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Companion to PPC's Guide to

Accounting and Reporting for Estates and Trusts

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Interactive Self-study CPE

Companion to PPC's Guide to Accounting and Reporting for Estates and Trusts

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

INTRODUCTION

Companion to PPC's Guide to Accounting and Reporting for Estates and Trusts consists of two interactive self-study CPE courses. These are companion courses to *PPC's Guide to Accounting and Reporting for Estates and Trusts* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **December 31, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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COMPANION TO PPC'S GUIDE TO ACCOUNTING AND REPORTING FOR ESTATES AND TRUSTS

COURSE 1

Fiduciary Accounting for Estates & Trusts (AETTG091)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course provides an introduction to the fiduciary's responsibilities for estate and trust accounting. Lesson 1 discusses the fiduciary's requirements as stated in the Principal and Income Acts. Lesson 2 discusses concepts and authoritative resources for estate and trust accounting.
PUBLICATION/REVISION DATE:	December 2009
RECOMMENDED FOR:	Users of *PPC's Guide to Accounting and Reporting for Estates and Trusts*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of estates and trusts
CPE CREDIT:	8 QAS Hours, 8 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **December 31, 2010**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Fiduciary Accounting and the Allocation of Principal and Income

Completion of this lesson will enable you to:
- Define the terms and importance of fiduciary accounting income and the Uniform Principal and Income Acts (UPIA).
- Discuss receipts and charges and the allocations to principal and income.
- Identify differences between the 1962 and 1931 UPIAs, and summarize the changes in the 1997 Revisions of the UPIA.

Lesson 2—Accounting for Estates and Trusts

Completion of this lesson will enable you to:
- Identify the accountant's role and describe GAAP principles concerning fiduciary accounting.
- Summarize accounting concepts for accounting for estates or trusts.
- Identify considerations related to specifying and using OCBOA to account for estates and trusts.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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Lesson 1: Fiduciary Accounting and the Allocation of Principal and Income

INTRODUCTION

The term *fiduciary accounting* has different meanings depending on the context in which it is used. The most commonly used definition of fiduciary accounting is provided by the Committee on National Fiduciary Accounting Standards in its report titled *Uniform Fiduciary Accounting Principles and Model Account Formats* (UFAP). Among other things, the Committee's report includes the following discussion about the meaning of the term *fiduciary accounting*:

> "Fiduciary Accounting" does not have one commonly understood meaning. In a broad sense, it can mean the entire process whereby a fiduciary—normally a personal representative, trustee or guardian—communicates information on an on-going basis regarding his administration of a fund and periodically justifies his administration to the parties in interest and, perhaps, to a court. In another sense, it may be the process whereby a fiduciary—here more often a trustee—periodically keeps parties in interest currently informed of transactions and investment policies being followed.
>
> In a narrower sense, . . . a fiduciary accounting may refer to the statement prepared by a fiduciary at the close of his administration of a fund (or at some appropriate intermediate stage) to reflect transactions that have occurred and to be presented to the parties in interest as part of a process whereby the fiduciary seeks discharge from liability for the events disclosed.

The term fiduciary accounting also refers to accounting for the different classes of beneficiaries of an estate or trust. This includes both accounting principles and accounting systems for fiduciary entities.

These lessons focus on the meaning of fiduciary accounting referred above, which is the accounting for different classes of beneficiaries of an estate or trust. In this course, fiduciary accounting is used to refer to accounting for an estate or trust. The guidelines for allocating specific transactions between principal and income beneficiaries are discussed in this lesson. Lesson 2 addresses the accounting principles, accounting systems, and journal entries used to account for fiduciary entities.

Learning Objectives:

Completion of this lesson will enable you to:

- Define the terms and importance of fiduciary accounting income and the Uniform Principal and Income Acts (UPIA).
- Discuss receipts and charges and the allocations to principal and income.
- Identify differences between the 1962 and 1931 UPIAs, and summarize the changes in the 1997 Revisions of the UPIA.

Relationship of Fiduciary Accounting to Federal Income Tax Accounting

In many ways, tax accounting and financial accounting are mutually exclusive. The Internal Revenue Code determines which items of income are taxable and which expenses are deductible in reaching taxable income. On the other hand, financial accounting standards are generally used to determine the financial condition and the results of operations when a business reports to shareholders and creditors. However, the purpose of financial accounting for fiduciary entities is different from that of commercial business enterprises. Fiduciary accounting focuses on reflecting who has rights to the assets of the entity and how the fiduciary has discharged his responsibility. In addition, one notable exception to the general rule that tax accounting and financial accounting are mutually exclusive is Subchapter J of the Internal Revenue Code. In Subchapter J, financial accounting rules for trusts and estates are directly incorporated into the determination of taxable income and the allocation of the tax burden among the fiduciary and beneficiaries.

