analyses or separate approval of start of construction
e. Separate accounting records, separate budgets and forecasts, or other accountability differences.

Costs incurred by the remainder of the system should be charged to the portion in the prematurity period only if they are specifically identified with the operations of that portion.

392. During the prematurity period:

a. Costs of cable television plant, including materials, direct labor, and construction overhead should continue to be capitalized in full.
b. **Subscriber-related costs** and general and administrative expenses should be expensed as period costs.
c. Programming costs and other system costs[192] that are incurred in anticipation of servicing a fully operating system and that will not vary significantly regardless of the number of subscribers should be allocated between current and future operations. The proportion attributable to current operations should be expensed currently and the remainder should be capitalized. The amount to be expensed currently should be determined by multiplying the total of such costs for the month by the fraction described in paragraph 396 determined for that month.

393. The following fraction should be determined each month of the prematurity period. The denominator of the fraction should be the total number of subscribers expected at the end of the prematurity period. The numerator of the fraction should be the greatest of (a)

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[191]Refer to paragraph 399 for a description of *head-end* in the definition of **cable television plant.**

[192]Those costs include 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 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 (that is, straight-line) monthly progress in adding new subscribers toward the estimate of subscribers at the end of the prematurity period, and (c) the average number of actual subscribers.

394. During the prematurity period, depreciation and amortization expense should be determined by multiplying (a) the monthly depreciation and amortization of total capitalized costs expected on completion of the prematurity period by (b) the fraction described in paragraph 393, using the depreciation method that will be applied by the government after the prematurity period.

395. The amount of interest cost that is capitalized during the prematurity period should be determined by applying an interest capitalization rate determined in accordance with paragraphs 12 and 13 to the average amount of qualifying assets[193] for the system during the period. Qualifying assets should be determined in accordance with the guidance in paragraphs 15 and 17. The amount of interest cost capitalized should not exceed the total amount of interest cost incurred by the cable television system in that period.

Depreciation of Capitalized Costs

396. Costs that have been capitalized in accordance with paragraph 392c should be depreciated over the same period used to depreciate the main cable television plant.

[193]During the prematurity period, a portion of the system is in use in the earnings activity of the government and is not eligible for interest capitalization. The portion of the cost of the system that represents a qualifying asset is the amount of accumulated disbursements in excess of the fraction specified in paragraph 393 of the total estimated cost of the system at the end of the prematurity period.

Hookup Revenue and Costs

397. Initial hookup revenue should be recognized as revenue to the extent of **direct selling costs**[194] incurred. The remainder should be deferred and amortized to revenue over the estimated average period that subscribers are expected to remain connected to the system.

398. Initial subscriber installation costs, including material, labor, and overhead costs of the drop,[195] should be capitalized and depreciated over a period no longer than the depreciation period used for a cable television plant. The costs of subsequently disconnecting and reconnecting should be charged to expense.

Glossary

399. This paragraph contains definitions of certain terms *as they are used in paragraphs 390–398;* the terms may have different meanings in other contexts.

Cable Television Plant

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

a. *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.
b. *Cable*—This consists of cable and amplifiers (which maintain the quality of the signal) covering the subscriber area, either on utility poles or underground.
c. *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.
d. *Converters and descramblers*—These devices are attached to the subscriber's television sets when special services are provided, such as "pay cable" or 2-way communication.

[194]Such costs are subscriber-related costs that are expensed in accordance with paragraph 392b.

[195]Refer to paragraph 399 for a description of *drop* in the definition of *cable television plant*.

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.

Prematurity Period

During the prematurity period, the cable television system is partially under construction and partially in service. The prematurity period begins with the first earned subscriber revenue. Its end will vary with circumstances of the system but will be determined based on plans for completion of the first major construction period[196] or achievement of a specified predetermined subscriber level at which no additional investment will be required other than for cable television plants. The length of the prematurity period varies with the franchise development and construction plans. Such plans may consist of:

a. Small franchise that is characterized by the absence of a free television signal and a short construction period. The entire system is "energized" at one time near the end of the construction period.
b. Medium-sized franchise that is characterized by some direct competition from free television and by a more extensive geographical franchise area lending itself to incremental construction. Some parts of the system are "energized" as construction progresses.
c. Large metropolitan franchise that is characterized by heavy direct competition from free television and fringe area signal inadequacy, high cost, and difficult construction. Many parts of the system are "energized" as construction progresses.

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[196]The construction period of a cable television system varies with the size of the franchise area, density of population, and difficulty of physical construction. The construction period is not completed until the head-end, main cable, and distribution cables are installed, and includes a reasonable time to provide for installation of subscriber drops and related hardware. During the construction period, many system operators complete installation of drops and begin to provide service to some subscribers in some parts of the system while construction continues. Providing the signal for the first time is referred to as "energizing" the system.

Except in the smallest systems, programming is usually delivered to portions of the system, and some revenues are obtained before construction of the entire system is complete. Thus, virtually every cable television system experiences a prematurity period during which it is receiving some revenue while continuing to incur substantial costs related to the establishment of the total system.

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.

Insurance Entities—Other Than Public Entity Risk Pools

400. Paragraphs 400–430 establish accounting and financial reporting of short-duration insurance contracts underwritten by insurance entities other than public entity risk pools. Those paragraphs also do not apply to insurance contracts to the extent that they are underwritten for the purpose of providing coverage for retiree healthcare and other postemployment benefits of state and local governments.

General Principles

401. Insurance contracts, for purposes of applying paragraphs 400–430, should be classified as short-duration if the contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions

of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

402. Examples of short-duration contracts include most property and liability insurance contracts and workers' compensation programs, as well as certain government credit enhancement and mortgage guaranty contracts. Accident and health insurance contracts may be short-duration or long-duration depending on whether the contracts are expected to remain in force[197] for an extended period. For example, individual and **group insurance**[198] contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.

403. Premiums from short-duration insurance contracts should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A **liability for unpaid claims** (including estimates of costs for **claims** relating to insured events that have occurred but have not been reported to the insurer) and a **liability for claim adjustment expenses** should be accrued when insured events occur.

404. Costs that vary with and are primarily related to the acquisition of insurance contracts (**acquisition costs**) should be capitalized and charged to expense in proportion to premium revenue recognized. Other costs incurred during the period, such as those relating to investments, general administration, and policy **maintenance,** should be charged to expense as incurred.

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[197]*In force* refers to the period of coverage, that is, the period during which the occurrence of insured events can result in liabilities of the insurance enterprise.

[198]Terms defined in the glossary (see paragraph 430) are shown in **boldface type** the first time they appear in paragraphs 402–429.

Premium Revenue Recognition

405. Premiums from short-duration contracts generally should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums should be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

406. If premiums are subject to adjustment (for example, retrospectively rated or other experience-rated insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue should be recognized as follows:

a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the period of the contract. The estimated ultimate premium should be revised to reflect current experience.
b. If the ultimate premium cannot be reasonably estimated, the **cost recovery method** or the **deposit method** may be used until the ultimate premium becomes reasonably estimable.

Claim Cost Recognition

407. A liability for unpaid claim costs relating to insurance contracts, including estimates of costs relating to **incurred but not reported claims,** should be accrued when insured events occur.

408. The liability for unpaid claims should be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience.[199] Changes in estimates of claim costs resulting from the continuous review process and 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 on unsettled claims, such as **salvage, subrogation,** or a potential ownership interest in real estate, should be evaluated in terms of their estimated realizable value and deducted from the liability for unpaid claims. Estimated recoveries on settled claims other than mortgage guaranty claims also should be deducted from the liability for unpaid claims.

409. Real estate acquired in settling mortgage guaranty claims should be reported at fair value, that is, the amount that reasonably could be expected to be received in a current sale between a willing buyer and a willing seller, other than in a forced or liquidation sale. If no market price is available, the expected cash flows (anticipated sales price less maintenance and selling costs of the real estate) may aid in estimating fair value. Real estate acquired in settling claims should be separately reported in the statement of net assets[200] and should not be classified as an investment. Subsequent reductions in the reported amount and realized gains and losses on the sale of real estate acquired in settling claims should be recognized as an adjustment to claim costs incurred.

[199]Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 429c).

[200]For purposes of applying paragraphs 400–430, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

410. A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (**claim adjustment expenses**) should be accrued when the related liability for unpaid claims is accrued. Claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Claim adjustment expenses also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function.

Costs Other Than Those Relating to Claims

411. Costs incurred during the period, such as those relating to investments, general administration, and policy maintenance, that do not vary with and are not primarily related to the acquisition of new and renewal insurance contracts should be charged to expense as incurred.

Acquisition Costs

412. Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred should be considered acquisition costs.

413. Acquisition costs should be capitalized and charged to expense in proportion to premium revenue recognized. To associate acquisition costs with related premium revenue, acquisition costs should be allocated by groupings of insurance contracts

consistent with the entity's manner of acquiring, servicing, and measuring the gains on its insurance contracts. Unamortized acquisition costs should be classified as an asset.

414. If acquisition costs for short-duration contracts are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once determined, should be applied to applicable unearned premiums throughout the period of the contracts.

Premium Deficiency

415. A probable loss on insurance contracts exists if there is a premium deficiency relating to insurance contracts. Insurance contracts should be grouped consistent with the entity's manner of acquiring, servicing, and measuring the gains on its insurance contracts to determine if a premium deficiency exists.

416. A premium deficiency should be recognized if the sum of expected claim costs and claim adjustment expenses, expected **dividends to policyholders,** and unamortized acquisition costs exceeds related unearned premiums.[201]

417. A premium deficiency should first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability should be accrued for the excess deficiency. Deficiencies in excess of unamortized acquisition costs should be recognized as a premium deficiency liability as of the date of the financial statements and as a premium deficiency expense. The premium deficiency liability should

[201]Disclosure is required regarding whether the insurance enterprise considers anticipated investment revenue in determining if a premium deficiency exists (paragraph 429d).

be adjusted in future periods as expected costs become incurred so that no premium deficiency liability remains at the end of the period covered by the contracts.

Reinsurance

418. Amounts that are recoverable from reinsurers and that relate to paid claims and claim adjustment expenses should be classified as assets, with an allowance for estimated uncollectible amounts. Estimated amounts recoverable from reinsurers that relate to the liabilities for unpaid claims and claim adjustment expenses should be deducted from those liabilities. Ceded unearned premiums should be netted with related unearned premiums. Receivables and payables from the same reinsurer, including amounts withheld, also should be netted. **Reinsurance** premiums ceded and reinsurance recoveries on claims may be netted against related earned premiums and incurred claim costs in the flows statement.[202]

419. Proceeds from reinsurance transactions that represent recovery of acquisition costs should reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized (paragraph 413). If the government has agreed to service all of the related insurance contracts without reasonable compensation, a liability should be accrued for estimated excess future servicing costs under the reinsurance contract. The net cost to the assuming government should be accounted for as an acquisition cost.

420. To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the government by the reinsurer against loss or liability, the premium

[202]For purposes of applying paragraphs 400–430, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

paid less the premium to be retained by the reinsurer should be accounted for as a deposit by the government. 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 government is a deposit, the amount paid should be accounted for as such. A net credit resulting from the contract should be reported as a liability by the government. A net charge resulting from the contract should be reported as an asset by the reinsurer.

Policyholder Dividends

421. Policyholder dividends should be accrued using an estimate of the amount to be paid.

422. Dividends declared or paid to participating policyholders should reduce that liability; dividends declared or paid in excess of the liability should be expensed.

Retrospective and Contingent Commission Arrangements

423. If retrospective commission or experience refund arrangements exist under experience-rated insurance contracts, a separate liability should be accrued for those amounts, based on experience and the provisions of the contract. Revenue in any period should not include any amounts that are expected to be paid to agents or others in the form of experience refunds or additional commissions. Contingent commissions receivable or payable should be accrued over the period in which the related revenue is recognized.

Investments

424. Mortgage loans should be reported at outstanding principal balances if acquired at par value, or at amortized cost if purchased at a discount or premium, with an allowance for estimated uncollectible amounts, if any. Amortization and other related charges or credits should be charged or credited to investment revenue. Changes in the allowance for

estimated uncollectible amounts relating to mortgage loans should be included in realized gains and losses.

425. Real estate investments should be reported at cost less accumulated depreciation and an allowance for any impairment in value. Depreciation and other related charges or credits should be charged or credited to investment revenue. Changes in the allowance for any impairment in value relating to real estate investments should be included in realized gains and losses.

426. Loan origination and commitment fees and direct loan origination costs should be accounted for as prescribed in paragraphs 431–451.

427. All investment revenue, including changes in fair value of investments, should be reported in the flows statement, recognized in accordance with Statement 31, paragraph 13.[203]

Real Estate Used in Operations

428. Real estate should be classified either as an investment or as real estate used in operations, depending on its predominant use. Depreciation and other real estate operating costs should be classified as investment expenses or operating expenses consistent with the statement of net assets classification of the related asset. Imputed investment revenue and rental expense should not be recognized for real estate used in operations.

Disclosures

429. Insurance entities other than public entity risk pools should disclose the following in their financial statements:

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[203]Losses on private-placement bonds should be accrued when both conditions in paragraph 102 are met.

a. The basis for estimating the liabilities for unpaid claims and claim adjustment expenses
b. The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period
c. The carrying amount of liabilities for unpaid claims and claim adjustment expenses relating to contracts that are presented at present value in the financial statements and the range of interest rates used to discount those liabilities
d. Whether the insurance enterprise considers anticipated investment revenue in determining if a premium deficiency exists
e. The nature and significance of reinsurance transactions to the insurance enterprise's operations, including reinsurance premiums assumed and ceded, and estimated amounts that are recoverable from reinsurers and that reduce the liabilities for unpaid claims and claim adjustment expenses
f. The relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional revenue allocated to participating policyholders.

Glossary

430. This paragraph contains definitions of certain terms *as they are used in paragraphs 402–429;* the terms may have different meanings in other contexts.

Acquisition Costs

Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

Claim

A demand for payment of a policy benefit because of the occurrence of an insured event, such as the death or disability of the insured; the incurrence of hospital or medical bills; the destruction or damage of property and related deaths or injuries; defects in or liens on real estate; or the occurrence of a surety loss.

Claim Adjustment Expenses

Expenses incurred in the course of investigating and settling claims. Claim adjustment expenses include any legal and adjusters' fees, and the costs of paying claims and all related expenses.

Cost Recovery Method

Under the cost recovery method, premiums are recognized as revenue in an amount equal to estimated claim costs as insured events occur until the ultimate premium is reasonably estimable, and recognition of revenue is postponed until that time.

Deposit Method

Under the deposit method, premiums are not recognized as revenue and claim costs are not charged to expense until the ultimate premium is reasonably estimable.

Dividends to Policyholders

Amounts distributable to policyholders of participating insurance contracts as determined by the insurer. Under various state insurance laws, dividends are apportioned to policyholders on an equitable basis. The dividend allotted to any contract often is based on the amount that the contract, as one of a class of similar contracts, has contributed to the changes in net assets available for distribution as dividends.

Group Insurance

Insurance protecting a group of persons, usually employees of an entity and their dependents. A single insurance contract is issued to their employer or other representative of the group. Individual certificates often are given to each insured individual or family unit. The insurance usually has an annual renewable contract period, although the insurer may guarantee premium rates for two or three years. Adjustments to premiums relating to the actual experience of the group of insured persons are common.

Incurred but Not Reported Claims

Claims relating to insured events that have occurred but have not yet been reported to the insurer or reinsurer as of the date of the financial statements.

Liability for Claim Adjustment Expenses

The amount needed to provide for the estimated ultimate cost required to investigate and settle claims relating to insured events that have occurred on or before a particular date (ordinarily, the financial statement date), whether or not reported to the insurer at that date.

Liability for Unpaid Claims

The amount needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the financial statement date). The estimated liability includes the amount of money that will be required for future payments on both (a) claims that have been reported to the insurer and (b) claims relating to insured events that have occurred but have not been reported.

Maintenance Costs

Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

Reinsurance

A transaction in which a reinsurer (assuming enterprise), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (government). However, the legal rights of the insured are not affected by the reinsurance transaction and the insurance enterprise issuing the insurance contract remains liable to the insured for payment of policy benefits.

Salvage

The amount received by an insurer from the sale of property (usually damaged) on which the insurer has paid a total claim to the insured and has obtained title to the property.

Subrogation

The right of an insurer to pursue any course of recovery of damages, in its name or in the name of the policyholder, against a third party who is liable for costs relating to an insured event that have been paid by the insurer.

Lending Activities

431. Paragraphs 431–451 establish standards of accounting and financial reporting for nonrefundable fees and costs associated with lending activities and loan purchases. Lending, committing to lend, refinancing or restructuring loans, arranging standby letters of credit, and leasing activities are "lending activities" for purposes of applying paragraphs 431–451. The lender's activities that precede the disbursement of resources generally can be distinguished between (a) efforts to identify and attract potential borrowers and (b) efforts necessary to originate a loan or loan commitment after a potential borrower requests a loan or loan commitment. Nonrefundable fees have many different names in practice, such as **origination fees,**[204] points, placement fees, **commitment fees,** application fees, management fees, and restructuring fees, but, for purposes of applying paragraphs 431–451, they are referred to as loan origination fees or commitment fees.

[204]Terms defined in the glossary (see paragraph 451) are shown in **boldface type** the first time they appear in paragraphs 431–450.

432. Paragraphs 431–451 address the recognition and the statement of net assets[205] classification of nonrefundable fees and costs associated with lending activities. The accounting for discounts, premiums, and commitment fees associated with the purchase of loans and groups of loans also are addressed by those paragraphs. Paragraphs 431–451 do not apply to loan origination or commitment fees that are refundable; however, those paragraphs do apply when such fees subsequently become nonrefundable. Paragraphs 431–451 also do not apply to costs that are incurred by the lender in transactions with independent third parties if the lender bills those costs directly to the borrower. Paragraphs 431–451 do not apply to nonrefundable fees and costs associated with originating or acquiring loans that are carried at fair value.

General

433. A government may acquire a loan by lending (originating the loan) or by purchasing (acquiring a loan from a party other than the borrower). Paragraphs 431–451 apply to both a lender and a purchaser. Those paragraphs should be applied to individual loan contracts. Aggregation of similar loans for purposes of recognizing net fees or costs and purchase premiums or discounts is permitted if the provisions of paragraph 446 are met.

Loan Origination Fees and Costs

434. Loan origination fees should be deferred and recognized over the life of the loan as an adjustment of yield[206] (interest revenue). Likewise, direct loan origination costs defined in paragraph 435 should be deferred and recognized as a reduction in the yield of the loan except as set forth in paragraph 441 (for a troubled debt restructuring). Loan origination

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[205]For purposes of applying paragraphs 431–451, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

[206]Methods for recognition of deferred fees and direct loan origination costs over the life of the loan as an adjustment of yield are set forth in paragraphs 445–447.

fees and related direct loan origination costs for a given loan should be offset, and only the net amount should be deferred and amortized.

435. Direct loan origination costs of a completed loan should include only (a) **incremental direct costs** of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's economic condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities should include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.

436. All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration, should be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time should be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and should be charged to expense as incurred.

Commitment Fees and Costs

437. Except as set forth in subparagraphs (a) and (b) below, 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 yield or, if the commitment expires unexercised, recognized in revenue upon expiration of the commitment.

a. If the government's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote,[207] the commitment fee should be recognized over the commitment period on a straight-line basis as service fee revenue. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise should be recognized over the life of the loan as an adjustment of yield.
b. 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 fee should be recognized as service fee revenue as of the determination date.

438. Direct loan origination costs (described in paragraph 435) incurred to make a commitment to originate a loan should be offset against any related commitment fee and the net amount recognized as set forth in paragraph 437.

Fees and Costs in Refinancings or Restructurings

439. If the terms of the new loan resulting from a loan refinancing or restructuring other than a troubled debt restructuring are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan should be accounted for as a new loan. This condition would be met if the new loan's effective yield is at least equal to the effective yield for such loans.[208] Any unamortized net fees or costs and any

[207]The term *remote* is used here, consistent with its use in paragraph 100 to mean that the likelihood is slight that a loan commitment will be exercised prior to its expiration.

[208]The effective yield comparison considers the level of nominal interest rate, commitment and origination fees, and direct loan origination costs and would also consider comparison of other factors where appropriate, such as compensating balance arrangements.

prepayment penalties from the original loan should be recognized in interest revenue when the new loan is granted.

440. If the refinancing or restructuring does not meet the condition set forth in paragraph 439 or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties should be carried forward as a part of the net investment in the new loan. In this case, the investment in the new loan should consist of the remaining net investment in the original loan,[209] any additional amounts loaned, any fees received, and direct loan origination costs set forth in paragraph 435 associated with the refinancing or restructuring.

441. Fees received in connection with a modification of terms of a troubled debt restructuring as defined in paragraphs 128–164 should be applied as a reduction of the recorded investment in the loan for purposes of applying paragraph 152. All related costs, including direct loan origination costs, should be charged to expense as incurred.

Purchase of a Loan or Group of Loans

442. The initial investment in a purchased loan or group of loans 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 purchase. This difference should be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans should be charged to expense as incurred.

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[209]The net investment in the original loan includes the unpaid loan principal, any remaining unamortized net fees or costs, any remaining unamortized purchase premium or discount, and any accrued interest receivable.

443. In applying the provisions of paragraphs 431–451 to loans purchased as a group, the purchaser may allocate the initial investment to the individual loans or may account for the initial investment in the aggregate. The cash flows provided by the underlying loan contracts should be used to apply the interest method, except as set forth in paragraph 446. If prepayments are not anticipated pursuant to paragraph 446 and prepayments occur or a portion of the purchased loans is sold, a proportionate amount of the related deferred fees and purchase premium or discount should be recognized in the flows statement[210] so that the effective interest rate on the remaining portion of loans continues unchanged.

Other

444. Deferred net fees or costs should not be amortized during periods in which interest revenue on a loan is not being recognized because of concerns about the realization of loan principal or interest.

Application of the Interest Method and Other Amortization Matters

445. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) should be recognized by the interest method except as set forth in paragraph 447. The objective of the interest method is to arrive at periodic interest revenue (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest revenue so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization.[211] Under the provisions of

[210]For purposes of applying paragraphs 431–451, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

[211]The “interest” method also is described in paragraphs 185 and 186.

paragraphs 431–451, the interest method should be applied as follows when the stated interest rate is not constant throughout the term of the loan:

a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest revenue should not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties should be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term.
b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest revenue that is calculated under the interest method. In that circumstance, the excess should be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate.
c. If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate [LIBOR], or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs should be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.[212]

446. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method should use the payment terms required by the loan contract, and prepayments of principal should not be anticipated to shorten the loan term. If the government holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the government may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the government anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the government should recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans should be adjusted to the amount that would

[212]A variable rate loan whose initial rate differs from the rate its base factor would produce also is subject to the provisions of paragraphs 445a and 445b.

have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans should be adjusted to the new balance with a corresponding charge or credit to interest revenue. Governments that anticipate prepayments should disclose that policy and the significant assumptions underlying the prepayment estimates.

447. Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).

a. For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding; any unamortized amount should be recognized when the loan is paid in full.
b. For revolving lines of credit (or similar loan arrangements), the net fees or costs should be recognized in the flows statement on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract. If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs should be recognized in the flows statement upon payment. The interest method should be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.[213]

Statement of Net Assets Classification

448. The unamortized balance of (a) loan origination, commitment, and other fees and costs, and (b) purchase premiums and discounts being recognized as an adjustment of

[213]For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as revenue on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in the flows statement upon payment.

yield pursuant to paragraphs 431–451 should be reported on the government's statement of net assets as part of the loan balance to which it relates.

Flows Statement Classification

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

Application to Leasing Activities

450. The provisions of paragraphs 434–438 should apply to lessors in determining the net amount of initial direct costs as that term is used in paragraphs 211–271. Lessors should account for initial direct costs as part of the investment in a direct financing lease.

Glossary

451. This paragraph contains definitions of certain terms *as they are used in paragraphs 431–450;* the terms may have different meanings in other contexts.

Commitment Fees

Fees charged for entering into an agreement that obligates the government to make or acquire a loan or to satisfy an obligation of the other party under a specified condition. For purposes of applying paragraphs 431–450, the term *commitment fees* includes fees for letters of credit and obligations to purchase a loan or group of loans.

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.

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.

Mortgage Banking Activities

452. Paragraphs 452–475 establish accounting and reporting standards for certain **mortgage banking activities.**[214]

Mortgage Loans

453. Mortgage loans held for sale should be reported at the lower of cost or fair value, determined as of the date of the financial statements. The amount by which cost exceeds fair value should be accounted for as a valuation allowance. Changes in the valuation allowances should be included in the flows statement[215] for the period in which the change occurs.

454. Purchase discounts on mortgage loans should not be amortized as interest revenue during the period the loans are held for sale.

455. A mortgage loan transferred to a long-term-investment classification should be transferred at the lower of cost or fair value on the transfer date. Any difference between the carrying amount of the loan and its outstanding principal balance should be recognized

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[214]Terms defined in the glossary (see paragraph 475) are shown in **boldface type** the first time they appear in paragraphs 452–474.

[215]For purposes of applying paragraphs 452–475, the term *flows statement* includes the government-wide statement of activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

as an adjustment to yield by the interest method.[216] A mortgage loan should not be classified as a long-term investment unless the mortgage banking activities have both the ability and the intent to hold the loan for the foreseeable future or until maturity.

456. If ultimate recovery of the carrying amount of a mortgage loan held as a long-term investment is doubtful and the impairment is considered to be other than temporary, the carrying amount of the loan should be reduced to its expected collectible amount, which becomes the new cost basis. The amount of the reduction should be reported as a loss. A recovery from the new cost basis should be reported as a gain only at the sale, maturity, or other disposition of the loan.

457. As a means of financing its mortgage loans held for sale, a mortgage banking activity may transfer mortgage loans temporarily to banks or other financial institutions under formal repurchase agreements that indicate that control over the future economic benefits relating to those assets and risk of market loss are retained by the mortgage banking activity. Under those agreements, those same mortgage loans generally are reacquired from the banks or other financial institutions when the mortgage banking activity sells the loans to permanent investors. The transfer of mortgage loans that qualify as collateralized borrowings under Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues,* should be reported in accordance with the provisions of that Statement.

458. The fair value of mortgage loans held for sale should be determined by type of loan. Either the aggregate or individual loan basis may be used in determining the lower of cost

[216]The interest method should be applied as set forth in paragraphs 445 and 446.

or fair value for each type of loan. Fair value for loans subject to investor purchase commitments (committed loans) and loans held on a speculative basis (uncommitted loans)[217] should be determined separately as follows:

a. *Committed Loans*. Fair value for mortgage loans covered by investor commitments should be based on commitment prices. Any commitment price that provides for servicing fee rates materially different from current servicing fee rates should be adjusted in accordance with paragraph 460.
b. *Uncommitted Loans*. Fair value for uncommitted loans should be based on the market in which the mortgage banking activities normally operates. That determination would include consideration of the following:
   (1) Commitment prices, to the extent the commitments clearly represent market conditions at the date of the financial statements
   (2) Market prices and yields sought by the mortgage banking activities' normal market outlets
   (3) Quoted **Government National Mortgage Association (GNMA)** security prices or other public market quotations for long-term mortgage loan rates
   (4) **Federal Home Loan Mortgage Corporation (FHLMC)** and **Federal National Mortgage Association (FNMA)** current delivery prices.

459. Capitalized costs of acquiring rights to service mortgage loans, associated with the purchase of existing mortgage loans (paragraphs 462 through 465), should be excluded from the cost of mortgage loans for the purpose of determining the lower of cost or fair value.

Servicing Fees

460. If mortgage loans are sold with **servicing** retained and the stated servicing fee rate differs materially from a **current (normal) servicing fee rate,** the sales price should be adjusted, for purposes of determining any gain or loss on the sale, to provide for the recognition of a normal servicing fee in each subsequent year. The amount of the adjustment should be the difference between the actual sales price and the estimated sales

[217] A mortgage loan should be considered uncommitted for purposes of determining fair value if the loan does not meet the specific terms of a commitment or if a reasonable doubt exists about the acceptance of the loan under a commitment.

price that would have been obtained if a normal servicing fee rate had been specified.[218] The adjustment and any gain or loss to be recognized should be determined as of the date the mortgage loans are sold. In addition, if normal servicing fees are expected to be less than estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing the loans should be accrued at that date.

Costs of Issuing Certain GNMA Securities

461. One month's interest cost, which is required to be paid to a trustee by issuers of GNMA securities electing the **internal reserve method,** should be capitalized and amortized. The aggregate amount capitalized, including amounts capitalized under other provisions of paragraphs 452–475, should not exceed the present value of net future servicing income (paragraph 464).

Servicing Rights

462. The right to service mortgage loans for other than an activity's own account is an intangible asset that may be acquired separately, in a purchase of mortgage loans, or in a government combination. Subject to the limitations specified in paragraphs 463 and 464, the cost of acquiring that right from others should be capitalized and amortized in accordance with the requirements of paragraph 465.

463. A mortgage banking activity acquiring the right to service loans in a purchase of mortgage loans should capitalize the portion of the purchase price representing the cost of acquiring that right if a definitive plan for the sale of the mortgage loans exists when the

[218]The adjustment generally will approximate the present value, based on an appropriate interest rate, of the difference between normal and stated servicing fees over the estimated life of the mortgage loans.

transaction is initiated.[219] A definitive plan exists if (a) the mortgage banking activity has obtained, before the purchase date, commitments from permanent investors to purchase the mortgage loans or makes a commitment within a reasonable period (usually not more than 30 days after the purchase date) to sell the mortgage loans to a permanent investor or underwriter, and (b) the plan includes estimates of the purchase price and selling price. The amount capitalized should not exceed (1) the purchase price of the loans, including any transfer fees paid, in excess of the fair value of the loans without servicing rights at the purchase date or (2) the present value of net future servicing income, determined in accordance with paragraph 464. The amount capitalized should be reduced by any amount that the final sales price to the permanent investor exceeds the fair value of the loans at the purchase date. All other costs, such as salaries and general and administrative expenses, should be expensed as period costs.

464. The amount capitalized as the right to service mortgage loans should not exceed the amount by which the present value of estimated future servicing revenue exceeds the present value of expected future servicing costs. Estimates of future servicing revenue should include expected late charges and other ancillary revenue. Estimates of expected future servicing costs should include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs may be determined on an incremental cost basis. The rate used to determine the present value should be an appropriate long-term interest rate.

[219] In the absence of a definitive plan for the sale of the related mortgage loans, the cost of acquiring the right to service mortgage loans generally is included as part of the cost of the loans for purposes of determining the lower of cost or fair value.

465. The amount capitalized as the right to service mortgage loans and the amount capitalized by certain issuers of GNMA securities (paragraph 461) should be amortized in proportion to, and over the period of, estimated net servicing income (servicing revenue in excess of servicing costs).

Loan and Commitment Fees

466. Mortgage banking activities may receive or pay nonrefundable loan and commitment fees representing compensation for a variety of services. Those fees may include components representing, for example, an adjustment of the interest yield on the loan, a fee for designating resources for the borrower, or an offset of loan origination costs. Loan and commitment fees should be accounted for as set forth in paragraphs 467–472.

Loan Origination Fees and Costs

467. If the loan is held for resale, loan origination fees and the direct loan origination costs as specified in paragraphs 431–451 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 as specified in paragraphs 445–447.

Fees for Services Rendered

468. Fees representing 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

469. Fees received for guaranteeing the funding of mortgage loans to borrowers, builders, or developers should be accounted for as prescribed in paragraph 437. Fees paid to permanent investors to ensure the ultimate sale of the loans (residential or commercial

loan commitment fees) should be recognized as expense when the loans are sold to permanent investors or when it becomes evident the commitment will not be used. Because residential loan commitment fees ordinarily relate to blocks of loans, fees recognized as revenue or expense as the result of individual loan transactions should be based on the ratio of the individual loan amount to the total commitment amount.

470. Fees for arranging a commitment directly between a permanent investor and a borrower (loan placement fees) should be recognized as revenue when all significant services have been performed. In addition, if a mortgage banking activity 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 will require (a) simultaneous assignment of the commitment to the investor and (b) simultaneous transfer to the borrower of the amount received from the investor, the related fees also should be accounted for as loan placement fees.

Fees Relating to Loans Not Held for Sale

471. Fees and costs associated with originating or acquiring or committing to originate or acquire loans for investment should be accounted for as prescribed in paragraphs 431–451.

Expired Commitments and Prepayments of Loans

472. If a loan commitment expires without the loan being made or if a loan is repaid before the estimated repayment date, any related unrecognized fees should be recognized as revenue or expense at that time.

Disclosures

473. The method used in determining the lower of cost or fair value of mortgage loans (that is, aggregate or individual loan basis) should be disclosed.

474. The amount capitalized during the period in connection with acquiring the right to service mortgage loans (paragraph 462), the method of amortizing the capitalized amount, and the amount of amortization for the period should be disclosed.

Glossary

475. This paragraph contains definitions of certain terms *as they are used in paragraphs 452–474;* the terms may have different meanings in other contexts.

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," FHLMC is 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," FNMA is an investor-owned corporation established by Congress to support the secondary mortgage loan market by purchasing mortgage loans when other investor resources are limited and selling mortgage loans when other investor resources are available.

Government National Mortgage Association (GNMA)

Often referred to as "Ginnie Mae," GNMA is a U.S. governmental agency that guarantees certain types of securities (mortgage-backed securities) and provides resources 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 Banking Activity

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

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 insurance from escrow resources when due.

Regulated Operations

476. Paragraphs 476–500 may be applied to activities reported in business-type activities that have regulated operations that meet all of the following criteria:

a. The regulated business-type activity's rates for regulated services provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.
b. The regulated rates are designed to recover the specific regulated business-type activity's costs of providing the regulated services.
c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the regulated business-type activity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

477. If some of a business-type activity's operations are regulated and meet the criteria of paragraph 476 and the entity elects to apply paragraphs 476–500, those provisions should be applied to only that portion of the business-type activity's operations.

478. Authoritative accounting pronouncements that apply to business-type activities in general also apply to regulated business-type activities. However, regulated business-type activities subject to paragraphs 476–500 should apply those paragraphs instead of any conflicting provisions of standards in other authoritative pronouncements.

479. Paragraphs 476–500 do not apply to accounting for price controls that are imposed by governmental action in times of emergency, high inflation, or other unusual conditions. Nor do those paragraphs cover accounting for contracts in general. However, if the terms of a contract between a regulated business-type activity and its customer are subject to regulation and the criteria of paragraph 476 are met with respect to that contract, paragraphs 476–500 should apply.

General Standards of Accounting for the Effects of Regulation

480. Rate actions of a regulator can provide a business-type activity with reasonable assurance of the existence of an asset.[220] A regulated business-type activity should capitalize all or part of an incurred cost[221] that otherwise would be charged to expense if both of the following criteria are met:

a. It is probable[222] that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

481. Rate actions of a regulator can reduce or eliminate the value of an asset. If a regulator excludes all or part of a cost from allowable costs and it is not probable that the cost will be included as an allowable cost in a future period, the cost cannot be expected to result in future revenue through the rate-making process. Accordingly, the carrying amount of any related asset should be reduced to the extent that the asset has been impaired. Whether the asset has been impaired should be judged the same as for governments in general.[223]

482. Rate actions of a regulator can impose a liability on a regulated business-type activity. Such liabilities are usually obligations to the regulated business-type activity's

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[220]Costs of impaired plants should be accounted for in accordance with paragraphs 488–491.

[221]An *incurred cost* is "a cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for" (Eric L. Kohler, *A Dictionary for Accountants,* 5th ed. [Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1975], p. 253).

[222]The term *probable* is used in paragraphs 476–500 consistent with its use in paragraph 100.

[223]Disallowances of costs of recently completed plants, whether direct or indirect, should be accounted for in accordance with paragraph 492.

customers. The usual ways in which liabilities can be imposed and the resulting accounting are as follows:

a. A regulator may require refunds to customers.[224] Refunds that meet the criteria of paragraph 102 (accrual of loss contingencies) should be recorded as liabilities and as reductions of revenue or as expenses of the regulated business-type activity.
b. A regulator can provide current rates intended to recover costs that are expected to be incurred in the future with the understanding that if those costs are not incurred, future rates will be reduced by corresponding amounts. If current rates are intended to recover such costs and the regulator requires the regulated business-type activity to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose,[225] the regulated business-type activity should not recognize as revenues amounts charged pursuant to such rates. Those amounts should be deferred and recognized as revenue when the associated costs are incurred.
c. A regulator can require that a gain or other reduction of net allowable costs be given to customers over future periods. That would be accomplished, for rate-making purposes, by amortizing the gain or other reduction of net allowable costs over those future periods and reducing rates to reduce revenues in approximately the amount of the amortization. If a gain or other reduction of net allowable costs is to be amortized over future periods for rate-making purposes, the regulated business-type activity should not recognize that gain or other reduction of net allowable costs in the current period. Instead, it should be deferred for future reductions of charges to customers that are expected to result.

483. Actions of a regulator can eliminate a liability only if the liability was imposed by actions of the regulator.

Specific Standards Derived from the General Standards

484. The following specific standards are derived from the general standards in paragraphs 480–483. The specific standards should not be used as guidance for other applications of the general standards in paragraphs 480–483.

[224]Refunds can be paid to the customers who paid the amounts being refunded; however, they usually are provided to current customers by reducing current charges.

[225]The usual mechanism used by regulators for this purpose is to require the regulated business-type activity to record the anticipated cost as a liability in its regulatory accounting records.

Allowance for Resources Used during Construction

485. In some cases, a regulator requires a regulated business-type activity, to capitalize as part of the cost of capital assets, the cost of financing construction as financed partially by borrowings and partially by fund equity. A computed interest cost and a designated cost of equity funds are capitalized, and the change in net assets for the current period is increased by a corresponding amount. After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for rate-making purposes. In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets should be capitalized for financial reporting purposes instead of the amount of interest that would be capitalized in accordance with paragraphs 5–22.[226] Those amounts should be capitalized only if their subsequent inclusion in allowable costs for rate-making purposes is probable. The flows statement[227] should include an item of other revenue, a reduction of interest expense, or both, in a manner that indicates the basis for the amount capitalized.

Intra-Entity Profit

486. Profit on intra-entity sales to other entities that are in the same reporting entity as the regulated business-type activity should not be eliminated in general-purpose external financial statements[228] if both of the following criteria are met:

a. The sales price is reasonable.

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[226]Paragraphs 5–22 require capitalization of interest cost on certain qualifying assets. The amount capitalized is the portion of the interest cost incurred during the period that theoretically could have been avoided if the outlays had not been made.

[227]For purposes of applying paragraphs 476–500, the term *flows statement* includes the government-wide statement of activities for business-type activities and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

[228]Statement 14, paragraph 73, as amended, discusses the elimination of profit on operating transactions and reducing fund equity in joint ventures for profit in the operating transaction.

b. It is probable that, through the rate-making process, future revenue approximately equal to the sales price will result from the regulated business-type activity's use of the services.

487. The sales price usually should be considered reasonable if the price is accepted or not challenged by the regulator that governs the regulated affiliate. Otherwise, reasonableness should be considered in light of the circumstances. For example, reasonableness might be judged by the return on investment earned by operations or by a comparison of the transfer prices with prices available from other sources.

Accounting for Impairments of Regulatory Assets

488. When an operating asset or an asset under construction of a regulated business-type entity becomes impaired as defined in Statement 42, the impairment should be accounted for in accordance with that Statement. In addition, the regulated business-type activity should determine whether recovery of any allowed cost is likely to be provided with (a) full return on investment during the period from the time the asset is impaired to the time when recovery is completed or (b) partial or no return on investment during that period. That determination should focus on the facts and circumstances related to the specific impairment and also should consider the past practice and current policies of the applicable regulatory jurisdiction on impairment situations. Based on that determination, the regulated business-type activity should account for the cost of the impaired plant as follows:

a. *Full return on investment is likely to be provided.* Any disallowance of all or part of the cost of the impaired plant that is both *probable* and *reasonably estimable,* as those terms are used in paragraphs 96–113, should be recognized as a loss, and the carrying basis of the recorded asset should be correspondingly reduced. The remainder of the cost of the impaired plant should be reported as a separate new asset.
b. *Partial or no return on investment is likely to be provided.* Any disallowance of all or part of the cost of the impaired plant that is both *probable* and *reasonably estimable,* as those terms are used in paragraphs 96–113, should be recognized as a

loss. The present value of the future revenues expected to be provided to recover the allowable cost of that impaired plant and return on investment, if any, should be reported as a separate new asset. Any excess of the remainder of the cost of the impaired plant over that present value also should be recognized as a loss. The discount rate used to compute the present value should be the regulated business-type activity's incremental borrowing rate, that is, the rate that the regulated business-type activity would have to pay to borrow an equivalent amount for a period equal to the expected recovery period. In determining the present value of expected future revenues, the regulated business-type activity should consider such matters as (1) the probable time period before such recovery is expected to begin and (2) the probable time period over which recovery is expected to be provided. If the estimate of either period is a range, the guidance of paragraphs 96–113 should be applied to determine the loss to be recognized. Accordingly, the most likely period within that range should be used to compute the present value. If no period within that range is a better estimate than any other, the present value should be based on the minimum time period within that range.

489. The recorded amount of the new asset should be adjusted from time to time as necessary if new information indicates that the estimates used to record the separate new asset have changed. Those estimates include (a) the determination of whether full return on investment will be provided and, if not, the probable time period before recovery is expected to begin and the probable time period over which recovery is expected to be provided and (b) the amount of any probable and reasonably estimable disallowance of recorded costs of the impaired plant. The amount of the adjustment should be recognized as a loss or gain. The recorded carrying amount of the new asset should not be adjusted for changes in the regulated business-type activity's incremental borrowing rate.

490. During the period between the date on which the new asset is recognized and the date on which recovery begins, the carrying amount should be increased by accruing a carrying charge. The rate used to accrue that carrying charge should be as follows:

a. If full return on investment is likely to be provided, a rate equal to the allowed overall cost of capital in the jurisdiction in which recovery is expected to be provided should be used.
b. If partial or no return on investment is likely to be provided, the rate that was used to compute the present value should be used.

491. During the recovery period, the new asset should be amortized as follows:

a. If full return on investment is likely to be provided, the asset should be amortized in the same manner as that used for rate-making purposes.
b. If partial or no return on investment is likely to be provided, the asset should be amortized in a manner that will produce a constant return on the unamortized investment in the new asset equal to the rate at which the expected revenues were discounted.

Disallowances of Costs of Recently Completed Plants

492. When it becomes probable that part of the cost of a recently completed plant will be disallowed for rate-making purposes and a reasonable estimate of the amount of the disallowance can be made,[229] the estimated amount of the probable disallowance should be deducted from the reported cost of the plant and recognized as a loss. If part of the cost is explicitly, but indirectly, disallowed (for example, by an explicit disallowance of return on investment on a portion of the plant), an equivalent amount of cost should be deducted from the reported cost of the plant and recognized as a loss.

Other Disclosure

Refunds

493. For refunds that are recognized in a period other than the period in which the related revenue was recognized, the regulated business-type activity should disclose the effect on the change in net assets and indicate the years in which the related revenue was recognized. Such effect may be disclosed by including it as a line item in the flows statement.

Recovery without Return on Investment

494. In some cases, a regulator may permit a regulated business-type activity to include a cost that would be charged to expense by an unregulated business-type activity as an

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[229]Paragraphs 96–113 provide guidance for making a reasonable estimate of the amount of a loss.

allowable cost over a period of time by amortizing that cost for rate-making purposes, but the regulator does not include the unrecovered amount in the rate base. That procedure does not provide a return on investment during the recovery period. If recovery of such major costs is provided without a return on investment during the recovery period, the regulated business-type activity should disclose the remaining amounts of such assets and the remaining recovery period applicable to them.

Discontinuation of Accounting for the Effects of Certain Types of Regulation

495. Deregulation of certain industries and changes in the method of regulating others have caused several regulated business-type activities to discontinue application of paragraphs 476–494 for some or all of their operations. Paragraphs 495–500 address the accounting that should result when a regulated business-type activity's operations cease to meet the criteria in paragraph 476.

496. Failure of a regulated business-type activity's operations to continue to meet the criteria in paragraph 476 can result from different causes. Examples include the following:

a. Deregulation
b. A change in the regulator's approach to setting rates from cost-based rate making to another form of regulation
c. Increasing competition that limits the regulated business-type activity's ability to sell utility services at rates that will recover costs
d. Regulatory actions resulting from resistance to rate increases that limit the regulated business-type activity's ability to sell utility services at rates that will recover costs if the regulated business-type activity is unable to obtain (or chooses not to seek) relief from prior regulatory actions through appeals to the regulator or the courts.

