

AUDITING AND REPORTING

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FASB "Cornerstone"—The Conceptual Framework

Excerpt from *Executive News Briefs*, (Arthur Andersen & Co.), December 1978.

The Financial Accounting Standards Board has issued its first definitive statement resulting from a major effort to establish a conceptual framework, or theoretical basis, for financial accounting and reporting. Statement of Financial Accounting Concepts No. 1 is titled "Objectives of Financial Reporting by Business Enterprises."

The statement establishes that financial reporting should provide useful information to investors and creditors; that objectives change with the economic, legal, political and social environment; and that the main focus of financial reporting is on earnings.

Financial reports should help users assess the cash flow from dividends or interest, as well as proceeds from sale, redemption or maturity of securities or loans. They also should inform users about economic resources of a business enterprise and any circumstances that may change those resources.

Thus, the FASB concludes that financial reporting cannot be limited purely to a company's historical results but also should help investors to evaluate its prospects.

FASB Chairman Donald J. Kirk described the document as "the cornerstone, the first in a series of FASB Statements that will, in effect, comprise a 'constitution' for financial accounting and reporting." He said it is the result of a long and broadbased effort to resolve "an intense debate" among businessmen

and accountants as to whether financial accounting and reporting should respond mainly to the internal needs of a business or to the needs of external users of financial information.

Mr. Kirk noted that FASB Statements on Financial Accounting Standards until now have emerged only as specific accounting problems have arisen. But while the board has worked on specific problems it also has recognized the need to develop a consistent framework.

The board's first statement of concepts does not require any change in existing generally accepted accounting principles, as FASB pronouncements often do. Any differences between the broad concepts and the accounting principles that auditors apply in everyday work will be resolved as the FASB reexamines existing standards.

AICPA Issues Tentative Report on Internal Accounting Control

Excerpt from *Executive Update*, (Harris, Kerr, Forster & Company) December 1978.

The AICPA has issued a tentative report of the Special Advisory Committee on Internal Control. The advisory group consisting of financial executives, internal auditors, CPAs engaged in management advisory services and one CPA engaged in the practice of auditing, was appointed to develop criteria for evaluating internal control.

The report cites two important reasons for an increased interest by

management and boards of directors in evaluating internal accounting control.

- The Securities and Exchange Commission's statement that public companies should "review their accounting procedures, systems of internal accounting controls and business practices" in order to take any actions necessary to comply with the requirements of the Foreign Corrupt Practices Act of 1977. The Act imposes, among other things, internal accounting control requirements on certain issuers of securities (public companies).

- The Commission on Auditors' Responsibilities' suggestion that there be a management report on the financial statements and that it "present management's assessment of the company's accounting system and controls over it . . ."

The Committee suggests that management:

- Initiate a preliminary assessment of the internal accounting control environment and of the appropriateness and effectiveness of existing accounting control procedures and techniques based on its overall knowledge of the company.
- Plan the manner, extent and timing of its evaluations of specific control procedures and techniques.
- Monitor compliance with established accounting control procedures to obtain reasonable assurance that controls in place continue to be appropriate and controls in effect continue to function properly.

The Committee has presented in its report suggestions on performing a preliminary assessment, on performing an evaluation of specific accounting control procedures and techniques, and on monitoring compliance with established procedures.

In the report, the Committee has used a "cycle approach" to illustrate an evaluation of internal accounting control. This entails classifying transactions as part of "cycles" into which they can be conveniently grouped (revenue, expenditures, production or conversion, financing and external financial reporting) and identifying appropriate internal accounting control criteria for each cycle.

The Committee's report represents a first step in what should be an ongoing effort by companies,

public accounting firms, academics and professional organizations to study internal accounting control requirements.

The Committee requests that interested parties provide written comments and suggestions, especially on the adequacy and usefulness of its suggested criteria.

Service Enterprises May Face New Accounting Rules

Excerpt from *SEC Accounting Report*, (Warren, Gorham & Lamont, Inc.) © 1978 — December 1978.

Government statistics provide evidence that the number and variety of businesses that offer services to the public are increasing and the range of services offered is broadening. Personal services offered range from legal and other professional services to maintenance and repair services. Notwithstanding the wide range of services offered, all service-related businesses must deal with the major accounting issues of determining the point or points at which revenue should be recognized as earned and costs should be recognized as expenses.

No uniformity. Service businesses are subject to the same accounting principles as manufacturing entities but over the years, diverse accounting methods have evolved to apply the fundamental principles to service revenues and costs. Furthermore, an AICPA task force has found that different accounting methods are used by entities engaging in similar transactions. The Accounting Standards Division (the Division) of the AICPA has issued a proposed Statement of Position (SOP) entitled "Accounting for Service Transactions" in order to narrow the range of alternative methods of accounting for service revenues and costs.

FASB takes over. The FASB has now reissued the draft SOP under a new experimental procedure which asks the public to comment on the proposal before it is considered by the Board. The new procedure is designed to enhance the Board's ability to deal with potential problems on a prompt basis and to utilize the knowledge and experience

of people in the field prior to Board deliberation.

SOP conclusions. The draft SOP sets forth conclusions on:

- The guidelines to apply to transactions in which both services and products are provided;
- The appropriate manner of revenue recognition;
- The classification of costs as initial direct costs, direct costs and indirect costs and the accounting for each; and
- The accounting for initiation and installation fees.

Both services and products. Many transactions involve a service and a tangible product. The following guidelines are provided to determine the accounting nature of the transaction:

- If the seller offers both a service and a product in a single transaction and the product is not separately priced and it is incidental to the rendering of the service, the transaction is a service transaction.
- If the seller offers both a product and a service in a single transaction and any service involved is incidental and is provided or available to all purchasers, the transaction is a product transaction.
- If the seller of a product offers a related service to purchasers of the product but separately prices the service and product elements, the transaction is both a product transaction and a service transaction, and each should be accounted for separately.

Revenue recognition. Revenue from service transactions should be recognized based on performance under one of the following four methods:

- *Specific performance method* — performance consists of a single act, and revenue is recorded when the act takes place.
- *Proportional performance method* — performance consists of more than one act and revenue should be recognized based on the proportionate performance of each act, either on a ratio of direct costs or over the performance period.
- *Completed performance method* — if services are performed in more than a single act and the final act is so significant to the entire transaction that performance has not taken place until the execu-