The fiduciary accounting rules vary from state to state because each has adopted its own set of guidelines. Most states have adopted a form of one of the three Uniform Principal and Income Acts (UPIA), which were drafted to provide a fair allocation between principal and income. Within broad limits, these Acts are controlling only if the governing document is silent or ambiguous on a specific topic covered by the Acts.

Organization of This Lesson

This lesson discusses fiduciary accounting including the relationship of fiduciary accounting to other principles. It addresses the 1931, 1962, and 1997 Uniform Principal and Income Acts; duties of trustees as to receipts and expenditures; components of fiduciary accounting income and principal; apportionment of income; charges against principal and income; and other topics. It provides guidance on the rules for allocating inflows and outflows between income and principal (corpus) with an emphasis on the UPIA.

FIDUCIARY ACCOUNTING INCOME: WHAT IS IT AND WHY IS IT IMPORTANT?

Fiduciary accounting income is trust or estate income determined in accordance with the terms of the governing document (i.e., will or trust instrument) and applicable local (i.e., state) law. It represents the income beneficiaries' interest in the various inflows and outflows of the fiduciary entity. Fiduciary accounting income is different from taxable income, gross income, and distributable net income, which are tax concepts.

What Is Fiduciary Accounting Income?

Fiduciary accounting income determines the economic interests of the income and remainder beneficiaries by providing a means of allocating receipts and disbursements between the estate or trust's income, which may be accumulated or distributed to the income beneficiary, and the principal, which will eventually be distributed to the remainder beneficiaries. In other words, fiduciary accounting income reflects the amount the fiduciary has available for current distributions to the income beneficiaries under the provisions of the government document.

When an estate or trust is established, the creator of the entity (e.g., decedent, grantor, or settlor) has the right to define "income" in any way he desires for purposes of determining how much is distributed to current income beneficiaries and how much is retained for the remaindermen. That definition of income may bear little resemblance to income in the traditional tax or financial accounting sense. However, unless the creator's concept of income as delineated in the governing document departs fundamentally from the concepts of state law, it will be the controlling definition of income for a number of federal income tax, as well as administrative, purposes. Therefore, fiduciary accounting income (also referred to as trust accounting income) is generally determined in accordance with the wishes of the creator, as expressed in the governing document, without regard to traditional tax concepts or financial accounting concepts for commercial business enterprises. Once such income is determined, the fiduciary distributes or accumulates it in accordance with the wishes of the creator.

Relationship of Fiduciary Accounting to Other Principals

When dealing with estates and trusts, both the terminology and the relationship between financial and tax accounting concepts can be confusing. This is especially true because the fiduciary income tax return (IRS Form 1041) actually includes three calculations of income: fiduciary (trust) accounting income (FAI, TAI), taxable income (TI), and distributable net income (DNI).

Fiduciary Accounting Income Defined. FAI (or TAI) is a *financial accounting concept*—not a tax concept. It is determined based on the provisions of the governing document and applicable state law. FAI reflects the amount the fiduciary has available for current distributions to the income beneficiaries under the provisions of the governing document.

Taxable Income Defined. Taxable income (TI) is a *tax accounting concept*. It is the base amount defined in Section 641 of the Internal Revenue Code (IRC) for calculating the annual income tax liability of the fiduciary entity. Subject to exceptions contained in Section 641 of the IRC, taxable income of an estate or trust is calculated similar to an individual. It is the amount remaining subject to tax at the fiduciary level after various deductions, including deductions relating to amounts taxed to the beneficiaries. Tax issues for fiduciary entities are beyond the scope of this course. However, tax issues are discussed in detail in *PPC's 706/709 Deskbook* and *PPC's 1041 Deskbook*.

Distributable Net Income Defined. Distributable net income (DNI) is a *fiduciary income tax concept*. The DNI of an estate or trust is the taxable income of the entity, recomputed with certain modifications. DNI serves as a limitation on the size of the distribution deduction that can be claimed by trusts and estates in computing the taxable income of the fiduciary entity. DNI is also the maximum amount that beneficiaries will have to include in their gross incomes. In addition, DNI is used to determine the character of items passing through to beneficiaries.

FAI, although not a tax concept, is nevertheless required to be disclosed by complex trusts, but not estates, on Schedule B of the fiduciary income tax form (IRS Form 1041) and is significant in a number of tax and nontax areas. Simple trusts indicate the FAI required to be distributed on a separate line on Schedule B.

When the term *income* is used in Subchapter J of the IRC, it generally means fiduciary accounting income (FAI), when not preceded by modifying terms such as *taxable*, *distributable net*, *undistributed net*, or *gross*. Subpart E of Subchapter J, which applies to grantor trusts, is an exception in that "income" when used alone in Subpart E refers to taxable income.