Regardless of the reason for a regulated business-type activity's discontinuation of application of paragraphs 476–494, paragraphs 495–500 specify how that discontinuation should be reported in the regulated business-type activity's financial statements.

Accounting and Reporting When the Criteria for Regulated Operations Are No Longer Met

497. When a regulated business-type activity determines that its operations in a regulatory jurisdiction no longer meet the criteria for application of paragraphs 476–494, that regulated business-type activity should discontinue application of those paragraphs to its operations in that jurisdiction. If a separable portion of the regulated business-type activity's operations within a regulatory jurisdiction ceases to meet the criteria for application of paragraphs 476–494, application of those paragraphs to that separable portion should be discontinued. That situation creates a presumption that application of paragraphs 476–494 should be discontinued for all of the regulated business-type activity's operations within that regulatory jurisdiction. That presumption can be overcome by establishing that the regulated business-type activity's other operations within that jurisdiction continue to meet the criteria for application of paragraphs 476–494.

Accounting to Reflect the Discontinuation of Accounting for the Effects of Certain Types of Regulation

498. When a regulated business-type activity discontinues application of paragraphs 476–494 to all or part of its operations, that regulated business-type activity should eliminate from its statement of net assets[230] prepared for general-purpose external financial reporting the effects of any actions of regulators that had been recognized as assets and liabilities pursuant to paragraphs 476–494 but would not have been recognized as assets and liabilities by business-type activities in general. However, the carrying amounts of capital

[230]For purposes of applying paragraphs 476–500, the term *statement of net assets* includes the government-wide statement of net assets for business-type activities and the proprietary fund statement of fund net assets.

assets and inventory measured and reported pursuant to paragraphs 476–494[231] should not be adjusted unless those assets are impaired, in which case the carrying amounts of those assets should be reduced to reflect that impairment. Whether those assets have been impaired should be judged in the same manner as for business-type activities in general. The net effect of the adjustments required by paragraphs 495–500 should be recognized in the period in which the discontinuation occurs and should be classified as a special or extraordinary item if it meets the criteria in Statement 34, paragraphs 55 and 56.

499. A regulated business-type activity that discontinues application of paragraphs 476–494 should no longer recognize the effects of actions of a regulator as assets or liabilities unless the right to receive payment or the obligation to pay exists as a result of past events or transactions and regardless of future transactions.

Disclosure

500. For the period in which a regulated business-type activity reflects the discontinuation of application of paragraphs 476–494 to all or a portion of its operations, the regulated business-type activity should disclose the reasons for the discontinuation and identify the portion of its operations to which the application of paragraphs 476–494 is being discontinued.

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[231]The carrying amounts of capital assets and inventory for regulated business-type activities applying paragraphs 476–494 differ from those for business-type activities in general only because of the allowance for resources used during construction, intra-entity profit, and disallowances of costs of recently completed plants. If any other amounts that would not be includable in the carrying amounts of capital assets or inventory by business-type activities in general (such as postconstruction operating costs capitalized pursuant to paragraph 480) are included in or netted against the carrying amounts of capital assets or inventory, those amounts should be accounted for as paragraphs 495–500 prescribe for the effects of actions of a regulator.

Right of Offset

501. Assets and liabilities should not be offset in the statement of net assets[232] except where a right of offset exists.

EFFECTIVE DATE AND TRANSITION

502. The requirements in this Statement are effective for financial statements for periods beginning after December 15, 2011. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this Statement should be applied retroactively by restating financial statements, if practical, for all prior periods presented. If restatement is not practical, the cumulative effect of applying this Statement, if any, should be reported as a restatement of beginning net assets, fund balances, or fund equity, as appropriate, for the earliest period restated. In the period this Statement is first applied, the financial statements should disclose the nature of any restatement and its effect. Also, the reason for not restating prior periods presented should be explained.

The provisions of this Statement need not be applied to immaterial items.

[232]For purposes of applying paragraph 501, the term *statement of net assets* includes the government-wide statement of net assets and the proprietary fund statement of fund net assets.

This Statement was issued by unanimous vote of the seven members of the Governmental Accounting Standards Board.

Robert H. Attmore, *Chairman*
Michael D. Belsky
Michael H. Granof
David E. Sundstrom
Jan I. Sylvis
Marcia L. Taylor
James M. Williams

Appendix A

BACKGROUND

503. NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles,* paragraph 18, provides that proprietary funds (enterprise funds and internal service funds) "are used to account for a government's ongoing organizations and activities which are similar to those often found in the private sector. . . ." It further provides that "the generally accepted accounting principles here are those applicable to similar businesses in the private sector; and the measurement focus is upon determination of *net income, financial position, and changes in financial position. . . .*"

504. NCGA Statement 1, paragraph 74, adds that "revenues earned and expenses incurred are recognized in a government's proprietary funds in essentially the same manner as in commercial accounting." However, where the GASB has issued pronouncements applicable to entities and activities recognized in a government's business-type activities and proprietary funds, those entities and activities should be guided by the GASB pronouncements. Business-type (commercial) accounting was generally defined by Financial Accounting Standards Board (FASB) pronouncements, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARB) of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure.

505. In its November 30, 1989 Jurisdiction Determination, the Financial Accounting Foundation (FAF) Trustees stated that the jurisdictional division between the GASB and the FASB shall continue to be as set forth in the 1984 GASB Structural Agreement but that the hierarchy should be changed. The objective of the hierarchy, as stated in the Jurisdiction Determination, is for each Board to have primary responsibility for setting

standards for the reporting entities in its jurisdiction; pronouncements of the other Board should not be mandatory unless designated as such by the primary Board.

506. Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, issued by the Auditing Standards Board of the AICPA, established a new generally accepted accounting principles (GAAP) hierarchy in 1992. Under SAS 69, category (a) in the GAAP hierarchy "consists of GASB Statements and Interpretations, as well as AICPA and FASB pronouncements specifically made applicable to state and local governmental entities by GASB Statements or Interpretations." FASB pronouncements not made applicable by the GASB are considered other accounting literature (below category (d) in the GAAP hierarchy) for state and local governmental entities. Prior to the issuance of SAS 69, pronouncements of the FASB were presumed to apply to state and local governmental entities if no applicable GASB pronouncements existed on a given subject.

507. In September 1993, the GASB issued Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* as interim guidance on business-type accounting and financial reporting for proprietary activities. Paragraph 6 of that Statement required proprietary activities to apply all applicable GASB pronouncements, as well as all FASB Statements and Interpretations, APB Opinions, and ARBs issued on or before November 30, 1989, collectively referred to as the "FASB and AICPA pronouncements," unless those pronouncements conflict with or contradict GASB pronouncements. Paragraph 7 of that Statement allowed proprietary activities to apply all FASB Statements and Interpretations

issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements.

508. In June 1999, the GASB issued Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* which extended the requirements of paragraph 6 of Statement 20 to the governmental activities reported in the government-wide financial statements. In addition, Statement 34 incorporated the provision in Statement 20, paragraph 7 that allowed enterprise funds (and business-type activities) to apply all FASB Statements and Interpretations issued after November 30, 1989, unless they conflict with or contradict GASB pronouncements. However, Statement 34 did not extend the provisions in paragraph 7 of Statement 20 to governmental activities.

509. In March 2009, the GASB issued Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments,* to incorporate the hierarchy of GAAP for state and local governments into its authoritative literature.

History of the Project

510. A draft project proposal was considered by the Governmental Accounting Standards Advisory Council (GASAC) at its March 2008 meeting and positive feedback was provided by the members. The GASAC members rated the project a high priority at that time. A draft project prospectus was considered by the GASAC at its March 2009 meeting, and positive feedback was provided by the members. The GASAC members rated the project a high priority among research and potential projects in the GASB's technical plan.

511. In April 2009, the Board added a project to its technical agenda to identify the specific provisions in the FASB and AICPA pronouncements, as referenced in paragraph 17 of GASB Statement 34, that do not conflict with or contradict GASB pronouncements and to incorporate those provisions into the GASB's literature. The Board and the project staff received a significant amount of assistance in the project from members of an expert group comprised of persons with extensive knowledge of the application of FASB and AICPA pronouncements to state and local governments.

512. In January 2010, the Board issued an Exposure Draft, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. The Board received 23 responses to the Exposure Draft. As discussed throughout the Basis for Conclusions of this Statement, the comments and suggestions from the organizations and individuals who responded to the Exposure Draft contributed to the Board's deliberations in finalizing the requirements of this Statement.

Appendix B

BASIS FOR CONCLUSIONS

513. This appendix summarizes factors considered significant by the Board members in reaching the conclusions in this Statement. It includes discussion of alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members may have given greater weight to some factors than to others.

514. At the beginning of its deliberations leading to this Statement, the Board evaluated two approaches. One approach it considered was the adoption of the accounting and reporting requirements essentially as they existed in the applicable pre-November 30, 1989 ("pre-1989") FASB and AICPA pronouncements, modifying the language as appropriate to recognize the effects of the governmental environment without affecting the substance of the provisions. The other approach considered was the redeliberation of the individual issues addressed in the FASB and AICPA pronouncements. The Board recognized that taking the first approach would not significantly affect practice because the accounting and financial reporting requirements would not change; only the source of the guidance would be different. The latter approach, involving significant redeliberation, could have resulted in changes in practice depending on the extent to which the Board modified the financial reporting requirements from the way they were stated in the FASB and AICPA pronouncements. After deliberating these alternatives, the Board decided to adopt the first approach. Some respondents to the Exposure Draft generally disagreed with the overall approach adopted by the Board, suggesting that the Board redeliberate and further modify the pre-1989 FASB and AICPA guidance incorporated into the GASB literature or consider incorporating post-November 30, 1989 pronouncements. Other

respondents only disagreed with the Board's approach with regard to specific topics addressed in the Statement. These respondents generally recommended that the Board make exceptions to its approach for the specific instances identified. For example, some respondents believed that, for certain issues, the Board should consider incorporating guidance from other literature, including Emerging Issues Task Force (EITF) Issues and discussion documents of other standards setters, rather than from only FASB and AICPA pronouncements. However, the Board concluded that the codification of the FASB and AICPA pronouncements into the GASB literature should be as undisruptive as possible. Therefore, the first approach was adopted.

515. This Statement is not intended to establish new financial reporting requirements or modify existing requirements; rather, it incorporates FASB and AICPA accounting and reporting guidance applicable to state and local governments into the GASB literature. However, the Board does recognize that practitioners in exercising professional judgment may have reached different conclusions in applying the hierarchy without specific guidance. Some respondents to the Exposure Draft provided comments seeking specific guidance or clarification related to the application of the provisions of the Statement. The Board concluded that incorporating the additional guidance or clarification requested by respondents would add more than minor modifications to the provisions of the pre-1989 FASB and AICPA literature and, therefore, would be inconsistent with the intention of this Statement.

Scope

516. Broadly, the literature considered by the GASB for codification consisted of the pronouncements issued by the FASB and its predecessors prior to November 30, 1989,

that were required to be followed by "proprietary activities" in GASB Statement 20, paragraph 6, and by "governmental and business-type activities" reported in government-wide statements in conformity with GASB Statement 34, paragraph 17. These FASB and AICPA pronouncements consist of:

a. Accounting Research Bulletins (ARBs) No. 43–51
b. Accounting Principles Board (APB) Opinions No. 1–31
c. FASB Statements No. 1–102
d. FASB Interpretations No. 1–38.

Forty-six FASB and AICPA pronouncements were superseded by others issued on or before November 30, 1989, and, therefore, were not applicable. Several others were superseded in part (and, therefore, were only partially applicable) or were amended by other pre-1989 FASB and AICPA pronouncements issued on or before November 30, 1989.

517. The Board's analysis of the pre-1989 FASB and AICPA pronouncements consisted of identifying the specific accounting and financial reporting requirements to be incorporated into the accounting and financial reporting category (a) GASB literature. The Board evaluated the pronouncements at varying levels of detail based upon the subject matter embedded within them, their relevance to the government environment, and previous actions, if any, taken by the GASB to address the subject matter. The Board also reviewed the GASB literature to identify guidance that would be amended or superseded by the incorporation of pre-1989 FASB and AICPA pronouncements into the GASB literature. For example, paragraphs 117 and 127 of NCGA Statement 1, as amended, provided guidance on terminology and account classifications for proprietary funds by referring to business enterprise practices. The Board determined that this guidance conflicts with the incorporated literature and other GASB provisions; therefore, these

paragraphs were superseded by this Statement to provide consistent guidance for proprietary funds.

FASB and AICPA Pronouncements Not Applicable to State and Local Governments

518. The Board identified certain FASB and AICPA pronouncements that were intended only for nongovernmental entities or activities that are outside the government environment and, therefore, were not incorporated into the GASB literature. Examples of pronouncements that state they are not applicable to governmental entities are as follows:

a. APB Opinion No. 15, *Earnings per Share*, paragraph 6 indicates that this Opinion does not apply to government-owned corporations. The related amendments and interpretation, therefore, also do not apply.
b. FASB Statement No. 12, *Accounting for Certain Marketable Securities*, paragraph 5, states, "This Statement does not apply to not-for-profit organizations. . . ." Footnote 2 to that paragraph further states, "For this purpose, not-for-profit organizations are those described in the third sentence of paragraph 5 of the Introduction to *ARB No. 43*." ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, "Introduction," defines not-for-profit organizations as "religious, charitable, scientific, educational, and similar non-profit institutions, municipalities, professional firms, and the like." The related interpretations to FASB Statement 12 also do not apply.

519. Examples of FASB and AICPA pronouncements that provide accounting standards for events or activities that do not occur in the government environment are as follows:

a. ARB 43, Chapter 7A, *Quasi-Reorganization or Corporate Readjustment* (Amplification of Institute Rule No. 2 of 1934), provides accounting standards for when, under certain conditions, an entity restates its balance sheet to fair value without the creation of a new corporate entity and without the intervention of formal court proceedings. Governments do not effect quasi-reorganizations, as contemplated by this chapter.
b. ARB 43, Chapter 10A, *Real and Personal Property Taxes,* contains accounting standards for the accrual of property taxes assessed on an entity. However, governments are not assessed real and personal property taxes.
c. ARB 43, Chapter 13B, *Compensation Involved in Stock Option and Stock Purchase Plans,* contains accounting standards for when stock is issued to employees through various employee compensation plans. However, governments do not issue stock to employees.

d. Governments do not issue debt convertible to equity securities and therefore would not apply related pronouncements such as APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants.*
e. FASB Statement No. 44, *Accounting for Intangible Assets of Motor Carriers,* provides accounting standards for entities that were granted or otherwise purchased intrastate operating rights such as a franchise or permit issued by the Interstate Commerce Commission to transport specified commodities over specified routes with limited competition, which were impacted from the deregulation of the trucking industry by the Motor Carrier Act of 1980. This transaction is considered to be not applicable to governments and their enterprise activities.
f. FASB Statement No. 61, *Accounting for Title Plant*, provides accounting standards for enterprises, such as title insurance enterprises and title agents that use a title plant[233] in their operations. Governments do not incorporate title plants into operations.

520. The Board also identified certain FASB and AICPA pronouncements that were not applicable to governments because they have only historical relevance and are unnecessary for current accounting and financial reporting and, therefore, were not incorporated into the GASB literature. For example:

a. FASB Statement No. 10, *Extension of "Grandfather" Provisions for Business Combinations,* amended the provisions in the Effective Date section of APB Opinion No. 16, *Business Combinations,* that pertain to a combination of an entity and its minority interest investment, which it held on October 31, 1970. Such guidance on historical circumstances is irrelevant to current financial accounting and reporting.
b. FASB Statement No. 11, *Accounting for Contingencies—Transition Method,* is an amendment to the transition method required for implementing FASB Statement No. 5, *Accounting for Contingencies.* Given that all governments have been directed to apply the accounting standards in FASB Statement 5 for decades, the transition guidance is irrelevant to current financial accounting and reporting.

Conflicting and Contradictory Literature

521. Certain FASB and AICPA pronouncements were identified as conflicting *in whole* with current GASB literature. For example, FASB Statement No. 95, *Statement of Cash Flows*, and related pronouncements were considered to be in conflict with GASB

[233]*Title plant* is a historical record of all matters affecting title to parcels of land in a particular geographic area. "The number of years covered by a title plant varies, depending on regulatory requirements and the minimum information period considered necessary to issue title insurance policies efficiently" (FASB Statement 61, paragraph 1).

Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, as amended, given that GASB Statement 9 currently establishes standards for reporting cash flows. Therefore, FASB Statement 95 and other pronouncements addressing the reporting of cash flows were excluded from GASB literature in their entirety. There are other standards that were classified in this category, including but not limited to the pronouncements mentioned in the Basis for Conclusions of GASB Statement 20.

522. The Board determined that the following FASB and AICPA pronouncements conflicted with or contradicted GASB pronouncements in their entirety and, therefore, were excluded from codification:

Committee on Accounting Procedure Accounting Research Bulletins

- ARB No. 43, Chapter 9A, *Depreciation and High Costs*
- ARB No. 43, Chapter 9C, *Emergency Facilities: Depreciation, Amortization and Income Taxes*
- ARB No. 51, *Consolidated Financial Statements.*

Accounting Principles Board Opinions

- APB Opinion No. 17, *Intangible Assets*
- APB Opinion No. 28, *Interim Financial Reporting.*

FASB Statements of Financial Accounting Standards

- FASB Statement No. 2, *Accounting for Research and Development Costs*
- FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*
- FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*
- FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*
- FASB Statement No. 18, *Financial Reporting for Segments of a Business Enterprise—Interim Financial Statements*
- FASB Statement No. 24, *Reporting Segment Information in Financial Statements That Are Presented in Another Enterprise's Financial Report*
- FASB Statement No. 30, *Disclosure of Information about Major Customers*

- FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*
- FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*
- FASB Statement No. 43, *Accounting for Compensated Absences*
- FASB Statement No. 47, *Disclosure of Long-Term Obligations*
- FASB Statement No. 56, *Designation of AICPA Guide and Statement of Position (SOP) 81-1 on Contractor Accounting and SOP 81-2 concerning Hospital-Related Organizations as Preferable for Purposes of Applying APB Opinion 20*
- FASB Statement No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*
- FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures*
- FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*
- FASB Statement No. 80, *Accounting for Futures Contracts*
- FASB Statement No. 81, *Disclosure of Postretirement Health Care and Life Insurance Benefits*
- FASB Statement No. 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*
- FASB Statement No. 87, *Employers' Accounting for Pensions*
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*
- FASB Statement No. 94, *Consolidation of All Majority-owned Subsidiaries*
- FASB Statement No. 95, *Statement of Cash Flows*
- FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale.*

FASB Interpretations

- FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*
- FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*
- FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*
- FASB Interpretation No. 37, *Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity.*

523. In addition to pronouncements that conflict with or contradict GASB pronouncements *in whole,* certain provisions within applicable pronouncements were identified as conflicting with GASB literature. For example, APB Opinion No. 26, *Early Extinguishment of Debt,* as amended, "concludes that all extinguishments of debt are fundamentally alike" and "that accounting for such transactions should be the same regardless of the means used to achieve the extinguishment." However, GASB Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities,* contradicts that conclusion and provides different reporting guidance for debt extinguishments accomplished by debt refundings. The debt extinguishment guidance in Opinion 26 should still be applied to governments when they extinguish their debt in other ways, such as through liquidation of assets or a debtor's forgiveness. Therefore, the provisions within Opinion 26 were modified accordingly and incorporated into GASB literature as they pertain to debt extinguishments other than debt refundings.

FASB and AICPA Pronouncements Rarely Applicable to State and Local Governments

524. Governments engage in many of the same activities that are inherently private-sector activities. It is difficult to conclude that FASB and AICPA pronouncements that pertain to more specialized private-sector activities and generally are outside the scope of the government services would not apply to the activities of a government. The Board considered whether FASB and AICPA pronouncements that rarely apply to governments should be incorporated into the GASB literature. If the Board codified these pronouncements into this standard, the GASB would need to maintain these rarely applied provisions. The Board concluded that the GASB's likely diminished effectiveness in

standards setting for all state and local governments would outweigh the benefits of maintaining this rarely applied literature.

525. The authoritative status of the FASB and AICPA pronouncements considered to be rarely applicable to governments would be affected by excluding them from consideration in this Statement. Previously, these pronouncements were classified as category (a) of the GAAP hierarchy established in GASB Statement 55, because all pre-1989 FASB and AICPA pronouncements that do not conflict with or contradict GASB pronouncements are specifically referenced in GASB Statements 20 and 34. Excluding FASB pronouncements from this Statement would effectively reclassify them from category (a) to other accounting literature according to Statement 55, paragraph 5, which states:

> If the accounting treatment for a transaction or other event is not specified by a pronouncement or established in practice as described in categories (a)–(d), a governmental entity should consider accounting principles for similar transactions or other events within categories (a)–(d) and may consider other accounting literature.

526. The Board considered the following pronouncements to be rarely applicable to state and local governments and, therefore, excluded them from incorporation into the GASB literature:

Committee on Accounting Procedure Accounting Research Bulletins

- ARB No. 43, Chapter 7B, *Stock Dividends and Stock Split-ups*
- ARB No. 43, Chapter 11, *Government Contracts*
- ARB No. 43, Chapter 12, *Foreign Operations and Foreign Exchange.*

Accounting Principles Board Opinions

- APB Opinion No. 2, *Accounting for the "Investment Credit"*
- APB Opinion No. 4, *Accounting for the "Investment Credit"*
- APB Opinion No. 23, *Accounting for Income Taxes—Special Areas.*

FASB Statements of Financial Accounting Standards

- FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*
- FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*
- FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies*
- FASB Statement No. 45, *Accounting for Franchise Fee Revenue*
- FASB Statement No. 49, *Accounting for Product Financing Arrangements*
- FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*
- FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*
- FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities*
- FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*
- FASB Statement No. 92, *Regulated Enterprises—Accounting for Phase-in Plans*
- FASB Statement No. 96, *Accounting for Income Taxes*
- FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- FASB Statement No. 100, *Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96.*

FASB Interpretations

- FASB Interpretation No. 1, *Accounting Changes Related to the Cost of Inventory*
- FASB Interpretation No. 7, *Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises*
- FASB Interpretation No. 9, *Applying APB Opinions No. 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 Interpretation No. 33, *Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method*
- FASB Interpretation No. 36, *Accounting for Exploratory Wells in Progress at the End of a Period.*

527. Some respondents to the Exposure Draft expressed concerns regarding the FASB and AICPA guidance considered by the Board to be rarely applicable to state and local governments. These respondents generally questioned whether the rarely applied guidance is, in fact, applicable to state and local governments. Other respondents raised issues

regarding the applicability of certain guidance incorporated into the Statement, believing the guidance to be rarely applicable to governments. After considering the respondents' comments, the Board concluded that the guidance provided in the Statement should be incorporated into the GASB literature as the provisions were considered to be widely used in practice and were not in conflict with or contradictory to other GASB pronouncements. The Board's conclusions were based on feedback from expert group members, research performed in developing the Statement, and the GASB's experiences in applying FASB and AICPA pronouncements.