Allocation of Receipts and Disbursements to Income and Principal

To determine fiduciary accounting income, the fiduciary must classify receipts as current income or additions to principal. Likewise, expenditures are classified as deductions from current income or from principal. Income is the return in money or property derived from the use of principal. Principal (corpus) is the property set aside by the owner for eventual delivery to a remainderman, even though the return for the use of the principal may be held for or distributed to an income beneficiary. Proper classification between income and principal transactions is necessary to carry out the desires of the grantor, as expressed in the governing instrument. The grantor has significant flexibility regarding the classification of income and principal.

What constitutes fiduciary accounting income and governs the proper allocation of principal and income is generally defined in state laws derived from the Uniform Principal and Income Act (UPIA). Most states have adopted some form of the UPIA. The rules governing allocation between principal and income according to the UPIA are presented in Exhibit 1-1. These represent the allocation guidance in the 1997 revision of the UPIA. An overview of the UPIAs, including the original Act and the 1962 and 1997 revised Acts is provided later. Note that the 1997 Revised Act gives a trustee broad authority to make adjustments between principal and income consistent with the "total return" concept of investing. A majority of states have adopted the 1997 Act.

Exhibit 1-1

Rules Governing Allocations between Principal and Income

Level of Authority	Treatment
1. Governing Document	Whatever the governing document defines as principal and income must be allocated as specified under the terms of the governing document.
2. Trustee's Discretion	The governing document may grant the trustee discretion as to how allocations are made even if the trustee's allocation produces a result different from state law. Any allocation must be done impartially.
3. Applicable Local (i.e., State) Law	If the governing document is silent and does not grant the trustee discretion, the provisions of state law must be followed.
4. Allocate to Principal	If the governing document is silent and does not grant the trustee discretion and state law is silent, then any inflow or outflow should be charged to principal.

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Governing Document (Terms of the Trust)

The document executed by the person creating a trust is referred to as the *governing document*, *governing instrument*, or the *trust instrument*. In the case of a trust created at death (a testamentary trust), the governing document usually is the decedent's will. The document governing a decedent's estate is either the decedent's will, a trust created by the decedent while alive that serves some of the functions of a will (e.g., a living trust), or the governing jurisdiction's intestacy statute if the decedent died without a will. The governing document contains the terms and conditions of a fiduciary entity and is the first source of guidance for classifying income and expenses. The governing instrument may sometimes provide a definition of *income*.

How principal and income are allocated is under the control of the creator when the governing document is drafted. When creating the trust or will, the creator is allowed to state what items shall be attributed to the income beneficiaries and what amounts should remain for the remaindermen. The reason for this flexibility is to provide the creator with the ultimate responsibility for determining what property should be transferred to each beneficiary, or class of beneficiaries.

If the creator wants every receipt to increase income and every disbursement to reduce principal, then the intent of the creator must be followed when allocating transactions between income and principal. Certain items that are income or expense under traditional financial accounting or tax accounting may not be income or expense under fiduciary accounting because of the latitude given the creator. Thus, it is essential that fiduciaries and accountants read the governing document in order to properly allocate principal and income. Note, under the 1997 UPIA, the term *governing document* has been replaced with the phrase *terms of the trust*. Although an estate is created by a will, an estate is essentially a statutory trust. As a result, many of the phrases that refer to a trust under the 1997 UPIA apply to estates as well, unless a specific section applies to estates.

Trustee's Discretion

Often the governing document gives the trustee discretion in how to allocate items between income and principal. While the trustee will be given leeway in how these allocations are made, discretion is never absolute. A trustee is governed by the various duties imposed by state law on trustees. One primary duty is the duty of impartiality. When making allocation decisions, a trustee must consider the interests of all beneficiaries, both income and remaindermen. If a trustee allocates too much to income and shows favoritism toward the income beneficiaries, the trustee can be in breach of the duty of impartiality. When making discretionary allocations, the trustee must exercise prudent judgment taking into account the entire trust document and the intent of the grantor. Unless the governing document authorizes the trustee to favor a particular beneficiary or group of beneficiaries over another, any discretionary allocation must consider the interests of all beneficiaries.

Section 103(b) of the 1997 UPIA expressly states that a discretionary power must be administered impartially, based on what is fair and reasonable to all beneficiaries, unless the governing document clearly manifests an intention for the fiduciary to favor one or more beneficiaries. Following the UPIA is presumed to be fair and reasonable to all beneficiaries. Most states do not allow a creator to grant a trustee with absolute or uncontrolled discretion. Courts will generally not interfere with a trustee's discretion except in the event of fraud, misconduct, or a clear abuse of discretion. The controlling consideration in deciding whether or not a trustee has abused his discretion is the intention of the creator, which the court determines from considering the trust instrument as a whole and considering the surrounding circumstances. In most cases, the court would not interfere with the trustee's allocation if the trustee has the power to make discretionary distributions of corpus to the income beneficiaries. If the trustee is not able to make discretionary distributions of corpus to the income beneficiaries, the court would limit the trustee's allocation if it would seriously deplete the corpus of the trust.

Applicable Local Law

Unfortunately, many trust instruments and wills are silent about the creator's intent concerning the allocation of principal and income. In such cases, state law prevails. Most states have adopted a form of one of the three Uniform Principal and Income Acts (UPIA), which were drafted with the intent to provide a fair allocation between principal and income. Within broad limits, these Acts are controlling only if the instrument is silent or ambiguous on a specific topic covered by the Acts. It is important for fiduciaries and accountants to remember that fiduciary accounting rules vary from state to state because each has adopted its own set of guidelines.

When the document and local law were silent, the 1962 Act used a "reasonable and equitable approach" to allocate items between income and principal. The 1997 Act replaced the 1962 Act's approach by having all undirected items allocated to principal. Allocating these items to principal implements the rule that requires a trustee to administer a trust impartially. By allocating a receipt to principal, an income beneficiary's distribution in subsequent years will be larger, and at termination the remainder beneficiaries will receive more. Allocating expenditures to principal reduces both future years' income and the amount at termination. The 1997 Act's approach attempts to remove potential disputes that could arise under the 1962 Act's approach while maintaining impartiality.

Fiduciary Accounting Income and Distributions

When the governing document requires all or a portion of the income to be distributed currently, the income referred to in the instrument is fiduciary accounting income. In addition, even though the meaning of the word "income" is determined under the terms of the governing document, provisions in the document departing fundamentally from the local law concept of "income" are not recognized for tax purposes.

Estate and Trust Income Taxation

The following paragraphs and the discussion of how fiduciary accounting and tax accounting concepts relate present only a brief overview of issues relating to taxation of fiduciary entities.

Among the purposes of fiduciary accounting is to (a) determine who is entitled to a distribution, (b) how much of a distribution should be made, and (c) when the distribution should be made. Fiduciary accounting involves allocating the assets between the various beneficiaries and making sure that each beneficiary receives only his or her required amount of assets. Fiduciary accounting income is reflected in the fiduciary income tax return (Form 1041). Although, fiduciary accounting and fiduciary income taxation have different purposes, the rules relating to both must be followed for compliance with the governing document, state law, and tax regulations.

According to IRC Sec. 641(b), probate estates and simple/complex trusts are taxed like individuals for income tax purposes. Unless modified by the Code, all income, deductions and credits are computed using individual income tax rules. When computing entity taxable income of a fiduciary entity, the first computation is adjusted total income (Line 17 on Form 1041). Adjusted total income (ATI) is the net taxable income that will be taxed to either the entity or a beneficiary. Once ATI is computed, the next step is to allocate the ATI between the entity and its beneficiaries. This is accomplished by calculating Distributable Net Income (DNI). DNI is composed of ATI adjusted for certain modifications, such as tax-exempt interest and certain capital transactions. DNI can not be less than zero, so only positive taxable income can be allocated to the beneficiaries while the entity is in existence. DNI is the maximum amount taxable to beneficiaries and is used to determine the character of items passing though to beneficiaries. It is also the ceiling on the amount of distributions to beneficiaries that is deductible by the fiduciary entity and includable in the beneficiary's income. If beneficiaries receive distributions during the year, DNI is generally allocated to them. To the extent DNI is allocated to the beneficiaries, the entity receives a deduction (referred to as a distribution deduction) for the taxable income included in DNI that is allocated to the beneficiaries. Any taxable income that is not included in DNI or any taxable income that is not allocated as part of DNI to the beneficiaries is taxed to the entity under a separate rate schedule.

One of the issues faced by many tax preparers when computing the taxable income of a fiduciary entity is confusion over whether fiduciary accounting rules or tax accounting rules should be followed. However, these rules exist independently. It is the differences between these rules which produces some difficult issues. For example, situations occur where the fiduciary entity may have taxable income but no fiduciary accounting income. In other cases, entities may have fiduciary accounting income that is not taxable income, or taxable income that is not fiduciary accounting income. When taxable income exceeds fiduciary accounting income, the entity can have what is sometimes referred to as "phantom" taxable income. Phantom taxable income causes the entity to have taxable income even though fiduciary accounting income may have already been distributed to beneficiaries under the terms of the governing document. For example, assume that the Ward Family Trust is a limited partner in Cleaver Holdings, LLP. Receipt of a Schedule K-1, Partner's Share of Income, Credits, Deductions, etc., from the partnership does not create fiduciary accounting income. However, it would result in the trust having taxable income. If the trust instrument only allows the distribution of fiduciary accounting income, the trust (rather than the beneficiary) would be required to pay taxes on the income from the limited partnership, since it does not have accounting income to distribute. Making a distribution to beneficiaries to allocate the taxable income would be a breach of duty by the trustee since the trust instrument only allows the distribution of fiduciary accounting income. Fiduciary accounting income rules determine the beneficiaries' rights to the entity's assets. Violation of these rules merely to reduce overall taxes would be a clear abuse of the trustee's discretion in this case.