FASB and AICPA Pronouncements Applicable to State and Local Governments

528. Certain FASB and AICPA pronouncements were referred to in GASB literature as the applicable guidance to be followed by governments and, therefore, the Board determined that this guidance residing in the FASB and AICPA literature should be incorporated into the GASB literature. Example excerpts from the GASB Codification that require the application of certain FASB and AICPA pronouncements by specific reference are as follows:

> ***Notes to Financial Statements***
>
> APB Opinion No. 22, *Disclosure of Accounting Policies*, requires the Summary of Significant Accounting Policies as an integral part of the financial statements. [NCGA Statement 1, fn7]
>
> ***Breaches of Contract and Other Claims***
>
> Subject to the accounting and financial reporting distinctions of governmental funds, the criteria of FASB Statement No. 5, *Accounting for Contingencies*, should be the guidelines for recognizing a loss liability resulting from all claims that result from actions not included in the scope of paragraphs .109 through .148 of this section. (See paragraphs .101 and .102.) Those claims include contractual actions, such as claims for delays or inadequate specifications on contracts, or for guarantees of the indebtedness of others, property tax appeals, and unemployment

compensation claims (footnote omitted). [NCGA Statement 4, ¶9 and ¶14, as amended by GASB Statement 10 and GASB Statement 34, ¶69]

Accounting and Financial Reporting for Lease Agreements

Subject to the accounting and financial reporting distinctions of governmental funds, the criteria of FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted, should be the guidelines for accounting and financial reporting for lease agreements, except for operating leases with scheduled rent increases, as provided in paragraphs .104 through .108. FASB Statement 13, as amended and interpreted, should be consulted for specific guidance concerning detailed criteria referenced in this section. [NCGA Statement 5, ¶11, as amended by GASB Statement 13, ¶5 and ¶6 and GASB Statement 34, ¶69]

Bond, Tax, and Revenue Anticipation Notes

Proprietary fund bond, tax, and revenue anticipation notes should be reported as current or long-term liabilities depending on the refinancing status in accordance with the criteria in FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced*. [NCGA Interpretation 9, ¶12]

Public Entity Risk Pools—Investments

Loan origination and commitment fees and direct loan origination costs should be accounted for as prescribed in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* which establishes the accounting for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or group of loans. The provisions of that Statement apply to all types of loans (including debt securities); they also specify the accounting for fees and initial direct costs associated with leasing. [GASB Statement 10, ¶45]

Investments

This [Investments] section does not apply to investments in equity securities that are accounted for under the equity method, as provided for in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* or to investments in joint ventures or component units as provided in Section 2100, "Defining the Financial Reporting Entity." [GASB Statement 31, ¶5]

Reporting Special and Extraordinary Items

> *Extraordinary items* are transactions or other events that are *both* unusual in nature *and* infrequent in occurrence. APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,* as amended and interpreted, defines the terms *unusual in nature* and *infrequency of occurrence.* [GASB Statement 34, ¶55]

Statement of Net Assets—Proprietary Funds

> Assets and liabilities of proprietary funds should be presented in a *classified* format to distinguish between current and long-term assets and liabilities as discussed in Chapter 3 of ARB 43, *Restatement and Revision of Accounting Research Bulletins*. [GASB Statement 34, ¶97]

529. The applicability of some of these FASB and AICPA pronouncements was specifically discussed within the authoritative guidance of GASB Statement 20, paragraph 9, as follows:

> FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation,* does not specifically exclude state and local governmental entities from its scope, nor does it preclude its application to governmental entities. FASB Statement 71 and related pronouncements issued on or before November 30, 1989,[4] may be applied to proprietary activities that meet the criteria of those pronouncements for reporting as regulated enterprises. (The last sentence and footnotes 2 and 3 were omitted.)
>
> [4]Related pronouncements include FASB Statements No. 90, *Regulated Enterprise—Accounting for Abandonments and Disallowances of Plant Costs;* No. 92, *Regulated Enterprises—Accounting for Phase-in Plans;* and No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71.*

530. Also with regard to applying specific FASB and AICPA pronouncements, GASB Statement 34, paragraph 17, footnote 13, stated that "changes in accounting principles, addressed in APB Opinion No. 20, *Accounting Changes*, as amended, should be reported as restatements of beginning net assets/fund equity, not as a separately identified cumulative effect in the current-period statement of activities or proprietary fund

statement of revenues, expenses, and changes in fund net assets." Other provisions of Opinion 20 that do not conflict with or contradict GASB pronouncements should be applied to governments.

531. The Board evaluated these pronouncements in greater detail and identified certain specific provisions within them that conflicted with or contradicted GASB pronouncements. The Board omitted these certain provisions or in some cases modified the specific provisions for incorporation into the GASB literature. For example, FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted, was designated in NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments,* as the lease accounting guidance to be followed by governments with lease arrangements. However, FASB Statement 13, as amended, requires that entities that transfer lease receivables to a third party follow FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse.* GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, provides guidance to governments for the transfer of receivables such as for leases, and therefore governments would apply it in lieu of FASB Statement 77. The Board modified the provisions pertaining to the transfer of lease receivables to reference GASB Statement 48 instead of FASB Statement 77 for this Statement.

Other Commonly Applied FASB and AICPA Pronouncements

532. The Board also included guidance from FASB and AICPA pronouncements that are commonly applied by governments, such as FASB Statement No. 52, *Foreign Currency*

Translation. Provisions within these pronouncements were evaluated to identify specific provisions that conflict with or contradict GASB pronouncements.

Specialized Industry Standards

533. The guiding principles presented within GASB's mission provide that the Board should "consider the applicability of its standards to the separately issued general purpose financial statements of governmentally owned special entities." With that in mind, the Board considered the relevance to governments of specialized guidance in the FASB and AICPA pronouncements and determined which specialized guidance should be evaluated in greater detail and considered for codification. Some governments' activities meet the scope of the standards pertaining to, for example, the broadcasting industry or mortgage banking activities and therefore those standards contained in FASB Statements No. 63, *Financial Reporting by Broadcasters,* and No. 65, *Accounting for Certain Mortgage Banking Activities,* were evaluated in greater detail. The Board did not consider specific guidance pertaining to industries that are rarely present in the governmental environment, such as the motion picture film and record and music industries.

Accounting and Financial Reporting Guidance Applied to Government Combinations

534. APB Opinion No. 16, *Business Combinations*, and its related amendments and interpretations presented additional issues that the Board considered. It is common for governments to apply the "pooling of interest method" provided in Opinion 16 to account for government combinations. The Board is currently considering the financial reporting requirements for government combinations in a separate project. The Board considered whether to incorporate the Opinion 16 provisions that are applicable to consolidation, acquisition, or other means as interim guidance or to exclude Opinion 16 provisions from

incorporation into the GASB literature until the Board could perform comprehensive research on government combinations. Due to the substantive modifications that would be necessary to adapt the criteria for when a combination should be treated as a pooling-of-interest versus a purchase acquisition to the government environment, the Board determined that Opinion 16 and its related amendments and interpretations should be excluded from incorporation, and the accounting and financial reporting of government combinations should be fully addressed in a separate project. In the interim, the Board believes that state and local governments should continue their current practice of accounting and reporting of government combinations until the Board can develop specific accounting and financial reporting standards for government combinations.

Disposal of a Segment of a Business

535. APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, addresses accounting for the disposal of a segment of a business. As explained in paragraph 8 of that Opinion, this refers to a segment of a business "that has been sold, abandoned, spun off, or otherwise disposed of or, although still operating, is the subject of a formal plan for disposal." However, the Board intends to address disposals of a segment of a business in the project on government combinations, which will examine certain devolution (spin-off) issues; for example, accounting for a library district that was formerly a department in a primary government. Consistent with its decision regarding Opinion 16, the Board concluded that provisions on disposals of a segment of a business should not be incorporated into the GASB literature with this Statement and that this issue should be fully addressed in the separate project on government combinations.

Other FASB and AICPA Literature

536. Based primarily upon conclusions reached in the issuance of GASB Statement 20, other FASB or AICPA literature pertaining to private-sector accounting was not considered by the Board for codification. The application of other literature to governments is discussed in the Basis for Conclusions in GASB Statement 20, paragraphs 32 and 33 as follows:

> The emphasis of this Statement is on the applicability of FASB Statements and Interpretations, APB Opinions, and ARBs to proprietary activities. The Board acknowledges, however, that there are other sources of accounting guidance that may be applicable to proprietary activities, including FASB Technical Bulletins, AICPA Statements of Position (SOPs), and AICPA Industry Audit and Accounting Guides. These other sources of accounting guidance are not specifically covered because GASB Statements address only category (a) guidance in the GAAP hierarchy.
>
> The Board presumes that the logic of the provisions of this Statement will be applied to other sources of accounting guidance. For example, if a new AICPA pronouncement (SOP or Industry Audit and Accounting Guide) does not include governmental entities in its scope, then it is *other accounting literature* in the GAAP hierarchy for proprietary activities that apply paragraph 6 of this Statement. However, if that AICPA pronouncement does not include governmental entities in its scope but it has been cleared by the FASB, then it would be considered category (b) guidance for proprietary activities that apply paragraph 7. An AICPA SOP or Industry Audit and Accounting Guide that includes governmental entities in its scope is category (b) guidance for all applicable governmental entities, including proprietary activities, if the GASB has cleared it.

Materiality

537. Certain FASB and AICPA pronouncements contain provisions that address materiality. For example, paragraph 24 of Opinion 30 provides the following:

> The effect of an extraordinary event or transaction should be classified separately in the income statement in the manner described in paragraph 11 if it is material in relation to income before extraordinary items or to the trend of annual earnings before extraordinary items, or is material by other appropriate criteria.

GASB guidance, in contrast, does not address the issue of materiality in the application of individual accounting principles. The extent to which GASB standards deal with materiality generally involves an explanation that their provisions need not be applied to immaterial items (often referred to as the materiality box). The FASB generally uses a similar approach to addressing materiality. In the *FASB Accounting Standards Codification*™, Notice to Constituents (v 1.05), the FASB explains that:

> Over the years, various standards have included language stating that a standard is applicable if an item is material. Retaining such individual materiality references in the Codification could lead users to believe that materiality applies to one set of standards, but not another. To provide greater consistency, the Codification excludes individual materiality references. Instead, the Codification solely provides the standards of accounting and reporting.

The Board concluded that such provisions pertaining to materiality should not be incorporated into this standard, given that these provisions would be inconsistent with the approach taken in other GASB standards regarding materiality considerations.

Applicability of Pre-1989 FASB and AICPA Pronouncements to Governmental Funds

538. As noted in paragraph 307 of the Basis for Conclusions of GASB Statement 34, "Generally, pronouncements of the FASB and its predecessors have not been applicable to governmental funds." In paragraph 17 of GASB Statement 34, pre-1989 FASB and AICPA pronouncements that do not conflict with or contradict GASB pronouncements were made applicable to governmental and business-type activities in the government-wide financial statements. In paragraph 93 of GASB Statement 34, these pronouncements were made applicable to proprietary funds financial statements. Therefore, the provisions of FASB and AICPA pronouncements that the Board determined should be incorporated into the GASB literature generally should be applicable to governmental and business-

type activities (government-wide financial statements) and proprietary funds financial statements. There are some exceptions because in certain cases, GASB or NCGA pronouncements that are applicable to governmental funds have referred to specific FASB and AICPA pronouncements as the applicable guidance to be followed. One example exists in NCGA Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, paragraph 14, as amended, which states that, "Subject to the accounting and financial reporting distinctions of governmental funds, the criteria of FASB Statement No. 5, *Accounting for Contingencies,* should be the guidelines for recognizing a loss liability. . . ." Another example exists in NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, paragraph 11, as amended, which states, ". . . subject to the accounting and financial reporting distinctions of governmental funds, that the criteria of FASB Statement 13 (as amended and interpreted) should be the guidelines for accounting and financial reporting for lease agreements." Therefore, the provisions of those FASB and AICPA pronouncements incorporated in the GASB literature are applicable to governmental funds, subject to the accounting and financial reporting distinctions of governmental funds.

539. Some respondents to the Exposure Draft expressed concerns related to applying the provisions of the Statement on the modified accrual basis of accounting. These respondents generally believed that the Statement should provide additional guidance for governmental funds. The Board concluded that the applicability of the Statement to governmental funds is adequately addressed in paragraph 3, which indicates that the requirements of the Statement apply to accounting and financial reporting for

governmental activities except as otherwise noted in the provisions of that paragraph. In addition, paragraph 3 expressly indicates that certain provisions of the Statement "also apply to governmental funds, subject to the accounting and financial reporting distinctions of governmental funds." The Board further concluded that any changes to the Statement to specifically address the modified accrual basis of accounting would result in more than a minor modification to the applicable provisions from FASB and AICPA pronouncements issued on or before November 30, 1989, which would be outside the scope and approach taken in this Statement, as discussed in paragraph 515.

Applicability of Pre-1989 FASB and AICPA Pronouncements to Fiduciary Funds

540. Some respondents to the Exposure Draft questioned why certain guidance in the Statement does not apply to fiduciary funds. Proprietary funds and governmental and business-type activities are required to apply all FASB and AICPA pronouncements issued on or before November 30, 1989 that do not conflict with or contradict GASB standards in accordance with GASB Statement 20, as amended by GASB Statement 34. However, neither GASB Statement 20 nor Statement 34 provides that such literature should be applied by fiduciary funds. Given that the purpose of this Statement is to incorporate FASB and AICPA guidance that is currently applicable to state and local governments without substantive modifications to that guidance or its applicability, the Board concluded that extending the provisions of the Statement to fiduciary funds would be inconsistent with the intended purpose of the Statement. As a result, the Board decided not to add provisions to the Statement regarding accounting by fiduciary funds.

Applicability of Pre-1989 FASB and AICPA Pronouncements to Supplementary Information

541. The Board considered whether the provisions from pre-1989 FASB and AICPA pronouncements, which pertain to supplementary information, should be incorporated into the GASB literature. For example, paragraph 39 of Opinion 20 provides that:

> In a summary of financial information that includes an accounting period in which a change in accounting principle was made, the amount of the cumulative effect of the change that was included in net income of the period of the change should be shown separately along with the net income and related per share amounts of that period and should not be disclosed only by a note or parenthetical notation.

Also, paragraph 27 of APB Opinion No. 9, *Reporting the Results of Operations,* provides that:

> It has become customary for business entities to present historical, statistical-type summaries of financial data for a number of periods—commonly five or ten years. The Board recommends that the format for reporting extraordinary items described in paragraph 20 be used in such summaries. The Board further recommends that, whenever prior period adjustments have been recorded during any of the periods included therein, the reported amounts of net income (and the components thereof), as well as other affected items, be appropriately restated, with disclosure in the first summary published after the adjustments.

In addition, some respondents to the Exposure Draft believed the guidance should apply to the supplementary information. As noted previously, GASB Statement 34 requires that FASB pronouncements only be applied to the governmental and business-type activities and proprietary funds financial statements. Therefore, the provisions that pertain to supplementary information beyond the basic financial statements were not incorporated into the GASB literature because governments have not been required to apply those provisions.

Nonauthoritative Appendices in FASB and AICPA Pronouncements

542. The appendices of FASB and AICPA pronouncements sometimes provide examples and illustrations of the application of the authoritative standards. The Board determined that these appendices generally should not be incorporated into GASB literature because they are nonauthoritative and often lack applicability to the government environment. Literature maintained in the appendices are considered nonauthoritative in both the private- and public-sector hierarchies of GAAP, and the provision in paragraph 6 of GASB Statement 20, from which the scope of this Statement is derived, does not address nonauthoritative provisions. In addition, the Board determined that the appendices generally are complementary to the authoritative guidance, rather than supplementary guidance that governments would need to apply in order to conform to the authoritative standards. However, the Board noted certain exceptions to the general nature of such literature in FASB Statement No. 66, *Accounting for Sales of Real Estate,* where guidance residing in Appendix B, "Description of Certain Methods of Accounting For Real Estate Sales Transactions," is supplementary to the authoritative standards in that it provides the only description in the accounting literature of specific accounting methods required by the authoritative standards to be applied to real estate transactions. The Board determined that it was appropriate and necessary to incorporate those certain provisions of Appendix B of FASB Statement 66 into the GASB literature.

Authoritative Illustrations in the FASB Interpretations

543. Certain FASB Interpretations include illustrations within the authoritative sections of the pronouncements. The Board evaluated the illustrations provided and determined if they were essential to the understanding of the guidance. If not, they were not incorporated into the GASB literature. For example, paragraph 7 of FASB Interpretation

No. 14, *Reasonable Estimation of the Amount of a Loss,* provides an illustration of the application of guidance set forth in FASB Statement 5. The Board considered this illustration to be essential in understanding the guidance incorporated into the GASB literature from FASB Statement 5 and, therefore, included paragraph 7 of FASB Interpretation 14 in this Statement.

Impact of FASB Codification on GASB Statement 20, Paragraph 7

544. Paragraph 7 of GASB Statement 20, as amended, provides that enterprise funds may elect to apply all FASB Statements and Interpretations issued after November 30, 1989, given that their provisions do not conflict with or contradict GASB pronouncements. Although the project was initially limited to FASB and AICPA pronouncements issued prior to November 30, 1989, some members of the expert group and respondents to the Exposure Draft commented that the impact of the FASB Codification and the resulting process to update the Codification on those governments electing to follow post-1989 FASB pronouncements should be addressed as well. The elimination of Statements and Interpretations and the various categories of the FASB GAAP hierarchy in favor of Codification Updates that are all considered the equivalent of category (a) GAAP will cause confusion on the part of "paragraph 7 electors" as to what updates they are required to apply. They believed that some governments may conclude that all Codification Updates should be applied regardless of the source because of the category (a) GAAP designation. Others may conclude that none of the updates are required to be applied because they no longer take the form of Statements or Interpretations as specified in GASB Statement 20. Still others may decide to try to discern the source (if possible) and apply those updates that analogize to the former FASB Statements and Interpretations.

These differing views could cause significant diversity in practice. Some members of the expert group believed that while the pre-1989 pronouncements project is important in the context of the FASB Codification from a logistical standpoint, the impact of the FASB Codification on the "paragraph 7 electors" is even more important because it may create confusion as to the application of prospective authoritative guidance.

545. The Board initially believed that paragraph 7 should not be addressed in the project and that a separate research project should be considered—an approach supported by some respondents to the Exposure Draft. However, prior to the issuance of the Exposure Draft, surveys regarding the application of paragraph 7 by governments were conducted with representatives of various accounting firms and preparers. A significant majority of the survey respondents said that they do not elect to follow FASB Statements and Interpretations under paragraph 7 of GASB Statement 20. Of those respondents who are paragraph 7 electors, the majority represented hospitals and utility companies that seek comparability with their private-sector counterparts within the conflict and contradict parameters of the current standards. Regarding those preparers who do not represent hospitals or utilities, they had elected to follow post-1989 FASB pronouncements primarily because at one point the GASB had not yet addressed specific guidance such as accounting for defined benefit plans, derivatives, fair value measurement, alternative investments, and asset retirement obligations. The GASB has now either issued standards or has most of these accounting issues on its current agenda or research projects, and most individuals surveyed stated that they no longer have a need for the paragraph 7 election.

Alternatives

546. The Board considered but decided not to incorporate post-November 30, 1989 FASB pronouncements into the GASB literature. The premise behind the paragraph 7 election in Statement 20 is that government enterprises can elect to apply all business enterprise standards (unless they conflict with or contradict GASB pronouncements) in order to facilitate comparability of their financial statements to those of similar private entities. Separate business enterprise standards maintained by the GASB would not meet the needs of those governments unless the GASB constantly amended those standards to conform to amendments by the FASB. Perpetually amending such business enterprise standards maintained by the GASB to conform to Codification Updates by the FASB in order to meet the needs of these government enterprises seems to outweigh the benefits based on the small number of preparers who elect to follow paragraph 7. Such efforts would likely diminish the GASB's effectiveness in standards setting for all governments.

547. The Board also considered replacing the references to FASB Statements and Interpretations, issued after November 30, 1989, in GASB Statement 20 with references to the FASB Codification. This approach could achieve the original objective of the GASB Statement 20, paragraph 7 election. However, this would elevate the status of previous non-category (a) private-sector accounting standards such as FASB Staff Positions and Emerging Issues Task Force Abstracts to category (a) authoritative literature for governments electing to follow paragraph 7. The guidance in each of those pronouncements would need to be reviewed, as incorporated into the FASB Codification, to determine if it conflicts with or contradicts GASB pronouncements. Many of those pronouncements were amended when incorporated into the FASB Codification.

548. After considering these alternatives and the survey results, the Board decided to supersede GASB Statement 20, including paragraph 7, so that GASB pronouncements would be the only category (a) authoritative literature for governments. The Board determined that the more significant accounting issues addressed in the FASB pronouncements issued after November 30, 1989, have now also been addressed by GASB pronouncements, and it is no longer necessary for some government enterprises to apply all FASB pronouncements. Many individuals surveyed also suggested this option, stating that it would simplify accounting guidance for governmental entities.

549. With the incorporation of all applicable provisions from the pre-1989 FASB and AICPA pronouncements, the remaining provisions of GASB Statement 20, which require the application of all pre-1989 pronouncements, are no longer necessary. Therefore, Statement 20 is superseded entirely by this Statement. For the governments who have accounting issues not addressed by the GASB literature, they could still apply FASB literature as other accounting literature if necessary, unless it conflicts with or contradicts GASB pronouncements, similar to AICPA Statements of Position or other non-category (a) private-sector accounting literature.

550. Some respondents to the Exposure Draft recommended that the effect on GASB Statement 20—and, in particular, on paragraph 7 of that Statement—be clarified in the standards section of this Statement. The respondents believed that the supersession of paragraph 7 of GASB Statement 20 would not be understood unless further emphasized in the standards section of this Statement. However, paragraph 4 of this Statement, which lists the pronouncements that are affected, clearly indicates that this Statement supersedes GASB Statement 20. In addition, subsequent issuances of the GASB's publications,

including the *Original Pronouncements* and the *Codification of Governmental Accounting and Financial Reporting Standards*, will reflect the supersession of GASB Statement 20. As a result, the Board concluded that it would be unnecessary for the standards section to include further clarification regarding this Statement's effect on GASB Statement 20.