Fiduciary accounting income is used to allocate DNI and depreciation between the entity and the beneficiaries and between beneficiaries. IRC Sec. 643(b) states that when the term *income* is used in Subchapter J of the IRC without a specific tax modifier like "gross," it means fiduciary accounting income as discussed in this lesson. While designating an item as taxable does not alter its accounting classification, computing fiduciary accounting income and determining how it is allocated assists in allocating DNI and depreciation for tax purposes. For example, if depreciation is deducted for fiduciary accounting purposes, a comparable amount of tax depreciation is deducted by the entity. If tax depreciation exceeds accounting depreciation, the excess tax depreciation is allocated based on the allocation of fiduciary accounting income. When an entity is required to distribute accounting income, the beneficiaries receiving this required accounting income distribution are allocated DNI first. Any remaining DNI is allocated to those beneficiaries receiving other forms of distributions.

Remembering that fiduciary accounting and tax accounting are two different concepts and that neither change the other can help reduce any potential problems when working with fiduciary entities. Understanding that fiduciary entities are taxed like individuals can prevent taking deductions that are not allowed or excluding income subject to taxation. Keeping the various sets of rules separate and using the appropriate rules can assist in the proper determination of both fiduciary accounting and taxable income.

IRS Issues Regulations That Clarify Trust Income. With the adoption of the 1997 UPIA and the Prudent Investor Act, the prior regulations under IRC Sec. 643(b) were not compatible with the new approach to computing trust account income. Questions concerning whether the IRS would accept the definition of income under the 1997 UPIA for tax purposes existed. The IRS issued final regulations (T.D. 9102) that revised the definition of income under IRC Sec. 643(b) to take into account the changes in how trust accounting income is computed under state law. Not only do these rules affect standard estates and trusts, they also affect pooled income funds, charitable remainder trusts, charitable lead trusts, trusts intended to qualify for the marital deduction, and trusts exempt from GST tax. Effectively, the final regulations allow the trust's definition of income to apply for federal income tax purposes, if it is consistent with the trust's terms and state law, and the definition does not go beyond traditional allocation concepts. If a trustee's allocation is consistent with the intent of maximizing the trust's total return and maintaining the balance between the income and remainder beneficiaries' interests, the trust's definition of income will apply for tax purposes. If the trustee's allocation is primarily tax motivated, the trust's definition of income will not apply. The IRS is attempting to adapt its regulations to conform to changing trust laws without giving the trustees unlimited discretion to abuse the tax system. Thus, when the term "income" is used in Subchapter J, it still refers to "accounting income," but incorporates the new ways of computing accounting income being enacted by state legislatures.

AN OVERVIEW OF THE UNIFORM PRINCIPAL AND INCOME ACTS (UPIA)

When the governing document is silent with regard to the computation of fiduciary accounting income, the fiduciary and the accountant must look to applicable "local" law for guidance. The applicable local law usually means the law of the state or other jurisdiction specified by the trust instrument or, in the case of wills, the law of the decedent's state of domicile. In addition, the law of the jurisdiction where the real estate is located may influence the treatment of real estate held by a fiduciary.

Each state has adopted a statute or set of guidelines for the allocation of receipts and disbursements between income and principal. Most states have adopted a form of one of the Uniform Principal and Income Acts as their source of guidance. It is important for fiduciaries and accountants to remember that fiduciary accounting rules vary from state to state because each has adopted its own set of guidelines. This section discusses these "Acts," their origin, and authority.

The original Act was approved in 1931 by the National Conference of Commissioners on Uniform State Laws and was later approved by the American Bar Association. The original Act was revised in 1962 and again in 1997, in response to requests from trustees who found it difficult to administer trusts under the original Act due to the development of new forms of investment property. These Acts (in many cases modified by the individual states), or their equivalent, are usually the "local law" referred to in the Internal Revenue Code and Regulations.

National Conference of Commissioners on Uniform State Laws

The National Conference of Commissioners on Uniform State Laws (NCCUSL) is an organization composed of state commissions on uniform laws from each state, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The organization drafts proposals for uniform and model laws in areas of law where it believes uniformity among the states is desirable and practicable. Then, the NCCUSL works toward enactment of the uniform and model laws by the various state legislatures. A state legislature has the flexibility to adopt a uniform act in whole, in part with modification, or not at all, in which case it would draft its own statute. In addition to the Uniform Principal and Income Act, other uniform laws that the NCCUSL has created include the Uniform Probate Code, Uniform Commercial Code, and the Uniform Partnership Act.

1931 Uniform Principal and Income Act

In 1924, the NCCUSL created a committee of its members to prepare a uniform act addressing issues relating to measurement of income and principal and the allocation of receipts and expenses between tenants (income beneficiaries) and remaindermen in trust and estates. The Uniform Principal and Income Act (UPIA) was approved by the NCCUSL in 1931. The UPIA was later approved by the American Bar Association. The goal of the Act is to provide for as simple and convenient administration of the estate as is consistent with fairness to all beneficiaries. The Act sets forth rules for administration of fiduciary entities, which are believed by the NCCUSL to be consistent with the wishes of most creators.

1962 Uniform Principal and Income Act

In 1959, the NCCUSL created a committee of its members to prepare a revision to the 1931 UPIA. The Revised UPIA was approved by the Commissioners in 1962 and later was approved by the American Bar Association. Requests for revision of the 1931 Act came from several sources, particularly from trustees who found if difficult to administer trusts under the original Act due to the development of new forms of investment property. Like the 1931 Act, the revised Act provides that the grantor's intent is the guiding principle that should control the disposition of all receipts. In addition, the 1962 Act adopted what is called the "Prudent Man Rule" for handling the disposition of receipts where there is no specific section in the revised UPIA dealing with a particular situation.

1997 Uniform Principal and Income Act

The 1997 Uniform Principal and income Act was approved by the NCCUSL on July 31, 1997. The NCCUSL had two primary objectives in developing new principal and income rules. First, revisions were needed to update earlier Acts. Second, the NCCUSL sought to add new provisions giving trustees greater freedom to make investments that are consistent with modern investment practices and the Uniform Prudent Investor Act. While the 1997 Act retains the traditional rule of following the document first and then state law, the 1997 Act allows the trustee, in certain circumstances, to recharacterize what would otherwise be income as principal (and vice versa), if the trustee believes an adjustment is necessary to treat the beneficiaries impartially.

2008 Amendments to the 1997 Act. On October 3, 2008, the National Conference of Commissioners on Uniform State Laws (NCCUSL) issued amendments to the 1997 Act. Those amendments generally affected Section 409—Deferred Compensation, Annuities, and Similar Payments and Section 505—Income Taxes.

The amendments to Section 409 were made in response to Revenue Ruling 2006-26 and are aimed at preserving the marital deduction where retirement plans are payable to a trust.

The changes to Section 505 result from a technical correction to clarify how a trust allocates undistributed funds retained in order to pay taxes on undistributed income from a flow-through entity (i.e., when distributions from a flow-through entity to a trust are less than the trust's distributive share of income).

The Four Areas of the Acts

The 1931 Act and the 1962 and 1997 revised Acts all address the following four questions affecting the rights of beneficiaries:

a. How is income earned during the probate of an estate to be distributed to trusts and to persons who receive outright bequests of specific property, pecuniary gifts, and the residue?

b. When an income interest in a trust begins (i.e., when a person who creates the trust dies or when he transfers property to a trust during life), what property is principal that will eventually go to the remainder beneficiaries and what is income?

c. When an income interest ends, who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?

d. After an income interest begins and before it ends, how should its receipts and disbursements be allocated to or between principal and income?

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Within limits, the Uniform Principal and Income Acts (UPIA) are controlling only when:

   a. Federal tax code is silent.

   b. Fiduciary accounting rules differ from GAAP.

   c. Governing documents are silent.

   d. Statutory law differs between states.

2. Which of the following is a financial accounting concept?

   a. Taxable income.

   b. Distributable net income.

   c. Grantor trust income.

   d. Fiduciary accounting income.

3. When the governing document and local law are silent as to allocation of items between principal and income, the 1997 Act:

   a. Allows the trustee discretion so long as the fiduciary intent is upheld.

   b. Requires allocation of all undirected items to principal.

   c. Requires a reasonable and equitable approach to allocation.

   d. Allows the trustee to allocate based on a proportional basis.

4. Which of the following is **not** correct concerning distributable net income (DNI)?

   a. DNI adjusts adjusted total income (ATI) for tax-exempt interest.

   b. DNI is the maximum amount taxable to the beneficiaries.

   c. DNI is used to determine the character of items passed through to beneficiaries.

   d. DNI below zero is subject to carryforward and carryback provisions.

5. The primary goal of the 1931 UPIA is to:

   a. Maximize earnings for the trust.

   b. Achieve simplicity and equity.

   c. Minimize income tax consequences.

   d. Achieve governmental consensus.

6. According to the text, the 1962 UPIA revised the 1931 UPIA in response to requests primarily from which group?

   a. The American Bar Association.

   b. Trust tenants.

   c. Trust administrators.

   d. Estate remaindermen.

7. According to the text which of the following questions was among those addressed by the 1931 Act and the 1962 and 1997 revised Acts?

   a. How is income earned during estate probation?

   b. When does an income interest in a trust begin?

   c. During the life of the trust, who gets accrued income not yet due?

   d. During the life of the trust, how should receipts and disbursements be allocated?