551. A respondent to the Exposure Draft recommended that the Board provide additional discussion in this Statement regarding governments that potentially will implement accounting changes as a result of this Statement. The respondent specifically discussed the impact of this Statement on those entities that have made the election provided in paragraph 7 of GASB Statement 20. The respondent suggested adding such discussion to paragraph 502, which includes the effective date and transition provisions of this Statement. The Board recognized that post-November 30, 1989 FASB pronouncements applied by paragraph 7 electors would no longer be considered category (a) guidance following the issuance of this Statement. However, the Board did not believe that the supersession of GASB Statement 20 would result in substantial accounting changes by paragraph 7 electors, given that FASB literature that provides guidance in areas not addressed in GASB standards could continue to be applied by governments as other accounting literature. As a result, the Board did not add further discussion to this Statement regarding this issue.

Incorporated Guidance from FASB and AICPA Pronouncements

552. The provisions of FASB and AICPA pronouncements considered by the Board to be applicable to governments are incorporated into GASB literature as provided in this Statement. The Board's basis for incorporating certain provisions of those pronouncements is described in the paragraphs that follow.

Capitalization of Interest Costs

Governmental Activities Scope Exclusion

553. GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus,* provides that construction-period interest on assets used in the governmental activities should not be capitalized. Therefore, the Board modified the scope of the provisions from FASB Statements No. 34, *Capitalization of Interest Cost*, and No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*, to exclude interest costs reported for governmental activities.

Assets Donated or Granted to Other Governments

554. The guidance from FASB pronouncements does not indicate whether qualified assets for interest capitalization would include assets that were constructed and donated or granted to others. The Board believed it was important to address assets being granted by governments within the provisions for capitalization of interest costs because it is a common occurrence in the public sector to grant assets to other governments. The Board determined that such assets should be considered qualified assets for interest capitalization because capitalizing the construction-period interest for these capital assets would be consistent with other constructed capital assets. Accordingly, the provisions from FASB Statement 34, paragraph 9, were modified to include assets granted to other governments.

Revenue Recognition for Exchange Transactions

555. The Board decided to incorporate the first provision of ARB 43, Chapter 1A, *Rules Adopted by Membership,* as amended by paragraph 12 of APB Opinion No. 10, *Omnibus Opinion—1966,* requiring profit to be realized once a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price

is not reasonably assured. GASB Statement 34 already provides that “revenues, expenses, gains, losses, assets, and liabilities resulting from exchange and exchange-like transactions should be recognized when the exchange takes place;” however, incorporating the guidance from ARB 43, Chapter 1A, provides clarification that governments may, when appropriate, use methods for recognizing revenue from exchange transactions that are in exception to the general principle. The Board also inserted a reference to more specific guidance in FASB Statement 66 for real estate transactions and the use of the installment method.

556. The Board omitted the last sentence of ARB 43, Chapter 1A, paragraph 1, which provided that “An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.” The circumstance rarely applies in the government environment; therefore, the Board concluded that it is not necessary to incorporate a specific exception for rare circumstances.

Revenue Recognition When Right of Return Exists

557. Some respondents to the Exposure Draft believed that the guidance related to revenue recognition when the right of return exists focuses on the sale of inventory or other goods and, therefore, applies mainly to a state and local government’s business-type activities. During its initial deliberations, the Board did not specifically limit the applicability of this guidance only to business-type activities, as suggested by the respondent. However, after further deliberations, the Board concluded that limiting the applicability of this guidance to business-type activities and proprietary funds is

appropriate, given the likelihood that business-type activities and proprietary funds would be the primary types of governmental entities to engage in product sales with rights of return. This conclusion, in turn, implied that business-type activities and proprietary funds would be the most likely entities to need to apply this guidance and other entities would find this guidance rarely applicable. As a result, the Board elected to limit the applicability of paragraphs 24–28 of the Statement to business-type activities and proprietary funds.

Statement of Net Assets Classification

Current Assets and Current Liabilities

558. ARB 43, Chapter 3A, *Current Assets and Current Liabilities,* is applicable to proprietary activities because they are required to present a classified balance sheet or statement of net assets. GASB Statement 34, paragraph 97, provides that "Assets and liabilities of proprietary funds should be presented in a *classified* format to distinguish between current and long-term assets and liabilities as discussed in Chapter 3 of ARB 43, *Restatement and Revision of Accounting Research Bulletins*." Use of a classified format also is permitted but not required by Statement 34 for government-wide financial statements.

The Operating Cycle

559. Paragraph 4 of ARB 43, Chapter 3A, provides that "For accounting purposes, the term *current assets* is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business." Paragraph 5 states that "The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an *operating cycle*." In the absence of a clearly defined operating cycle, the one-year provision should govern. The Board

considered whether GASB literature should permit the use of an operating cycle that extends beyond one year. Because the Board is unaware of any governments adopting an operating cycle greater than a year to determine its current assets and liabilities, the Board concluded that modifying the provisions of ARB 43, Chapter 3A, to permit only the use of a one-year period for determining current assets and liabilities in all government financial statements was appropriate.

Demand Bonds

560. Specific guidance for classifying demand bonds as current or long-term liabilities is provided in GASB Interpretation No. 1, *Demand Bonds Issued by State and Local Governmental Entities.* Therefore, the Board inserted a footnote in paragraph 7 of ARB 43, Chapter 3A, as amended by FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor,* to refer preparers to Interpretation 1 for specific guidance on classifying demand bonds.

Valuation of Marketable Securities and Temporary Investments

561. Paragraph 9 of ARB 43, Chapter 3A, provides guidance for the valuation of marketable securities and temporary investments. The Board determined that such guidance was in conflict with the provisions for valuing investments in GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools,* and, therefore, the guidance was not incorporated into the GASB literature.

Prior-Period Adjustments and Special and Extraordinary Items

562. The Board evaluated the guidance contained in Part I of Opinion 9 *(Net Income and the Treatment of Extraordinary Items and Prior Period Adjustments);* Opinion 30; and FASB Statement No. 16, *Prior Period Adjustments,* for incorporation into the GASB

literature. The Board determined that reporting and disclosure requirements for prior-period adjustments in Opinion 9 and FASB Statement 16 are applicable to governments and should be incorporated into the GASB literature. However, the guidance in Opinion 9 and Opinion 30 pertaining to the *presentation* of extraordinary items conflicts with GASB Statement 34 requirements for reporting special and extraordinary items. As previously noted, guidance pertaining to reporting financial date and historical summaries does not apply to reporting for governmental or business-type activities or proprietary funds and, therefore, was not incorporated into the GASB literature. Also, guidance in these pronouncements pertaining to interim financial reporting was not incorporated into the GASB literature because the Board determined that FASB and AICPA guidance conflicts with the provisions on interim reporting in NCGA Statement 1. The Board also omitted provisions in these FASB and AICPA pronouncements pertaining to the accounting and financial reporting of income taxes and capital transactions because the Board believes that they rarely apply to state and local governments. Provisions pertaining to the reporting of earnings per share information also were omitted because they are not applicable to state and local governments.

Classification of Special and Extraordinary Items

563. Paragraphs 19–24 of Opinion 30 provide the criteria for classifying items as extraordinary. These paragraphs are referenced in paragraph 17 of GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, as the guidance to apply when reporting impairment losses as extraordinary items. That Opinion, as amended and interpreted, also "defines the terms *unusual in nature* and *infrequency of occurrence*," as indicated in paragraph 55 of GASB Statement 34. These definitions are used in the governmental environment to classify

special items as well, although not in the private sector. According to paragraph 56 of GASB Statement 34, special items are "significant transactions or other events *within the control of management* that are *either* unusual in nature *or* infrequent in occurrence." Because the terms from Opinion 30 play an important role in defining extraordinary and special items in the GASB literature, the Board concluded that the definitions of *unusual in nature* and *infrequency of occurrence*, provided in paragraphs 19–23 of Opinion 30, should be incorporated into the GASB literature. Paragraph 24 of that Opinion addresses matters pertaining to materiality and therefore was not incorporated into the GASB literature.

Comparative Financial Statements

564. The notion in paragraphs 1 and 2 of ARB 43, Chapter 2A, *Comparative Financial Statements*, that comparative financial statements are more desirable than single-period statements conflicts with GASB Statement 34 in that the minimum requirements for the presentation of financial statements in GASB Statement 34, paragraphs 6 (general purpose governments) and 138 (single-purpose business-type activities) do not require or recommend comparative financial statements. However, many governments present comparative financial statements annually, and in those instances this guidance is applicable. Therefore, the Board determined that it was appropriate to incorporate reporting guidance for governments who choose to present prior-period financial statements with the current-period financial statements.

565. Paragraph 2 of ARB 43, Chapter 2A, provides that certain disclosures presented for prior periods should be repeated or referred to in comparative financial statements if they remain significant. The Board considered also including "required supplementary

information" among the required prior period disclosures, given that it is a part of the minimum financial reporting requirements of GASB Statement 34, paragraph 6. The GASB *Comprehensive Implementation Guide,* Q&A 7.5.4, addresses comparative data in the management, discussion, and analysis (MD&A), a component of required supplementary information. Q&A 7.5.4 provides that "in a comparative financial statement setting, MD&A should provide data so that each of the two years presented in the comparative financial statements can be compared to its prior year." However, the Board determined that making such modification was beyond the scope of the project considering that the pre-1989 FASB and AICPA pronouncements apply only to the reporting of the financial statements and decided against modifying the provision. Guidance for the presentation of accountants' qualifications was not incorporated because the presentation of auditors' reports also is outside the confines of the financial statements.

Related Parties

Definition of Related Parties

566. GASB literature requires governments to report activities with related organizations, joint ventures, and jointly governed organizations as related party transactions in the notes to the financial statements, as required by GASB Statement No. 14, *The Financial Reporting Entity*, as amended. Therefore, the Board modified the definition of a related party from FASB Statement No. 57, *Related Party Disclosures*, to incorporate those relationships as well as to remove specific relationships in the FASB Statement 57 definition that are not prevalent in the government environment.

Accounting Changes and Error Corrections

Changes in Accounting Principle

567. Governments should report the cumulative effect of an accounting change as an adjustment of beginning net assets, in accordance with GASB Statement 34, paragraph 17, footnote 13, and not include it in net income of the current period as required in Opinion 20. The Board modified the provisions from Opinion 20 for reporting changes in accounting principle accordingly for incorporation into the GASB literature.

Changes in depreciation method

568. Opinion 20, paragraph 9, includes a *change in depreciation method of previously recorded assets* in the examples of changes in accounting principle. However, as discussed in paragraph 11, sometimes a new accounting method is adopted in recognition of the change in estimated future benefits making it difficult to distinguish a change in accounting principle from a change in estimate. Paragraph 11 requires that, in this circumstance, the change in method be reported as a change in estimate. The Board believes that if a government changes the depreciation method of a previously recorded asset, the decision should most likely be based on additional information obtained indicating that the new method better reflects the pattern of consumption of the asset (that is, estimated future benefits) over future periods. The Board decided to omit a change in depreciation method from the examples of changes in accounting principle because it may mislead readers to the conclusion that a change in depreciation should always be reported as a change in accounting principle.

Retroactive application of special changes in accounting principle

569. Paragraph 27 of Opinion 20 describes “special changes in accounting principle reported by applying retroactively the new method in restatements of prior periods.” The

Opinion provides that the following changes are examples of instances where the financial statements of all periods presented should be restated:

> . . . (a) a change from the LIFO method of inventory pricing to another method, (b) a change in the method of accounting for long-term construction-type contracts, and (c) a change to or from the "full cost" method of accounting which is used in the extractive industries.

570. The Board concluded that these examples rarely occur in the government environment and the GASB literature need not distinguish a difference in applying accounting changes for rare situations. Therefore, provisions for special application of these accounting changes were omitted from the GASB literature.

Special exemption for an initial public distribution

571. Paragraphs 29 and 30 of Opinion 20 describe the accounting and disclosures required for situations in which a company issuing its first financial statements may provide retroactively restated financial statements for all prior periods presented. As provided in paragraph 29, the Opinion allows this treatment "for any one of the following purposes: (a) obtaining additional equity capital from investors, (b) effecting a business combination, or (c) registering securities." Paragraph 30 requires that a company falling under this special exemption disclose the nature of and justification for the change in accounting principle.

572. The special exemption for an initial public distribution described in paragraphs 29 and 30 is not applicable to governments because the financial statements included in general purpose external financial reports of governments are always available for public distribution, as opposed to only available to private owners of a private entity. Therefore, the Board omitted this guidance from the GASB literature.

Contingencies

573. The scope of the provisions from FASB Statement 5 was modified to omit specific contingencies that are already covered in the GASB literature in NCGA Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences,* GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues,* and GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations.* The examples added were noted in the GASB literature, which describes the applicability of FASB Statement 5 to governments. Some respondents to the Exposure Draft suggested adding a footnote to paragraph 99 of this Statement that would indicate the GASB standards that provide guidance on accounting and financial reporting for the risks of loss associated with the specific types of events identified in that paragraph. These respondents believed that the footnote would assist governments in applying the appropriate GASB guidance in a given situation. As a result, the Board concluded that the addition of a footnote to paragraph 99 of the Statement would be useful in understanding and applying the GASB standards that address accounting and financial reporting for risks of loss.

Construction-Type Contracts—Long-Term

574. Some respondents to the Exposure Draft believed that the guidance provided in the Statement regarding long-term construction-type contracts generally is rarely applicable to state and local governments. However, the Board discussed the applicability of ARB No. 45, *Long-Term Construction-Type Contracts,* to governments during its deliberations and concluded that the pronouncement is applicable based on feedback received from expert group members who indicated that some governments act as contractors for other

governments and need to apply the guidance in ARB 45. As a result, the Board incorporated the provisions of ARB 45 into the GASB literature.

Commitments

575. The Board omitted the provisions in ARB 45 pertaining to disclosures of commitments to complete contracts because they are in conflict with the general requirement to disclose significant commitments in NCGA Statement 1, paragraph 158.

Extinguishments of Debt

Debt Defeased by Current or Advanced Refundings

576. Opinion 26, as amended by FASB Statement No. 76, *Extinguishment of Debt,* is applicable to governments to the extent that it applies to the early extinguishment of debt through means other than refundings. Governments should apply GASB Statement 23, to refundings of outstanding debt. Therefore, the Board modified the scope of the application of the provisions from these two pronouncements to exclude debt defeased by a current or advanced refunding. Provisions from paragraphs 3(c) and 4 of FASB Statement 76 also describe an in-substance defeasance as a circumstance when Opinion 26 should be applied. That requirement conflicts with guidance in GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt,* and GASB Statement 23 for accounting and reporting in-substance defeasances. Therefore, those provisions were omitted from incorporation into the GASB literature.

Troubled Debt Restructuring

Exclusion of Debt Restructurings in Chapter 9 Bankruptcies

577. GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies,* provides accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of

the United States Bankruptcy Code. However, that guidance would not apply to troubled debt restructurings that occur outside of bankruptcy. Therefore, FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* would still apply in those circumstances. FASB Statement 15 also would apply when the government is a *creditor* in a bankruptcy proceeding. Therefore, the Board modified the scope of FASB Statement 15 for incorporation into the GASB literature to exclude restructuring, which should be accounted for in accordance with GASB Statement 58.

Foreign Currency Transactions

Translation of Foreign Currency Financial Statements

578. FASB Statement 52 applies to governments who hold investments denominated in foreign currencies and enter into foreign currency transactions. However, the guidance of FASB Statement 52 for accounting and financial reporting of the translation of foreign currency financial statements for inclusion in the reporting entity has rare application in the government environment. Governments seldom if ever report component units or other operations in foreign countries that prepare financial statements denominated in a foreign currency. Therefore, the provisions of FASB Statement 52 that pertain to the translation of foreign currency financial statements were omitted from incorporation into the GASB literature.

Interest Costs—Imputation

Government Below-Market Rate Loans

579. Members of the Expert Group raised concerns about the impact of Q&A 7.8.7 in the *Comprehensive Implementation Guide* on the application of APB Opinion No. 21, *Interest on Receivables and Payables,* to government issued loans. It provides that a government making economic development loans to private parties at below-market rates is not

required to discount the loan at a higher imputed interest rate and recognize additional interest income because of certain provisions of Opinion 21. Because the government makes the low-interest loan to carry out governmental objectives, it "makes the market" for the loan. The market rate is the rate that the government charges. The Expert Group members believed that low or zero-interest long-term receivables resulting from government programs should be specifically exempted from the provisions related to the imputing of interest. The Board modified the application of the provisions of Opinion 21 accordingly to exempt low-interest loans issued by governments to carry out governmental objectives.

Inventory

580. The conclusions on the general principles for inventory pricing in ARB 43, Chapter 4, *Inventory Pricing*, as indicated in paragraph 2, were not directed to or necessarily applicable to noncommercial businesses or regulated utilities. The Board determined it was appropriate to restrict the application of those provisions to only business-type activities. It is also not necessary to exclude regulated utilities from the scope of its provisions because FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, paragraph 7, provides that "Authoritative accounting pronouncements that apply to enterprises in general also apply to regulated enterprises. However, enterprises subject to this Statement shall apply it instead of any conflicting provisions of standards in other authoritative pronouncements." The Board also determined it was not necessary to incorporate specific guidance from Chapter 4, "Statement 8," regarding consistent application of the basis of stating inventories because guidance pertaining to consistent application of accounting principles already exists in Opinion 20.

581. A respondent to the Exposure Draft believed that the guidance on inventory in the Statement did not address tangible property held for installation or use in the provision of services to customers, which is considered common in the governmental environment. However, the respondent suggested that new guidance did not need to be developed in order to address this type of inventory; rather, the respondent recommended that an excluded provision from ARB 43, Chapter 4 be reconsidered for incorporation into the GASB literature. The Board reconsidered the excluded provision from Chapter 4 and concluded it was appropriate to include this provision in the Statement to properly address tangible property held for installation or use in the provision of services to customers.

Investments in Common Stock

Application to State and Local Governments

582. GASB Statement 31, as amended, provides the accounting standards to be applied to all investments of governmental external investments pools, defined benefit pension or other postemployment benefit plans, and Internal Revenue Code (IRC) Section 457 deferred compensation plans. For all other governmental entities, GASB Statement 31 does not apply to investments in equity securities that meet the scope of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, or to investments in joint ventures or component units as provided in GASB Statement 14. The Board modified the provisions from Opinion 18, paragraph 2, for incorporation into the GASB literature accordingly to exclude the investments that should be accounted for under the guidance of GASB Statement 14, as well as investments that are accounted for under the guidance in GASB Statement 31.

Limitations on the Use of the Equity Method

583. Footnote 4 of Opinion 18 indicates that the limitations in paragraphs 2 and 3 of ARB 51 (as amended by FASB Statement 94) also should be applied as limitations to the use of the equity method. The limitations referenced provide that "A majority-owned subsidiary shall not be consolidated if control is likely to be temporary or if it does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary)."

584. ARB 51 was omitted from incorporation into the GASB literature because it conflicts with GASB Statement 14 as a whole; however, the limitations described within ARB 51 still apply to investments under the equity method. Therefore, the Board modified the provisions from Opinion 18 to incorporate the limitations as they apply to the equity method.

References to Guidance on Consolidated Subsidiaries

585. Paragraph 19 of Opinion 18 in several instances requires investors accounting for investments under the equity method to account or report certain transactions or events with the investee "as if it were a consolidated subsidiary." This guidance becomes estranged in the government application of the standard because the guidance for consolidated subsidiaries is in conflict with GASB's reporting entity standards in Statement 14 and was omitted from incorporation into the GASB literature. The Board modified the provisions of Opinion 18 to eliminate the references to consolidated subsidiaries. In certain cases, eliminating the reference did not impair the meaning of the

guidance. In other cases, it was necessary to insert additional guidance to complete the directive for accounting for the transaction. For guidance pertaining to accounting for the difference between the cost and the underlying equity in an acquired investment, the Board replaced the reference with a directive providing that the difference should be accounted for as goodwill and amortized in a systematic and rational manner that is consistent with accounting for an acquisition of a subsidiary under the pre-1989 FASB and AICPA pronouncements.

Leases

Related Parties in Leasing Transactions

586. FASB Statement 13 is the only FASB pronouncement that provides a related-party definition within the standard rather than a reference to the definition provided in FASB Statement 57. The Board omitted the definition in FASB Statement 13 from GASB literature. The definition of related parties as incorporated from FASB Statement 57 should be used for related party transactions.

Executory Costs

587. In incorporating the provisions of FASB Statement 13 into this Statement, the Board decided to delete taxes from the examples of executory costs provided in that guidance, because the Board believed that this example was rarely applicable to governments. However, some respondents to the Exposure Draft suggested that the examples of executory costs provided in the guidance on leases in the Statement should include taxes. These respondents noted that, although governments generally are not subject to tax, a government could lease property from a nongovernmental lessor that may be taxed on the leased property. If the lessor then passed those taxes on to the government lessee, the respondents believed that it would be appropriate for the government to treat those taxes

as executory costs and thereby exclude them from minimum lease payments. In response to the concerns expressed by respondents, the Board noted that the deletion of taxes from the examples of executory costs does not change the substance of the guidance regarding such costs but, instead, modifies the examples so that only those most applicable to governments are listed. If a government has a justifiable reason for considering an amount to be an executory cost, then the examples of executory costs would not necessarily limit a government's ability to treat the amount as such.

Nonmonetary Transactions

Nonreciprocal Transfers

588. APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, provides accounting guidance for nonreciprocal transfers. However, nonreciprocal transfers fall within the scope of GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance;* GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions;* or GASB Statement 34. The term *nonreciprocal interfund activity* is used in GASB Statement 34, paragraph 112, to refer to transfers between funds. The terminology in Opinion 29 conflicts with the definition of nonexchange transactions from paragraph 7 of Statement 33. In the Basis for Conclusions of GASB Statement No. 11, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements*, the Board noted that the term *nonreciprocal* was used by the FASB for similar or analogous transactions but preferred the term *nonexchange* because it more accurately describes the indirect receiving and giving of value in the governmental environment. GASB Statement 34 referred to nonreciprocal interfund activity as the "internal" counterpart to nonexchange transactions.

589. A nonreciprocal transfer also includes a transfer of assets or services in one direction, either as part of a spin-off or reorganization, or from an individual or another entity to the organization. The Board intends to address those transfers later along with all government combinations. The Board concluded that guidance for financial accounting and reporting of government combinations and related transactions should not be incorporated into GASB literature until it can be addressed more fully in a separate project.