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Within limits, the Uniform Principal and Income Acts (UPIA)are controlling only when: **(Page 4)**

   a. Federal tax code is silent. [This answer is incorrect. IRC Subchapter J covers federal tax rules for determining estate and trust income and allocating related income tax burden. The UPIA were not developed for the primary purpose of addressing federal tax law.]

   b. Fiduciary accounting rules differ from GAAP. [This answer is incorrect. Accounting for a fiduciary entity follows the will of the entity's creator, and may vary from GAAP as a matter of practice.]

   c. Governing documents are silent. [This answer is correct. Uniform Principal and Income Acts are generally controlling only when governing documents (i.e. will or trust documents) are ambiguous or silent concerning a matter covered by the Acts.]

   d. Statutory law differs between states. [This answer is incorrect. Laws concerning fiduciary accounting may vary between states. Most states have therefore adopted some form of the UPIA to promote fair allocation between principal and income, but this fact per se does not determine when UPIA are controlling.]

2. Which of the following is a financial accounting concept? **(Page 4)**

   a. Taxable income. [This answer is incorrect. As the name implies, taxable income is a tax accounting concept.]

   b. Distributable net income. [This answer is incorrect. Distributable net income is a fiduciary tax concept.]

   c. Grantor trust income. [This answer is incorrect. This is considered a tax accounting term under IRC Subchapter J, Subpart E.]

   d. Fiduciary accounting income. [This answer is correct. Fiduciary accounting income is determined by governing documents and state law. It is a financial accounting concept.]

3. When the governing document and local law are silent as to allocation of items between principal and income, the 1997 Act: **(Page 7)**

   a. Allows the trustee discretion so long as the fiduciary intent is upheld. [This answer is incorrect. The fact that the governing document is silent indicates that fiduciary intent is questionable or unknown.]

   b. Requires allocation of all undirected items to principal. [This answer is correct. The 1997 Act replaced the 1962 "reasonable and equitable" approach, thereby seeking to achieve impartiality in trustee administration.]

   c. Requires a reasonable and equitable approach to allocation. [This answer is incorrect. The reasonable and equitable approach was advocated by the 1962 Act.]

   d. Allows the trustee to allocate based on a proportional basis. [This answer is incorrect. The 1997 Act seeks trustee impartiality. This approach is not that which is prescribed.]

4. Which of the following is **not** correct concerning distributable net income (DNI)? **(Page 7)**

   a. DNI adjusts adjusted total income (ATI) for tax-exempt interest. [This answer is incorrect. DNI is ATI modified for certain items such as tax-exempt interest and certain capital transactions.]

   b. DNI is the maximum amount taxable to the beneficiaries. [This answer is incorrect. DNI sets both the maximum amount taxable to the beneficiaries and the maximum distribution deduction available to the fiduciary entity.]

   c. DNI is used to determine the character of items passed through to beneficiaries. [This answer is incorrect. Any taxable items not included in DNI are taxed to the fiduciary entity.]

   d. DNI below zero is subject to carryforward and carryback provisions. [This answer is correct. DNI cannot be negative during the life of the fiduciary entity.]

5. The primary goal of the 1931 UPIA is to: **(Page 9)**

   a. Maximize earnings for the trust. [This answer is incorrect. Trustees are concerned with adhering to stipulations in governing documents and state laws; these duties do not necessarily coincide with seeking to maximize trust earnings.]

   b. Achieve simplicity and equity. [This answer is correct. Simplicity of estate administration and equitable treatment of beneficiaries is the primary goal of the 1931 UPIA.]

   c. Minimize income tax consequences. [This answer is incorrect. Income tax consequences are of little or no concern in the UPIA.]

   d. Achieve governmental consensus. [This answer is incorrect. Governmental consensus is important in achieving uniformity of application, but this is not the primary goal of the 1931 UPIA.]

6. According to the text, the 1962 UPIA revised the 1931 UPIA in response to requests primarily from which group? **(Page 9)**

   a. The American Bar Association. [This answer is incorrect. Although the text indicates that the ABA approved the 1962 UPIA, there is no mention of the ABA requesting the revisions.]

   b. Trust tenants. [This answer is incorrect. Trust tenants are income beneficiaries. This group was not mentioned by the text as requesting changes to the 1931 UPIA.]

   c. Trust administrators. [This answer is correct. Trustees were concerned with administering trusts in light of new forms of investment property.]

   d. Estate remaindermen. [This answer is incorrect. Estate remaindermen are beneficiaries of the estate principal. The text does not indicate this group as responsible for requesting the changes to the 1931 Act.]