Costs and Initial Rental Operations of Real Estate Projects

Insufficient Rental Demand

590. Paragraph 25 of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects,* provides that evidence of insufficient rental demand for a rental project currently under construction may indicate an impairment of the carrying value. However, GASB Statement 42, paragraph 10, explains that a change in demand is not a separate indicator of impairment; therefore, another indicator would be necessary in order for impairment testing to occur. Governments should apply the provisions of GASB Statement 42 to real estate assets in lieu of the provisions of paragraph 25 of FASB Statement 67.

Research and Development Arrangements

591. FASB Statement No. 68, *Research and Development Arrangements,* specifies how an enterprise should account for its obligation under an arrangement for the funding of its research and development by others, but it does not address reporting of government-sponsored research and development. Under FASB Statement 68, the enterprise is required to determine whether it is obligated only to perform contractual research and development for others or is otherwise obligated. To the extent that the enterprise is

obligated to repay the other parties, it records a liability and charges research and development costs to expense as incurred. Paragraph 10 of GASB Statement 33 discusses instances in which a for-profit entity sponsors research conducted by a government as follows:

> . . . a for-profit organization may provide resources to a public university for research that may result in commercial applications. The award may be referred to as a "grant." However, if the for-profit organization retains the right of first refusal to benefit from the research results, the award may be an exchange or exchange-like transaction. Alternatively, the characteristics of the award may indicate that part of the transaction should be accounted for as an exchange transaction and part as a nonexchange transaction.

If such arrangements are considered exchange or exchange-like transactions, the provisions of FASB Statement 68 apply.

592. The scope of this section was modified to clarify that it applies to research and development arrangements that are exchange or exchange-like transactions. GASB Statement 33 should be applied by governments to all research and development grants that are nonexchange transactions.

Broadcasters

Accounting for License Agreements

593. Broadcasters should account for license agreements as intangible assets in accordance with GASB Statements 34, 42, and No. 51, *Accounting and Financial Reporting for Intangible Assets,* and, therefore, the guidance from FASB Statement 63 pertaining to accounting for license agreements, including the amortization and valuation, was omitted from incorporation into the GASB literature.

Cable Television Systems

Recoverability

594. FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, paragraph 14, provides that capitalized plant and intangible assets shall be evaluated periodically to determine whether the costs are recoverable (through operations or sale of the system) and provides the accounting for when those assets are not recoverable. The concept of recoverability is generally less relevant in the governmental environment where governments, including many business-type activities such as cable television systems, often do not recover their costs. GASB Statement 42 rather than the guidance in paragraph 14 regarding "recoverability," should be applied because GASB Statement 42 focuses on the "decline in service utility," rather than cost recoveries, which is not always the government's intent. Therefore, the recoverability provisions in paragraph 14 of FASB Statement 51 were omitted from incorporation into the GASB literature.

Insurance Entities—Other Than Public Entity Risk Pools

595. If a risk financing group consists primarily of nongovernmental participants and there is a transfer of risk from the participants to the group, then an insurance entity exists, not a pool. Entities, other than public entity risk pools, engaging in insurance activities should be reported in an enterprise fund using the provisions of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended. Thus, the provisions of FASB Statement 60, as amended, should be applied to entities engaging in insurance activities. However, if an entity is a public entity risk pool, then GASB Statement 10 applies. The provisions that pertain to long-duration insurance contracts in FASB Statement 60 were not incorporated into the GASB literature because they have rare application to governments.

596. Paragraph 35 of GASB Statement 10 was amended by GASB Statement No. 30, *Risk Financing Omnibus*, to omit maintenance costs from the premium deficiency calculation, because incurred maintenance costs are period costs that cannot be attributed to future or past events. The Board, therefore, intended to emphasize with this amendment that there should be no expected policy maintenance costs associated with a premium deficiency. Accordingly, paragraph 33 of FASB Statement 60 was similarly modified for incorporation into the GASB literature.

597. GASB Statement 10, paragraph 36, was amended by Statement 30 to emphasize the importance of recognizing a premium deficiency liability and expense in such a way that it is apparent that a premium deficiency exists. Paragraph 34 of FASB Statement 60 was modified to be consistent with GASB Statement 10.

Mortgage Banking Activities

Mortgage-Backed Securities

598. Governments should account for mortgage-backed securities in accordance with GASB Statement 31. FASB Statement 65 provisions pertaining to accounting for mortgage-backed securities by mortgage banking activities conflict with the provisions of GASB Statement 31. References and guidance pertaining to mortgage-backed securities from FASB Statement 65 were not incorporated into the GASB literature.

Transfer of Mortgage Loans

599. The transfer of mortgage loans that qualify as collateralized borrowings under GASB Statement 48 should be reported in accordance with the provisions of that Statement instead of the provisions in FASB Statement 65.

Regulated Operations

Accounting for Impairments

600. Governments should apply the guidance in GASB Statement 42 when it is probable that capital assets are abandoned to determine if the asset is impaired and apply the guidance therein for accounting for impairments. Paragraph 3 of FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs*, indicates that for regulated enterprises, such abandonments should be removed from capital assets once the abandonment becomes probable and provides guidance for accounting for any recovery allowed by the regulator. The provisions in paragraph 3 were modified to indicate that a regulated business-type activity should apply GASB Statement 42 to the circumstances to determine if the asset is impaired. For any assets determined to be impaired, governments should follow the provisions in paragraph 3 for determining the accounting for any recoverable costs allowed by the regulator.

Right to Offset

601. In its initial deliberations, the Board discussed the applicability to state and local governments of Opinion 10. During those deliberations, the Board decided that paragraph 7 of Opinion 10, pertaining to income taxes and the offsetting of U.S. government securities with taxes payable, was not applicable to state and local governments. However, paragraph 7 of that Opinion also provides general guidance on the right of offset (referred to as "setoff" in Opinion 10). The first sentence of paragraph 7(1) sets out the general principle of offsetting in accounting. Although taxes are the focus of the remaining provisions of paragraph 7, the Board believes that this general principle can be applied more broadly to areas of governmental accounting. Thus upon further review, the Board decided to incorporate the first sentence of paragraph 7(1) into the GASB literature.

Effective Date and Transition

602. Some respondents to the Exposure Draft recommended that the Statement be effective upon issuance, rather than "effective for financial statements for periods beginning after December 15, 2011," as provided in the Statement, given that the approach taken by the Board in this Statement was not to establish new guidance but rather to provide one source of the currently applicable guidance from FASB and AICPA pronouncements. Because the literature is already applicable to state and local governments, the respondents suggested that an extended period to implement this guidance would not be needed. The Board considered the comments from these respondents but decided to make this Statement effective for financial statements for periods beginning after December 15, 2011. The Board believes this will provide governments with the opportunity to review the provisions of this Statement and make an assessment of their current practices to determine if any accounting changes should be retroactively applied as a result of implementing the Statement. Although this Statement is not effective immediately, the Board does encourage early application, given that the Board does not anticipate that this standard will lead to substantial changes in practice.

Appendix C

CODIFICATION INSTRUCTIONS

603. The sections that follow update the June 30, 2010, *Codification of Governmental Accounting and Financial Reporting Standards*, for the effects of this Statement. Only the paragraph number of the Statement is listed if the paragraph will be cited in full in the Codification.

* * *

[Modify sections as indicated below; update cross-references throughout.]

* * *

THE HIERARCHY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES **SECTION 1000**

.104 [In the first sentence, replace *Financial Accounting Standards Board Concepts Statements* with *Financial Accounting Standards Board Statements, Interpretations, and Concepts Statements.*] [GASBS 55, ¶6, as amended by GASBS 62, ¶4]

* * *

REPORTING CAPITAL ASSETS **SECTION 1400**

Sources: [Add the following:] GASB Statement 62

.115 [Revise sources as follows:] [GASBS 34, ¶92 and ¶97, as amended by GASBS 62, ¶29–¶43]

[Insert new paragraphs .120–.137 as follows; renumber subsequent paragraphs and footnotes:]

.120–.137 [GASBS 62, ¶5–¶22, including headings and footnotes.]

[Replace the first sentence of current footnote 23 with the following:] The following paragraphs also apply to business-type activities and enterprise funds that apply Section Re10, “Regulated Operations,” but do not preclude them from reporting a regulatory asset related to an impairment loss when appropriate in accordance with the provisions of that section. [GASBS 42, fn2, as amended by GASBS 62, ¶476–¶500]

.191 [Revise the first sentence of current paragraph .173 as follows:] Unless the impairment is considered temporary as described in paragraph .192, the loss[33] from impairment should be reported in the statement of activities and statement of revenues, expenses, and changes in fund net assets, if appropriate, as a program or operating expense, special item, or extraordinary item in accordance with the guidance in paragraphs .126–.131, .140, .141, .145–.149, .167, and .168 of Section 2200. [GASBS 42, ¶17, as amended by GASBS 62, ¶45–¶49]

[33][Insert current fn26.]

[Insert new paragraphs .196–.199 as follows:]

.196–.199 [GASBS 62, ¶488–¶491, including heading.]

* * *

Sources: [Add the following:] GASB Statement 62

.102 [Revise sources as follows:] [NCGAS 1, ¶42, as amended by NCGAS 4, ¶14, NCGAI 9, ¶12, GASBS 6, ¶13 and ¶23, GASBS 10, ¶53, GASBS 13, ¶7, GASBS 16, ¶6, GASBS 18, ¶7, GASBS 27, ¶17, GASBS 47, ¶3, GASBS 49, ¶9, GASBS 62, ¶34–¶43 and ¶96–¶113, and GASBI 1, ¶13; GASBS 34, ¶6, ¶30, ¶81, ¶82, ¶92, and ¶108]

.103 [Revise sources as follows:] [NCGAS 1, ¶43, as amended by NCGAS 4, ¶14, NCGAI 9, ¶12, GASBS 6, ¶17, GASBS 13, ¶9, GASBS 16, ¶13, GASBS 17, ¶6, GASBS 18, ¶10, GASBS 27, ¶16, GASBS 47, ¶3, GASBS 49, ¶9 and ¶24, GASBS 62, ¶34–¶43 and ¶96–¶113, and GASBI 1, ¶10 and ¶12; GASBS 34, ¶82]

[Insert new paragraphs .105–.115 as follows; renumber subsequent paragraphs and footnotes:]

.105–.115 [GASBS 62, ¶29 and ¶34–¶43, including headings and footnotes.]

[Replace current paragraph .116, including heading, with the following:]

Debt Extinguishments and Troubled Debt Restructuring

.127 Accounting and financial reporting for debt extinguishments, including advance refundings that result in legal or in-substance defeasance of debt, and troubled debt restructuring is discussed in Section D20.

* * *

BASIS OF ACCOUNTING **SECTION 1600**

Sources: [Add the following:] GASB Statement 62

[Replace current paragraph .104 with the following; renumber subsequent footnotes:]

.104 [GASBS 62, ¶23, including footnote.]

.129 [Revise sources as follows:] [NCGAS 4, ¶16 and ¶17, as amended by GASBS 62, ¶96–¶113; GASBS 16, ¶13; GASBS 17, ¶6; GASBS 34, ¶82; GASBI, ¶14]

[Delete current paragraphs .131 and .132; insert new paragraphs .131–.136 as follows; renumber subsequent paragraphs and footnotes:]

.131 [GASBS 62, ¶23, including footnote.]

.132–.136 [GASBS 62, ¶24–¶28, including headings and footnotes.]

[Replace current paragraph .133 with the following:]

.137 Section Re10, "Regulated Operations," may be applied to qualifying *enterprise* funds as discussed in paragraph .103 of Section P80. [GASBS 34, ¶95, as amended by GASBS 62, ¶476–¶500]

* * *

THE BUDGET AND BUDGETARY ACCOUNTING **SECTION 1700**

[Delete current paragraph .127; renumber subsequent paragraphs.]

* * *

Sources: [Delete GASB Statement 20; add the following:] GASB Statement 62

[Insert new paragraphs .108–.123 as follows; renumber subsequent paragraphs and footnotes:]

.108–.122 [GASBS 62, ¶29–¶43, including headings and footnotes; modify heading of ¶29 as follows:] Statement of Net Assets Classification in Government-wide and Proprietary Fund Financial Statements

.123 A total of current liabilities should be presented in classified statements of net assets. [GASBS 62, ¶44]

[Replace current paragraph .122 with the following:]

.138 The proprietary fund statement of revenues, expenses, and changes in fund net assets should distinguish between operating and nonoperating revenues and expenses, as discussed in Section P80, beginning in paragraph .113. Proprietary fund revenues should be reported by major sources. [GASBS 34, ¶100]

[Replace current paragraph .129 with the following:]

.145 *Extraordinary items* are transactions or other events that are both unusual in nature and infrequent in occurrence. Paragraphs .147–.151 define the terms *unusual in nature* and *infrequency of occurrence.* As discussed in paragraph .144, extraordinary items should be reported separately at the bottom of the statement of activities. [GASBS 34, ¶55, as amended by GASBS 62, ¶45–¶49]

[Insert new paragraphs .147–.151 as follows; renumber subsequent paragraphs and footnotes:]

.147–.151 [GASBS 62, ¶45–¶49, including footnote.]

[Insert new paragraphs .153 and .154, including headings, as follows; renumber subsequent paragraphs:]

Reporting Assets and Liabilities in Government-wide Financial Statements

.153 Assets and liabilities should not be offset in the government-wide statements of net assets except where a right of offset exists. [GASBS 62, ¶501 and fn232]

Reporting Assets and Liabilities in Proprietary Funds

.154 Assets and liabilities should not be offset in the proprietary fund statement of fund net assets except where a right of offset exists. [GASBS 62, ¶501 and fn232]

[Replace current footnote 8 with the following:]

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[21]Enabling legislation also includes restrictions on asset use established by a governmental utility's own governing board when that utility reports based on Section Re10, "Regulated Operations." [GASBS 34, fn25, as amended by GASBS 62, ¶476–¶500]

* * *

COMPREHENSIVE ANNUAL FINANCIAL REPORT **SECTION 2200**

Sources: [Add the following:] GASB Statement 62

.115 [Insert new sentence between current first and second sentences as follows:] Assets and liabilities should not be offset except where a right of offset exists. [GASBS 34, ¶30; GASBS 62, ¶501 and fn232]

[Replace current footnote 16 with the following:]

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[16]Enabling legislation also includes restrictions on asset use established by a governmental utility's own governing board when that utility reports based on Section Re10, "Regulated Operations." [GASBS 34, fn25, as amended by GASBS 62, ¶476–¶500]

[Replace current paragraph .143 with the following:]

.143 *Extraordinary items* are transactions or other events that are both unusual in nature and infrequent in occurrence. Paragraphs .145–.149 define the terms *unusual in nature* and *infrequency of occurrence.* As discussed in paragraph .141, extraordinary items should be reported separately at the bottom of the statement of activities. [GASBS 34, ¶55, as amended by GASBS 62, ¶45–¶49]

[Insert new paragraphs .145–.150 as follows; renumber subsequent paragraphs and footnotes:]

.145–.150 [GASBS 62, ¶45–¶50, including heading from ¶50 and footnote.]

[Replace current paragraph .166 with the following:]

.172 Assets and liabilities of proprietary funds should be presented in a *classified* format to distinguish between current and long-term assets and liabilities as discussed in paragraphs .174–.178 and paragraphs .180–.189. Assets and liabilities should not be offset except where a right of offset exists. [GASBS 34, ¶97, as amended by GASBS 62, ¶29–¶43; GASBS 62, ¶501 and fn232]

[Insert new paragraphs .174–.178 as follows; renumber subsequent paragraphs and footnotes:]

.174–.178 [GASBS 62, ¶29–¶33, including headings and footnotes.]

[Insert new paragraphs .180–.189 as follows; renumber subsequent paragraphs and footnotes:]

.180–.189 [GASBS 62, ¶34–¶43, including headings and footnotes.]

[Insert new paragraphs .201–.203 as follows; renumber subsequent paragraphs and footnotes:]

.201–.203 [GASBS 62, ¶51–¶53, including heading and footnote.]

* * *

ADDITIONAL FINANCIAL REPORTING CONSIDERATIONS **SECTION 2250**

Sources: [Add the following:] GASB Statement 62

.101 [Replace the first sentence with the following:] This section establishes accounting and financial reporting standards for related party transactions, subsequent events, going concern considerations, prior-period adjustments, and accounting changes and error corrections. [GASBS 56, ¶2; GASBS 62, ¶54–¶89]

[Insert new paragraph .102 as follows; renumber subsequent paragraphs and footnotes:]

.102 [GASBS 62, ¶54, including footnote.]

[Replace current footnote 1 with the following:]

[2]See paragraphs .107 and .108. [GASBS 62, ¶55 and ¶56]

[Insert new paragraphs .107 and .108 as follows; renumber subsequent paragraphs and footnotes:]

.107–.108 [GASBS 62, ¶55 and ¶56, including heading and footnotes.]

[Insert new paragraphs .121–.152 as follows; renumber subsequent paragraphs and footnotes:]

.121–.138 [GASBS 62, ¶58–¶75, including headings and footnotes.]

.139 [GASBS 62, ¶76; insert new footnote after comma as follows; add GASBS 34, fn13, as amended by GASBS 62, ¶76–¶82, to sources:] Changes in accounting principles should not be reported as a separately identified cumulative effect in the current-period statement of activities or proprietary fund statement of revenues, expenses, and changes in fund net assets.

.140–.152 [GASBS 62, ¶77–¶89, including headings and footnotes.]

[Insert new paragraphs .501–.504 as follows:]

DEFINITIONS

.501 The following paragraphs contain definitions of certain terms *as they are used in certain paragraphs in this section.* The paragraphs to which each definition applies are noted parenthetically at the end of each entry; the terms may have different meanings in other contexts. [GASBS 62, ¶57]

.502–.504 [Individual terms and definitions from GASBS 62, ¶57; parenthetically identify the specific paragraph ranges to which each definition relates.]

* * *

NOTES TO FINANCIAL STATEMENTS **SECTION 2300**

Sources: [Add the following:] GASB Statement 62

[Replace current footnote 1 with the following:]

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[1]Paragraphs .110–.114 require the Summary of Significant Accounting Policies as an integral part of the financial statements. [NCGAS 1, fn7, as amended by GASBS 62, ¶90–¶94]

.106 [Insert new subparagraph (7) under subparagraph a as follows and renumber subsequent subparagraphs:]

(7) The basis upon which inventory amounts are stated and, where practicable, indication of the method of determining the cost. (See Section I40, paragraph .114.)

(8) [Insert the following at the end of the first sentence of current subparagraph (7) under subparagraph a:] and the method or methods used in computing depreciation with respect to major classes of depreciable assets.

[Delete current subparagraph (10) under subparagraph a.]

[Replace current subparagraphs d and j with the following:]

d. Significant contingent liabilities. (See Section 1500, “Reporting Liabilities,” paragraph .125, and Section C50, “Claims and Judgments,” paragraphs .115, .161–.164, .167, and .168.)

j. Required disclosures about leases. (See Section L20, “Leases,” paragraphs .127, .128, .140, .153, .154, .170, .171, and .185.)

[Revise sources as follows:] [NCGAS 1, ¶158; NCGAI 6, ¶4, as amended; GASBS 34 ¶113–¶123, as amended by GASBS 62, ¶4; GASBS 38, ¶6, ¶7, ¶9, ¶10, ¶14, and ¶15; GASBS 45, ¶24 and ¶25; GASBS 54, ¶23 and ¶24; GASBS 56, ¶8–¶14; GASBS 62, ¶90–¶94, ¶95, ¶106–¶109, ¶112, ¶113, ¶201, ¶223, ¶231, ¶239, ¶255, ¶256, and ¶270]

.107 [Replace current subparagraph a with the following:]

a. Entity risk management activities. (See Sections C50, paragraphs .115, .145, .146, and .161–.164, and Po20, “Public Entity Risk Pools,” paragraphs .148 and .149.)

[Delete current subparagraph h and renumber subsequent subparagraphs.]

[Replace current subparagraph j with the following:]

i. Debt refundings and troubled debt restructuring. (See Section D20, “Debt Extinguishments and Troubled Debt Restructuring,” paragraphs .117, .118, .138, .139, .153, and .154.)

[Insert new subparagraphs pp–ddd as follows:]

pp. Changes in the manner of or basis for presenting corresponding items for two or more periods in comparative financial statements. (See Section 2200, paragraph .202.)
qq. Asset valuation allowances. (See Section 2200, paragraph .178.)
rr. Short-term obligations. (See paragraph .116 below.)
ss. Long-term construction-type contracts. (See Section C75, paragraph .103.)
tt. Effects of prior-period adjustments on the change in net assets of prior periods. (See Sections 2200, paragraph .150, and 2250, paragraph .125.)
uu. Accounting changes and error corrections. (See Section 2250, paragraphs .138, .148, .150, and .152.)
vv. Investments in common stock. (See Section I50, paragraphs .128 and .145.)
ww. Description of receivables and payables that represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest, including the effective interest rate and the face amount. (See Section I30, paragraph .115.)
xx. Nonmonetary transactions. (See Section N70, paragraph .109.)
yy. Foreign currency transactions. (See Section F70, “Foreign Currency Transactions,” paragraphs .106 and .107.)
zz. Insurance enterprises. (See Section In3, “Insurance Enterprises,” paragraph .139.)
aaa. Lending and mortgage banking activities. (See Section L30, “Lending Activities,” paragraphs .117, .142, and .143.)
bbb. Retail land sales operations. (See Section R30, “Real Estate,” paragraph .151.)
ccc. Research and development arrangements. (See Section R50, “Research and Development Arrangements,” paragraph .111.)
ddd. Regulated business-type activities. (See Section Re10, “Regulated Operations,” paragraphs .121, .122, and .128.)

[Revise sources as follows:] [NCGAI 6, ¶5, as amended; GASBS 34, ¶46, ¶56, ¶77, ¶89, and fn41; GASBS 38, ¶13; GASBS 42, ¶17, as amended by GASBS 62, ¶45–¶49; GASBS

43, ¶30; GASBS 46, ¶6; GASBS 54, ¶23–¶27 and ¶32; GASBS 56, ¶4–¶7 and ¶16–¶19; GASBS 62, ¶33, ¶44, ¶50, ¶52, ¶62, ¶75, ¶85, ¶87, ¶89, ¶116, ¶170, ¶171, ¶187, ¶210, ¶280, ¶330, ¶384, ¶429, ¶446, ¶ 473, ¶474, ¶493, ¶494, and ¶500]

[Insert new paragraphs .110–.114 as follows; renumber subsequent paragraphs:]

Accounting Policies

.110–.114 [GASBS 62, ¶90–¶94, including heading from ¶93.]

[Insert new paragraph .116 as follows; renumber subsequent paragraphs:]

.116 [GASBS 62, ¶44, omitting first sentence.]

* * *

REPORTING ENTITY AND COMPONENT UNIT PRESENTATION AND DISCLOSURE **SECTION 2600**

.115 [Revise sources as follows:] [GASBS 14, ¶55 and ¶73; GASBS 31, ¶5, as amended by GASBS 62, ¶202–¶210]

* * *

BOND, TAX, AND REVENUE ANTICIPATION NOTES **SECTION B50**

Sources: [Add the following:] GASB Statement 62

[Replace current paragraph .101, including footnote, with the following; renumber subsequent footnotes:]

.101 Proprietary fund bond, tax, and revenue anticipation notes should be reported as current or long-term liabilities depending on the refinancing status in accordance with the criteria in Section 2200, paragraphs .180–.189. [NCGAI 9, ¶12, as amended by GASBS 62, ¶34–¶43]

.102 [Change *FASB Statement 6* to *Section 2200, paragraphs .180–.189* and delete current footnote 3.] [NCGAI 9, ¶12, as amended by GASBS 62, ¶34–¶43; GASBS 34, ¶82]

* * *

CLAIMS AND JUDGMENTS **SECTION C50**

Sources: [Add the following:] GASB Statement 62

.101 [Revise fourth sentence as follows:] Risks of loss from the following kinds of events are included within the scope of paragraphs .109–.148 of this section: [Revise sentence following list as follows:] The recognition and measurement requirements for these risks of loss are provided in paragraphs .109–.148.

.102 [Add the following to the sources:] GASBS 62, ¶99

.121 [Revise sources as follows:] [GASBS 34, ¶41, ¶55, and ¶56, as amended by GASBS 62, ¶45–¶49]

.150 [Revise the second sentence as follows:] Subject to the accounting and financial reporting distinctions of governmental funds, the criteria of paragraphs .151–.168 should be the guidelines for recognizing a loss liability resulting from all claims that result from actions not included in the scope of paragraphs .109–.148 of this section. [In the last sentence, replace *A loss liability* with *As discussed in paragraphs .151–.168, a loss liability*.] [NCGAS 4, ¶9, as amended by GASBS 10, ¶3, GASBS 34, ¶69, and GASBS 59, ¶3 and ¶8; NCGAS 4, ¶14, as amended by GASBS 62, ¶96–¶113]

[Insert new paragraphs .151–.168 as follows; renumber subsequent paragraph:]

.151–.168 [GASBS 62, ¶96–¶113, including headings and footnotes.]

[Insert the following heading before current paragraph .151:]

Liability Adjustments in Bankruptcy

.501 [Revise as follows:] The following paragraphs contain definitions of certain terms *as they are used in paragraphs .101–.148 of this section;* the terms may have different meanings in other contexts.

* * *

[Create new section as follows:]

CONSTRUCTION-TYPE CONTRACTS—LONG-TERM **SECTION C75**

Source: GASB Statement 62

Scope of This Section

.101 [GASBS 62, ¶114]

Interim Billings

.102 [GASBS 62, ¶115]

.103–.110 [GASBS 62, ¶116–¶123, including headings and footnote.]

* * *

[Revise section title as follows:]

DEBT EXTINGUISHMENTS AND TROUBLED DEBT RESTRUCTURING **SECTION D20**

Sources: [Add the following:] GASB Statement 62

[Insert new paragraph .101 under heading *Scope of This Section*; renumber subsequent paragraphs.]

.101 Paragraphs .102 and .103 apply to all extinguishments of debt, whether early or not, except debt defeased by a current or advanced refunding and debt that is extinguished through a troubled debt restructuring. Paragraphs .105–.118 provide guidance on accounting and financial reporting for advance and current refundings that result in defeasance of debt reported as general long-term debt. Those paragraphs also provide guidance on accounting and financial reporting for current refundings and advance refundings resulting in defeasance of debt reported by business-type activities—that is, proprietary funds and special-purpose governments that report using enterprise fund accounting and financial reporting. Paragraphs .119–.155 establish standards of accounting and financial reporting by the debtor and by the creditor for a troubled debt restructuring. [GASBS 7, ¶1 and ¶7, as amended by GASBS 34, ¶82; GASBS 23, ¶3; GASBS 34, ¶16; GASBS 35, ¶5; GASBS 62, ¶124 and ¶128]

[Insert new paragraphs .102–.104 as follows; update heading levels; renumber subsequent paragraphs and footnotes:]

Extinguishments of Debt

.102–.103 [GASBS 62, ¶125–¶126, including headings and footnotes.]

Debt Refundings

Applicability

.104 [Replace current paragraph .101 with the following:] Paragraphs .105–.118 apply to all state and local governmental entities, including public benefit corporations and authorities and public utilities, hospitals and other healthcare providers, and colleges and universities. [GASBS 7, ¶7, as amended by GASBS 34, ¶82; GASBS 23, ¶3]

.118 [Insert current paragraph .115; revise sources as follows:] [GASBS 23, ¶6, as amended by GASBS 62, ¶4]

[Insert new paragraphs .119–.155 as follows:]

Troubled Debt Restructuring

.119 [GASBS 62, ¶128]

Introduction

.120–.155 [GASBS 62, ¶129–¶164, including headings and footnotes.]

[Insert new paragraphs .501–.504 as follows:]

DEFINITIONS

.501 The following paragraphs contain definitions of certain terms *as they are used in certain paragraphs in this section.* The paragraphs to which each definition applies are noted parenthetically at the end of each entry; the terms may have different meanings in other contexts. [GASBS 62, ¶127]

.502–.504 [Individual terms and definitions from GASBS 62, ¶127; parenthetically identify the specific paragraph ranges to which they relate.]

* * *

DEMAND BONDS **SECTION D30**

.108 [Revise sources as follows:] [GASBI 1, ¶10; GASBS 34, ¶12, ¶82, ¶91, and ¶97, as amended by GASBS 62, ¶29–¶43]

[Revise sources of footnote 3 as follows:] [GASBI 1, fn2, as amended by GASBS 34, ¶82 and ¶97, and GASBS 62, ¶29–¶43]

* * *

DERIVATIVE INSTRUMENTS **SECTION D40**

[Revise footnote 8 as follows:]

[8]Business-type activities and enterprise funds that apply Section Re10, "Regulated Operations," should apply the provisions of this section. Only when a derivative instrument is determined to be ineffective should the provisions of Section Re10 be applied. [GASBS 53, fn8, as amended by GASBS 62, ¶476–¶500]

* * *

[Create new section as follows:]

FOREIGN CURRENCY TRANSACTIONS **SECTION F70**

Source: GASB Statement 62

Scope of This Section

.101 [GASBS 62, ¶165, including footnote.]

Recognition

.102–.103 [GASBS 62, ¶166–¶167, including footnote.]

Exchange Rates

.104–.105 [GASBS 62, ¶168–¶169]

Disclosure

.106–.107 [GASBS 62, ¶170–171]

DEFINITIONS

.501–.504 [GASBS 62, ¶172]

* * *

[Create new section as follows:]

INTEREST COSTS—IMPUTATION **SECTION I30**

Source: GASB Statement 62

See also: Section 1400, “Reporting Capital Assets”

Applicability of This Section

.101–.103 [GASBS 62, ¶173–¶175]

.104–.115 [GASBS 62, ¶176–¶187, including headings and footnotes.]

* * *

[Create new section as follows:]

INVENTORY **SECTION I40**

Source: GASB Statement 62

Scope of This Section

.101 [GASBS 62, ¶188]

.102–.114 [GASBS 62, ¶189–¶201, including headings and footnotes.]

* * *

INVESTMENTS **SECTION I50**

Sources: [Add the following:] GASB Statement 62

.101 [In first sentence, replace *This section establishes* with *Paragraphs .105–.119 establish*; in second sentence replace *it establishes* with *those paragraphs establish*; in first sentence following lettered list, replace *This section also provides* with *Paragraphs .105–.118 also provide*.]

[Replace current paragraph .104 with the following:]

.104 Paragraphs .105–.119 do not apply to investments in equity securities accounted for under the equity method, which are addressed in paragraphs .120–.128. Paragraphs .105–.119 also do not apply to securities or other instruments if they are not held by the government for investment purposes, either for itself or for parties for which it serves as investment manager or other fiduciary. In addition, this section does not apply to investments in joint ventures or component units as provided in Section 2100, "Defining the Financial Reporting Entity.". [GASBS 31, ¶5, as amended by GASBS 62, ¶202–¶210]

[Delete footnote 8 and renumber subsequent footnotes.]

[Insert new paragraphs .120–.128 as follows; renumber subsequent paragraphs and footnotes:]

.120–.128 [GASBS 62, ¶202–¶210, including headings and footnotes.]

[Replace current paragraph .501 with the following:]

.501 The following paragraphs contain definitions of certain terms *as they are used in certain paragraphs in this section.* The paragraphs to which each definition applies are noted parenthetically at the end of each entry; the terms may have different meanings in other contexts.

.502–.564 [Following each definition, parenthetically identify the specific paragraph ranges in the section to which it relates.]

* * *

[Revise entire section as follows:]

LEASES **SECTION L20**

Sources:	NCGA Statement 5, GASB Statement 13, GASB Statement 14, GASB Statement 34, GASB Statement 38, GASB Statement 56, GASB Statement 60, GASB Statement 62
See also:	Section 1400, "Reporting Capital Assets" Section Bn5, "Bankruptcies" Section S30, "Service Concession Arrangements"

Background

.101–.102 [Insert current paragraphs .101–.102.]

Scope of This Section

.103 [GASBS 62, ¶211, including footnote; insert the following sentence after the text from ¶211:] This section also does not apply to arrangements that meet the definition of a service concession arrangement in paragraph .101 of Section S30, to which the guidance in that section should apply. [NCGAS 5, ¶11, as amended by GASBS 60, ¶4 and ¶7, and GASBS 62, ¶211–¶271; GASBS 62, ¶211]

Classification of Leases

.104 [GASBS 62, ¶212, including footnotes.]

Criteria for Classifying Leases (Other Than Leveraged Leases)

.105–.107 [GASBS 62, ¶213–¶215, including footnotes.]

Fiscal Funding or Cancellation Clauses

.108–.110 [Insert current paragraphs .115, .117, and .118, including footnote; revise sources of current paragraph .115 as follows:] [NCGAS 5, ¶18, as amended by GASBS 62, ¶213–¶215]

Accounting and Reporting by Lessees

Capital Leases

.111 [GASBS 62, ¶216, including footnote; insert the following sentence before the text from ¶216:] If a lease agreement is a capital lease following the criteria of this section, the lease agreement should be capitalized. [NCGAS 5, ¶12, as amended by GASBS 62, ¶213–¶215; GASBS 62, ¶216]

.112–.116 [GASBS 62, ¶217–¶221, including footnotes; in footnote 12, change *and the proprietary fund statement of revenues, expenses, and changes in fund net assets* to *the proprietary fund statement of revenues, expenses, and changes in fund net assets, and the fiduciary fund statement of changes in fiduciary net assets* and update sources as follows:] [NCGAS 5, ¶11, as amended by GASBS 13, ¶5 and ¶6 and GASBS 34, ¶69; GASBS 62, fn95]

Accounting and Reporting in Government-wide Financial Statements

.117 Capital lease accounting in the government-wide financial statements should follow paragraphs .111–.116. [NCGAS 5, ¶16, as amended by GASBS 62, ¶216–¶221]

Accounting and Reporting in Proprietary and Fiduciary Fund Financial Statements

.118 [Replace first sentence of current paragraph .111 as follows:] Capital lease accounting for proprietary and trust funds should follow paragraphs .111–.116. [NCGAS 5, ¶16, as amended by GASBS 13, ¶4–¶7, GASBS 34, ¶69, and GASBS 62,

¶216–¶221; and NCGAS 5, ¶17, as amended by GASBS 13, ¶4–¶7 and GASBS 34, ¶69; GASBS 34, ¶92, ¶106, and ¶107]

Accounting and Reporting in Governmental Fund Financial Statements

.119–.120 [Insert current paragraphs .112–.113.]

Operating Leases

.121 [GASBS 62, ¶222]

Operating Leases with Scheduled Rent Increases

.122 [Insert current paragraph .104, omitting the first two sentences; retain sources.]

Measurement Criteria

.123 [Insert current paragraph .105, including footnote.]

.124 [Insert current paragraph .106, including footnote; in third sentence of subparagraph b, change *receivable or payable* to *payable*.]

Recognition in Government-wide, Proprietary, and Fiduciary Fund Financial Statements

.125 [Insert current paragraph .107; in first sentence, change *revenue or expense* to *expense*; in second sentence, change *revenue (expense)* to *expense*.]

Recognition in Governmental Fund Financial Statements

.126 Entities that report operating leases with scheduled rent increases in the governmental fund financial statements should recognize rental expenditures each period using the modified accrual basis of accounting. The lessee should recognize expenditures and liabilities in governmental funds to the extent that the amounts are payable with expendable, available financial resources. [GASBS 13, ¶9, as amended by GASBS 34, ¶69; GASBS 34, ¶6, ¶79, ¶82, ¶83, and ¶119]

Disclosures

.127 Lessees should disclose the future minimum payments for each of the five subsequent fiscal years and in five-year increments thereafter for their obligations under capital and noncancelable operating leases. The disclosures should be made by state and local governments in accordance with Section 2300, "Notes to Financial Statements." [NCGAS 5, ¶27; GASBS 38, ¶11]

.128 [GASBS 62, ¶223; replace the first sentence with the following, add NCGAS 5, ¶27 to sources:] In addition to the information required by paragraph .127, the following information should be disclosed in the notes to the lessee's financial statements.

Accounting and Reporting by Lessors

Sales-Type Leases

.129–.130 [GASBS 62, ¶224–¶225, including footnotes.]

Direct Financing Leases

.131 [GASBS 62, ¶226, including footnotes.]

Accounting and Reporting in Governmental Fund Financial Statements

.132 [Insert current paragraph .114, including footnote.]

Operating Leases

.133 [GASBS 62, ¶227]

Operating Leases with Scheduled Rent Increases

.134 Sometimes an operating lease with scheduled rent increases[29] contains payment requirements in a particular year or years that are artificially low when viewed in the context of earlier or later payment requirements. This situation may take place, for example, when a lessor provides a rent reduction or "rent holiday" that constitutes a financing arrangement between the lessor and the lessee. As another example, a lessor may provide a lessee reduced rents as an inducement to enter into the lease. In these cases, the operating lease transactions should be measured using either of the following methods.

a. The operating lease transactions may be measured on a straight-line basis over the lease term.
b. The operating lease transactions may be measured based on the estimated fair value of the rental.[30] The implicit financing by the lessor of the lessee's cash flow should be accounted for using the interest method. That is, interest should be calculated for each period so that it results in a constant rate of interest over the lease term on the period's outstanding accrued lease receivable. (See paragraph .901, Illustration 2.)

[GASBS 13, ¶6]

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[29]Operating leases with scheduled rent increases are defined in paragraph .122.
[30]See footnote 17.

Recognition in Government-wide, Proprietary, and Fiduciary Fund Financial Statements

.135 Entities that report operating leases with scheduled rent increases in the government-wide financial statements and in proprietary and trust fund financial statements should recognize rental revenue each period as it accrues over the lease term using the measurement criteria provided in paragraphs .123 and .124. If the fair value measurement of paragraph .124b is used, the interest portion should be recognized as revenue each period using the interest method. [GASBS 13, ¶7, as amended by GASBS 34, ¶79; GASBS 34, ¶16, ¶92, and ¶107]

Recognition in Governmental Fund Financial Statements

.136 Entities that report operating leases with scheduled rent increases in the governmental fund financial statements should recognize rental revenue each period using the modified accrual basis of accounting. That is, the amount calculated in accordance with the measurement criteria in paragraphs .123 and .124 should be recognized as revenue to the extent it is available to finance expenditures of the fiscal period. Accrued receivables should be reported in the fund. Deferred revenue also should be reported for the portion not yet recognized as revenue. [GASBS 13, ¶9, as amended by GASBS 34, ¶69; GASBS 34, ¶6, ¶79, ¶82, ¶83, and ¶119]

Participation by Third Parties

.137–.139 [GASBS 62, ¶228–¶230]

Disclosures

.140 [GASBS 62, ¶231; add NCGAS 5, ¶27, to sources.]

Leases Involving Real Estate

.141 [GASBS 62, ¶232]

.142–.147 [GASBS 62, ¶233–¶238, including headings and footnotes.]

Leases between State and Local Governments and Public Authorities

.148 [Insert current paragraph .119; in first sentence, change *FASB Statement 13* to *this section*.] [NCGAS 5, ¶22, as amended by GASBS 34, ¶80 and GASBS 62, ¶211–¶271]

.149 [Insert current paragraph .120.]

.150 [Insert current paragraph .121; in first sentence, change *FASB Statement 13* to *this section*.] [NCGAS 5, ¶24, as amended by GASBS 62, ¶211–¶271; GASBS 14, ¶58, as amended by GASBS 34, ¶67; GASBS 34, ¶80 and ¶82]

.151 [Insert current paragraph .122; in second sentence, delete *and FASB Statement 13*.] [NCGAS 5, ¶24, as amended by GASBS 34, ¶61 and GASBS 62, ¶211–¶271; GASBS 14, ¶58]

.152 [Insert current paragraph .123; in last sentence, delete *and FASB Statement 13*.] [NCGAS 5, ¶25, as amended by GASBS 62, ¶211–¶271]

.153 [Insert current paragraph .124; replace *in FASB Statement 13, paragraph 29* with *paragraph .154 of this section*.] [NCGAS 5, ¶26, as amended by GASBS 62, ¶239; GASBS 56, ¶4–¶7]

Leases between Related Parties

.154–.155 [GASBS 62, ¶239 and ¶240]

.156–.184 [GASBS 62, ¶241–¶269, including headings and footnotes.]

Disclosures

.185 [GASBS 62, ¶270; add NCGAS 5, ¶27, to sources.]

DEFINITIONS

.501 The following paragraphs contain definitions of certain terms *as they are used in this section.* The paragraphs to which each definition applies are noted parenthetically at the end of each entry; the terms may have different meanings in other contexts. [GASBS 62, ¶271]

.502–.515 [Individual terms and definitions from GASBS 62, ¶271, including footnotes]

* * *

NONAUTHORITATIVE DISCUSSION

Illustration of the Calculation of Operating Lease Revenue and Expenditures/Expense

.901 [GASBS 13, ¶28]

[Create new section as follows:]

LENDING ACTIVITIES **SECTION L30**

Source: GASB Statement 62

Scope

.101 Paragraphs .102–.121 establish standards of accounting and financial reporting for nonrefundable fees and costs associated with lending activities and loan purchases. Lending, committing to lend, refinancing or restructuring loans, arranging standby letters of credit, and leasing activities are "lending activities" for purposes of applying paragraphs .102–.121 Paragraphs .122–.143 establish accounting and reporting standards for certain **mortgage banking activities.**[1] [GASBS 62, ¶431 and ¶452]

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[1]Terms defined in the glossary (paragraphs .501–.511) are shown in **boldface type** the first time they appear in this section. [GASBS 62, fn204 and fn214]

Nonrefundable Fees and Costs

.102 The lender's activities that precede the disbursement of resources generally can be distinguished between (a) efforts to identify and attract potential borrowers and (b) efforts necessary to originate a loan or loan commitment after a potential borrower requests a loan or loan commitment. Nonrefundable fees have many different names in practice, such as **origination fees,** points, placement fees, **commitment fees,** application fees, management fees, and restructuring fees, but, for purposes of applying paragraphs .102–.121, they are referred to as loan origination fees or commitment fees. [GASBS 62, ¶431]

.103–.121 [GASBS 62, ¶432–¶450, including headings and footnotes; merge footnotes 210 and 215.]

Mortgage Banking Activities

.122–.143 [GASBS 62, ¶453–¶474, including headings and footnotes; omit footnotes 214 and 215.]

DEFINITIONS

.501 The following paragraphs contain definitions of certain terms *as they are used in certain paragraphs in this section.* The paragraphs to which each definition applies are noted parenthetically at the end of each entry; the terms may have different meanings in other contexts. [GASBS 62, ¶451 and ¶475]

.502–.511 [Individual terms and definitions from GASBS 62, ¶451 and ¶475; insert terms in alphabetical order and parenthetically identify the specific paragraph ranges to which they relate.]

* * *

NONEXCHANGE TRANSACTIONS **SECTION N50**

Sources: [Add the following:] GASB Statement 62

[Replace footnote 6 with the following:]

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[6]In this section, the term *probable* has the meaning assigned in paragraph .112 of Section C50, "Claims and Judgments." [GASBS 33, fn7, as amended by GASBS 62, ¶100]

* * *

[Create new section as follows:]

NONMONETARY TRANSACTIONS **SECTION N70**

Source: GASB Statement 62

Background and Scope

.101–.102 [GASBS 62, ¶272 and ¶273, including footnotes.]

.103–.109 [GASBS 62, ¶274–¶280, including headings and footnotes.]

DEFINITIONS

.501–.506 [GASBS 62, ¶281]

* * *

POLLUTION REMEDIATION OBLIGATIONS **SECTION P40**

[Revise footnote 2 as follows:]

[2]This section applies to business-type activities and enterprise funds that apply Section Re10, "Regulated Operations." Those business-type activities and enterprise funds should report a regulatory asset related to a pollution remediation loss when appropriate in accordance with the provisions of Section Re10. [GASBS 49, fn2, as amended by GASBS 62, ¶476–¶500]

[Revise footnote 7 as follows:]

[7]Accrual of contingent liabilities for fines, penalties, and toxic torts is discussed in Section C50, "Claims and Judgments," paragraphs .151–.168. [GASBS 49, fn7, as amended by GASBS 62, ¶96–¶113]

* * *

PROPRIETARY FUND ACCOUNTING AND FINANCIAL REPORTING **SECTION P80**

Sources: [Delete GASB Statement 20]

See also: [Add the following:] Section Re10, "Regulated Operations"

[Replace current paragraphs .101 and .102 with the following; renumber subsequent footnotes:]

.101 Proprietary fund reporting focuses on the determination of operating income, changes in net assets, financial position, and cash flows. The proprietary fund category includes enterprise and internal service funds.[1] [GASBS 34, ¶66]

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[1]Enterprise and internal service funds are defined in Section 1300, paragraphs .109 and .110.

.102 Proprietary fund financial statements should be presented using the economic resources measurement focus and the accrual basis of accounting. Proprietary funds should be reported based on all applicable GASB pronouncements (including all NCGA Statements and Interpretations currently in effect). [GASBS 1, ¶8; GASBS 34, ¶92]

[Delete current paragraphs .103 and .104; renumber subsequent paragraphs.]

[Replace current paragraph .105 with the following; renumber subsequent footnotes:]

.103 The provisions of Section Re10, "Regulated Operations," may be applied to enterprise funds that meet the criteria of that section for reporting as regulated enterprises. [GASBS 34, ¶95, as amended by GASBS 62, ¶476–¶500]

[Replace current paragraph .112 with the following:]

.110 Assets and liabilities of proprietary funds should be presented in a classified format to distinguish between current and long-term assets and liabilities as discussed in paragraphs .108–.122 of Section 1800, "Classification and Terminology." [GASBS 34, ¶97, as amended by GASBS 62, ¶29–¶43]

[Delete current paragraph .117; renumber subsequent paragraphs.]

* * *

[Create new section as follows:]

Source: GASB Statement 62

See also: Section 1400, "Reporting Capital Assets"
Section I50, "Investments"
Section Pe5, "Pension Plans—Defined Benefit"
Section Po20, "Public Entity Risk Pools"
Section Po50, "Postemployment Benefit Plans Other Than Pension Plans—Defined Benefit"

Scope and Applicability of This Section

.101 [GASBS 62, ¶282; revise first sentence as follows:] Paragraphs .105–.170 establish standards for recognition of gain on all real estate sales transactions reported in governmental activities, business-type activities, and proprietary funds.

.102 [GASBS 62, ¶283]

.103 [GASBS 62, ¶350; revise first sentence as follows:] Paragraphs .171–.192 establish accounting and reporting standards for acquisitions, development, construction, selling, and rental costs associated with real estate projects reported in governmental activities, business-type activities, and proprietary funds.

.104 Paragraphs .193–.197 of this section provide references to other guidance related to accounting and financial reporting for real estate.

Sales of Real Estate

.105–.170 [GASBS 62, ¶284–¶349, including headings and footnotes.]

Costs and Initial Rental Operations of Real Estate Projects

.171–.192 [GASBS 62, ¶351–¶372, including headings and footnotes.]

Other Guidance

General Guidance

.193 Section 1400 provides guidance on accounting and reporting for capital assets, including land.

Real Estate Held by Public Entity Risk Pools

.194 Paragraphs .142 and .147 of Section Po20 provide additional guidance regarding accounting and financial reporting for real estate by public entity risk pools.

Investments in Real Estate Held by External Investment Pools

.195 Paragraphs .105–.119 of Section I50 provide additional guidance regarding accounting and financial reporting for all investments held by governmental external investment pools.

Investments in Real Estate Held by Defined Benefit Pension and Other Postemployment Benefit Plans

.196 Paragraph .116 of Section Pe5 and paragraph .118 of Section Po50 provide guidance regarding accounting and financial reporting for investments in real estate of defined benefit pension and other postemployment benefit plans, respectively.

Investments in Real Estate Held by Endowments

.197 Paragraph .106 of Section I50 provides guidance regarding accounting for land and other real estate held as investments by endowments, including permanent and term endowments, and permanent funds. Endowments and permanent funds also should apply the applicable disclosure provisions in paragraph .129 of Section I50 to their land and other real estate held as investments.

DEFINITIONS

.501–.515 [GASBS 62, ¶373]

* * *

[Create new section as follows:]

RESEARCH AND DEVELOPMENT ARRANGEMENTS **SECTION R50**

Source: GASB Statement 62

See also: Section 1400, "Reporting Capital Assets"

Scope and Applicability of This Section

.101 [GASBS 62, ¶374]

.102–.111 [GASBS 62, ¶375–¶384, including headings and footnotes.]

* * *

[Create new section as follows:]

BROADCASTERS **SECTION Br10**

Source: GASB Statement 62

Scope of This Section

.101 [GASBS 62, ¶385, including footnote.]

.102–.103 [GASBS 62, ¶386–¶387, including headings and footnote.]

DEFINITIONS

.501–.504 [GASBS 62, ¶388]

* * *

[Create new section as follows:]

CABLE TELEVISION SYSTEMS **SECTION Ca5**

Sources: GASB Statement 14, GASB Statement 20, GASB Statement 34, GASB Statement 51, GASB Statement 62

See also: Section Br10, "Broadcasters"
Section Sp20, "Special-Purpose Governments"

Introduction

.101 This Codification is written from the perspective of general purpose governments—states, cities, counties, towns, and villages. However, many governments are special-purpose governments. Special-purpose governments are legally separate entities, as discussed in Section 2600, "Reporting Entity and Component Unit Presentation and Disclosure," and may be component units[1] or other stand-alone governments.[2] Paragraphs .102–.109 describe the accounting and financial reporting requirements for cable television systems that are special-purpose governments (including component units). [GASBS 34, ¶3 and ¶134]

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[1]As defined in Section 2100, "Defining the Financial Reporting Entity," *component units* are legally separate organizations for which the elected officials of the primary government are financially accountable. In addition, a component unit can be another organization for which the nature and significance of its relationship with a primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. [GASBS 34, fn59]

[2]As defined in Section 2100, an *other stand-alone government* is a legally separate governmental organization that (a) does not have a separately elected governing body and (b) does not meet the definition of a component unit. Other stand-alone governments include some special-purpose governments, joint ventures, jointly governed organizations, and pools. [GASBS 34, fn60]

.102 Cable television systems may be engaged in either governmental or business-type activities or both. Governmental activities are financed primarily through taxes, intergovernmental revenues, and other nonexchange revenues. They are generally reported in governmental funds and internal service funds. Business-type activities[3] are financed in whole or in part by fees charged to external users for goods or services. They are usually reported in enterprise funds. [GASBS 34, ¶15, ¶69, and ¶135]

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[3]This paragraph is not intended to require segregation of activities into governmental and proprietary funds beyond what is currently reported by management of the government unless the activity is required to be reported as an enterprise fund, as discussed in paragraph .103. [GASBS 34, fn10]

.103 Enterprise funds may be used to report any activity for which a fee is charged to external users for goods or services. Activities are required to be reported as enterprise funds if any one of the following criteria is met. Governments should apply each of these criteria in the context of the activity's principal revenue sources.[4]

a. The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity. Debt that is secured by a pledge of net revenues from fees and charges and the full faith and credit of a related primary government or component unit—even if that government is not expected to make any payments—is not payable solely from fees and charges of the activity. (Some debt may be secured, in part, by a portion of its own proceeds but should be considered as payable "solely" from the revenues of the activity.)
b. Laws or regulations require that the activity's costs of providing services, including capital costs (such as depreciation[5] or debt service), be recovered with fees and charges, rather than with taxes or similar revenues.
c. The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs (such as depreciation or debt service).[6]

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[4]These criteria do not require insignificant activities of governments to be reported as enterprise funds. For example, state law may require a county's small claims court to assess plaintiffs a fee to cover the cost of frivolous claims. However, taxes, not fees, are the principal revenue source of the county's court system, and the fees in question cover only the cost of frivolous small claims court cases. In this case, the county would not be required to remove its court system or the small claims court activity from its general fund and report it in an enterprise fund. Conversely, a state department of environmental protection regulation may require a water utility to recover the costs of operating its water plant, including debt service costs, through charges to its customers—the utility's principal revenue source. Because these charges are the activity's principal revenue source and because the water utility is required to recover its costs, the utility should be reported as an enterprise fund. [GASBS 34, fn33]
[5]As used in this section, the term *depreciation* (and related forms of the term) includes amortization of intangible assets. [GASBS 51, ¶5]
[6]The primary focus of these criteria is on fees charged to external users. [GASBS 37, ¶14]

Cable Television Systems Engaged Only in Business-type Activities

.104 Governments engaged only in business-type activities should present only the financial statements required for enterprise funds. (See Section 1600, "Basis of Accounting," paragraphs .130–.137, and Section 2200, "Comprehensive Annual Financial Report," paragraphs .170–.195.) For these governments, basic financial statements and RSI consist of:

a. MD&A (Section 2200, paragraphs .106–.109, as appropriate)
b. Enterprise fund financial statements (Section 2200, paragraphs .170–.195), consisting of:
   (1) Statement of net assets or balance sheet
   (2) Statement of revenues, expenses, and changes in fund net assets
   (3) Statement of cash flows
c. Notes to financial statements (Section 2300, "Notes to Financial Statements")
d. RSI other than MD&A, if applicable (Section 2200, paragraph .205).

[GASBS 34, ¶138]

Cable Television Systems Engaged in Governmental Activities or in Both Governmental and Business-type Activities

.105 Cable television systems engaged in more than one governmental program or that have both governmental and business-type activities should provide both fund financial statements and government-wide financial statements. For these governments, all the requirements for basic financial statements and RSI, discussed in Section 2200, apply. [GASBS 34, ¶135]

.106 For cable television systems engaged in a single governmental program, the fund financial statements and the government-wide statements may be combined using a columnar format that reconciles individual line items of fund financial data to government-wide data in a separate column on the face of the financial statements rather than at the bottom of the statements or in an accompanying schedule.[7] Or the single-program government may present separate government-wide and fund financial statements and may present its government-wide statement of activities using a different format. For example, the statement of activities may be presented in a single column that reports expenses first followed by revenues (by major sources). The difference between these amounts is net revenue (expense) and should be followed by contributions to permanent and term endowments, special and extraordinary items, transfers, and beginning and ending net assets. [GASBS 34, ¶136]

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[7]If a columnar format is used, single-program governments should provide the reconciliation information required by Section 2200, paragraphs .164 and .169, between the fund financial data and the government-wide data. Descriptions of the reconciling items should be presented either on the face of the financial statements, in an accompanying schedule, or in the notes to the financial statements, as discussed in paragraph .160 of that section. [GASBS 34, fn62]

.107 For the purpose of applying the provisions of paragraph .106, a government should not be considered "single-program" if it budgets, manages, or accounts for its activities as multiple programs. [GASBS 34, ¶137]

Component Unit Financial Statements

.108 Section 2100 generally defines a "primary government" as having a separately elected governing body—one that is elected by the citizens in a general, popular election. Although the nucleus of a financial reporting entity usually is a primary government, an organization other than a primary government (such as a cable television system) may serve as a nucleus for a reporting entity when it issues separate financial statements. The requirements of Sections 2100 and 2600 apply to the separately issued financial statements of governmental cable television systems. The requirements of those sections should be applied in layers "from the bottom up." That is, each component unit "layer" should apply the definition and display provisions of Sections 2100 and 2600 to its own component unit financial reports. Because both sections are written from the perspective of the primary government, a governmental component unit should apply the provisions of Sections 2100 and 2600 as if it were a primary government. Separately issued financial statements of a component unit cable television system should acknowledge that it is a component unit of another government—for example, “Sample County Cable Television System, a component unit of Sample County.” In addition, the notes to the financial statements should identify the primary government in whose financial reporting entity it is included and describe its relationship with the primary government. [GASBS 14, ¶13 and ¶65]

Other Stand-Alone Government Financial Statements

.109 Although the nucleus of a financial reporting entity usually is a primary government, an organization other than a primary government (such as an other stand-alone government) serves as a nucleus for its reporting entity when it issues financial statements. The requirements of Sections 2100 and 2600 apply to the separately issued financial statements of all state and local governments. Because both sections are written from the perspective of a primary government, a stand-alone government should apply the provisions of those sections as if it were a primary government. The financial reporting entity consists of the stand-alone government and all component units for which it is financially accountable, and other organizations for which the nature and significance of their relationship with the stand-alone government are such that exclusion would cause the reporting entity’s financial statements to be misleading or incomplete. (See Section 2100, paragraphs .119–.141.) In accordance with Section 2600, paragraph .127, any stand-alone government with a voting majority of its governing board appointed by a primary government should disclose that accountability relationship in its financial statements. [GASBS 14, ¶66]

Specific Transactions

.110–.119 [GASBS 62, ¶389–¶398, including headings from ¶390–¶398 and footnotes.]

DEFINITIONS

.501 The following paragraphs contain definitions of certain terms *as they are used in certain paragraphs in this section.* The paragraphs to which each definition applies are noted parenthetically at the end of each entry; the terms may have different meanings in other contexts. [GASBS 62, ¶399]

.502–.505 [Individual terms and definitions from GASBS 62, ¶399, including footnote; parenthetically identify the specific paragraph ranges to which they relate.]

* * *

[Create new section as follows:]

INSURANCE ENTITIES—OTHER THAN PUBLIC ENTITY RISK POOLS **SECTION In3**

Sources: GASB Statement 14, GASB Statement 20, GASB Statement 34, GASB Statement 51, GASB Statement 62

See also: Section Sp20, “Special-Purpose Governments”

Introduction

.101 This Codification is written from the perspective of general purpose governments—states, cities, counties, towns, and villages. However, many governments are special-purpose governments. Special-purpose governments are legally separate entities, as discussed in Section 2600, “Reporting Entity and Component Unit Presentation and

Disclosure," and may be component units[1] or other stand-alone governments.[2] Paragraphs .102–.109 describe the accounting and financial reporting requirements for insurance entities that are special-purpose governments (including component units). [GASBS 34, ¶3 and ¶134]

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[1]As defined in Section 2100, "Defining the Financial Reporting Entity," *component units* are legally separate organizations for which the elected officials of the primary government are financially accountable. In addition, a component unit can be another organization for which the nature and significance of its relationship with a primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. [GASBS 34, fn59]

[2]As defined in Section 2100, an *other stand-alone government* is a legally separate governmental organization that (a) does not have a separately elected governing body and (b) does not meet the definition of a component unit. Other stand-alone governments include some special-purpose governments, joint ventures, jointly governed organizations, and pools. [GASBS 34, fn60]

.102 Insurance entities may be engaged in either governmental or business-type activities or both. Governmental activities are financed primarily through taxes, intergovernmental revenues, and other nonexchange revenues. They are generally reported in governmental funds and internal service funds. Business-type activities[3] are financed in whole or in part by fees charged to external users for goods or services. They are usually reported in enterprise funds. [GASBS 34, ¶15, ¶69, and ¶135]

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[3]This paragraph is not intended to require segregation of activities into governmental and proprietary funds beyond what is currently reported by management of the government unless the activity is required to be reported as an enterprise fund, as discussed in paragraph .103. [GASBS 34, fn10]

.103 Enterprise funds may be used to report any activity for which a fee is charged to external users for goods or services. Activities are required to be reported as enterprise funds if any one of the following criteria is met. Governments should apply each of these criteria in the context of the activity's principal revenue sources.[4]

a. The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity. Debt that is secured by a pledge of net revenues from fees and charges and the full faith and credit of a related primary government or component unit—even if that government is not expected to make any payments—is not payable solely from fees and charges of the activity. (Some debt may be secured, in part, by a portion of its own proceeds but should be considered as payable "solely" from the revenues of the activity.)

b. Laws or regulations require that the activity's costs of providing services, including capital costs (such as depreciation[5] or debt service), be recovered with fees and charges, rather than with taxes or similar revenues.
c. The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs (such as depreciation or debt service).[6]

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[4]These criteria do not require insignificant activities of governments to be reported as enterprise funds. For example, state law may require a county's small claims court to assess plaintiffs a fee to cover the cost of frivolous claims. However, taxes, not fees, are the principal revenue source of the county's court system, and the fees in question cover only the cost of frivolous small claims court cases. In this case, the county would not be required to remove its court system or the small claims court activity from its general fund and report it in an enterprise fund. Conversely, a state department of environmental protection regulation may require a water utility to recover the costs of operating its water plant, including debt service costs, through charges to its customers—the utility's principal revenue source. Because these charges are the activity's principal revenue source and because the water utility is required to recover its costs, the utility should be reported as an enterprise fund. [GASBS 34, fn33]

[5]As used in this section, the term depreciation (and related forms of the term) includes amortization of intangible assets. [GASBS 51, ¶5]

[6]The primary focus of these criteria is on fees charged to external users. [GASBS 37, ¶14]

Insurance Entities Engaged Only in Business-type Activities

.104 Governments engaged only in business-type activities should present only the financial statements required for enterprise funds. (See Section 1600, "Basis of Accounting," paragraphs .130–.137, and Section 2200, "Comprehensive Annual Financial Report," paragraphs .170–.195.) For these governments, basic financial statements and RSI consist of:

a. MD&A (Section 2200, paragraphs .106–.109, as appropriate)
b. Enterprise fund financial statements (Section 2200, paragraphs .170–.195), consisting of:
    (1) Statement of net assets or balance sheet
    (2) Statement of revenues, expenses, and changes in fund net assets
    (3) Statement of cash flows
c. Notes to financial statements (Section 2300, "Notes to Financial Statements")
d. RSI other than MD&A, if applicable (Section 2200, paragraph .205).

[GASBS 34, ¶138]

Insurance Entities Engaged in Governmental Activities or in Both Governmental and Business-type Activities

.105 Insurance entities engaged in more than one governmental program or that have both governmental and business-type activities should provide both fund financial statements and government-wide financial statements. For these governments, all the requirements for basic financial statements and RSI, discussed in Section 2200, apply. [GASBS 34, ¶135]

.106 For insurance entities engaged in a single governmental program, the fund financial statements and the government-wide statements may be combined using a columnar format that reconciles individual line items of fund financial data to government-wide data in a separate column on the face of the financial statements rather than at the bottom of the statements or in an accompanying schedule.[7] Or the single-program government may present separate government-wide and fund financial statements and may present its government-wide statement of activities using a different format. For example, the statement of activities may be presented in a single column that reports expenses first followed by revenues (by major sources). The difference between these amounts is net revenue (expense) and should be followed by contributions to permanent and term endowments, special and extraordinary items, transfers, and beginning and ending net assets. [GASBS 34, ¶136]

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[7]If a columnar format is used, single-program governments should provide the reconciliation information required by Section 2200, paragraphs .164 and .169, between the fund financial data and the government-wide data. Descriptions of the reconciling items should be presented either on the face of the financial statements, in an accompanying schedule, or in the notes to the financial statements, as discussed in paragraph .160 of that section. [GASBS 34, fn62]

.107 For the purpose of applying the provisions of paragraph .106, a government should not be considered "single-program" if it budgets, manages, or accounts for its activities as multiple programs. [GASBS 34, ¶137]

Component Unit Financial Statements

.108 Section 2100 generally defines a "primary government" as having a separately elected governing body—one that is elected by the citizens in a general, popular election. Although the nucleus of a financial reporting entity usually is a primary government, an organization other than a primary government (such as an insurance entity) may serve as a nucleus for a reporting entity when it issues separate financial statements. The requirements of Sections 2100 and 2600 apply to the separately issued financial statements of governmental insurance entities. The requirements of those sections should be applied in layers "from the bottom up." That is, each component unit "layer" should apply the definition and display provisions of Sections 2100 and 2600 to its own component unit financial reports. Because both sections are written from the perspective of the primary government, a governmental component unit should apply the provisions of Sections 2100 and 2600 as if it were a primary government. Separately issued financial statements of a component unit insurance enterprise should acknowledge that it is a component unit of another government—for example, "Sample County Insurance Entity, a component unit of Sample County." In addition, the notes to the financial statements should identify the primary government in whose financial reporting entity it is included and describe its relationship with the primary government. [GASBS 14, ¶13 and ¶65]

Other Stand-Alone Government Financial Statements

.109 Although the nucleus of a financial reporting entity usually is a primary government, an organization other than a primary government (such as an other stand-alone government) serves as a nucleus for its reporting entity when it issues financial statements. The requirements of Sections 2100 and 2600 apply to the separately issued financial statements of all state and local governments. Because both sections are written from the perspective of a primary government, a stand-alone government should apply the provisions of those sections as if it were a primary government. The financial reporting entity consists of the stand-alone government and all component units for which it is financially accountable, and other organizations for which the nature and significance of their relationship with the stand-alone government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. (See Section 2100, paragraphs .119–.141.) In accordance with Section 2600, paragraph .127, any stand-alone government with a voting majority of its governing board appointed by a primary government should disclose that accountability relationship in its financial statements. [GASBS 14, ¶66]

Specific Transactions

.110–.139 [GASBS 62, ¶400–¶429, including headings from ¶401–¶429 and footnotes.]

DEFINITIONS

.501 The following paragraphs contain definitions of certain terms *as they are used in certain paragraphs in this section.* The paragraphs to which each definition applies are noted parenthetically at the end of each entry; the terms may have different meanings in other contexts. [GASBS 62, ¶430]

.502–.515 [Individual terms and definitions from GASBS 62, ¶430; parenthetically identify the specific paragraph ranges to which they relate.]

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PUBLIC ENTITY RISK POOLS **SECTION Po20**

.115 [Replace the second sentence with the following:] As discussed in Section P80, public entity risk pools and other entities that use proprietary (enterprise) fund accounting and reporting should apply all applicable GASB pronouncements (including all NCGA Statements and Interpretations currently in effect). [GASBS 1, ¶8; GASBS 10, ¶18]

.145 [Change *FASB Statement No. 91,* Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases to *Section L30, "Lending Activities"*; change *The provisions of that Statement* to *Those provisions*; change *FASB Statement 91* to *Section L30.*] [GASBS 10, ¶45, as amended by GASBS 62, ¶431–¶451]

[Delete current footnote 7; renumber subsequent footnotes.]

* * *

[Create new section as follows:]

REGULATED OPERATIONS **SECTION Re10**

Source: GASB Statement 62

Scope and Applicability of This Section

.101–.104 [GASBS 62, ¶476–¶479]

.105–.117 [GASBS 62, ¶480–¶492, including headings and footnotes.]

.118–.120 [GASBS 62, ¶252–¶254, including heading.]

.121–.128 [GASBS 62, ¶493–¶500, including headings and footnotes.]

* * *

SPECIAL-PURPOSE GOVERNMENTS **SECTION Sp20**

See also: [Add the following:] Section Re10, “Regulated Operations”

.111 [Revise sources as follows:] [GASBS 34, ¶147, as amended by GASBS 62, ¶4]

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UTILITIES **SECTION Ut5**

See also: [Add the following:] Section Re10, “Regulated Operations”

.110 [Replace with the following:] The provisions of Section Re10, “Regulated Operations,” may be applied to utilities that use enterprise fund accounting and financial reporting and that meet the criteria of that section for reporting as regulated enterprises. [GASBS 34, ¶95, as amended by GASBS 62, ¶476–¶500]