7. According to the text which of the following questions was among those addressed by the 1931 Act and the 1962 and 1997 revised Acts? **(Page 10)**

   a. How is income earned during estate probation? [This answer is incorrect. The question is how this income is to be distributed and to whom?]

   b. When does an income interest in a trust begin? [This answer is incorrect. The issue is rather, how to distinguish principal and income when the income interest in the trust begins.]

   c. During the life of the trust, who gets accrued income not yet due? [This answer is incorrect. This question would not be relevant until the income interest ends.]

   d. During the life of the trust, how should receipts and disbursements be allocated? [This answer is correct. Answering this question in a way that was simple yet equitable and in conformity with the intent expressed in the governing documents was part of the reason for the original UPIA in 1931, and continued to be a concern for each successive UPIA.]

CLASSIFICATION OF RECEIPTS—PRINCIPAL OR INCOME

Income is the return in money or property derived from the use of principal. Principal, or corpus, is the property set aside by the grantor or the fiduciary for eventual delivery to one or more remaindermen. In classifying cash received by a trust as income or principal, the governing document is consulted first. The document may clearly specify the grantor's intent or give the fiduciary discretion in crediting a receipt or charging an expenditure to income or principal or partly to each. However, the document is often silent with regard to classification of a receipt or an expenditure as a principal or an income transaction.

When the document fails to provide guidance, state law applies, which often is in the form of the original or one of the revised Uniform Principal and Income Acts. If neither the document nor the law of the applicable jurisdiction (including applicable case law) applies, the fiduciary is required to allocate all receipts and expenditures to principal. Income tax considerations do not enter into the determination of whether a receipt or an expenditure is income or principal for administration purposes. Exhibit 1-2 presents some common classifications of receipt transactions. These items and more are discussed in detail in the following paragraphs.

Exhibit 1-2

Common Classifications of Receipt Transactions

Income	**Principal**
Interest	Liquidating dividends
Cash dividends	Sales proceeds
Rents	Stock dividends
Loan repayment penalties	
Lease cancellation charges	
Lease renewal fees	

* * *

Apportionment of Income

An estate is created upon the death of the creator. A trust becomes operational when the grantor transfers assets to the trust. Because a trust is not considered active until funded, no allocations may occur before the funding date. Section 4 of the 1962 Act and Section 301 of the 1997 Act detail when an income beneficiary's interest in the fiduciary entity begins and ends and when the entity is first considered to have acquired an interest in an asset.

Key Dates. The key dates that impact how transactions are recorded as either income or principal are:

- The date of death (DOD) of the testator.
- The date an asset becomes subject to a trust.
- The date when the tenancy (rights of the income beneficiary) terminates and the remainderman (principal beneficiaries) receive the principal.

As illustrated in Section 301 of the 1997 UPIA, it is important to know these dates so the accounting records can properly reflect the property rights of the various parties (emphasis added):

a. An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the *date an asset becomes subject to a trust* or successive income interest. An asset becomes subject to a trust:

   (1) On the date it is transferred to the trust in the case of an asset that is transferred *during the transferor's life*;

(2) On the *date of a testator's death* in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the testator's estate; or

(3) On the *date of an individual's death* in the case of an asset that is transferred to a fiduciary by a third party because of the individual's death.

b. An income interest ends on the day before an income beneficiary dies or another terminating event occurs, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

The creator can defer an income beneficiary's interest in the trust or estate to any date he desires. However, if the creator fails to designate a specific date, the income beneficiary has a right to income from any asset controlled by the fiduciary entity. Generally, assets received from a grantor during the grantor's lifetime, a decedent's estate, a trust with a terminating interest, or a payer under a contract naming the trust or its trustee as beneficiary are allocated to principal under Section 404 of the 1997 Act.

The date an asset becomes subject to a trust depends on the type of trust, as follows:

- For *inter vivos trusts*, the trust acquires the property on the date the grantor actually transfers the property to the trust.

- For *testamentary trusts*, the trust is considered to have acquired the asset on the decedent's date of death, even if the asset is subject to a period of probate administration.

- For *property acquired from a third party due to an individual's death*, the trust is considered to have acquired the asset on the date of the individual's death.

Termination of Income Interest. When a mandatory income beneficiary dies or her interest terminates, she is still entitled to certain distributions from the trust to reflect income earned while her interest was still in existence. Only amounts actually received and allocated to income before the interest ends may be distributed. Accrued income paid after the interest ends is added to corpus.

An income interest ends on the day before an income beneficiary dies or another terminating event occurs, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income. At the end of a period during which there is no beneficiary to whom a trustee may distribute income, the trustee must apply the same apportionment rules that apply when a mandatory income interest ends. This provision would apply, for example, if a grantor creates a trust for grandchildren before any grandchildren are born. When the first grandchild is born, the period preceding the date of birth is treated as having ended, followed by a successive income interest.

When a mandatory income interest ends, the trustee shall pay to the beneficiary or the beneficiary's estate, the beneficiary's share of the undistributed income not disposed of under the terms of the document, unless the beneficiary has an unqualified power to revoke more than 5% of the trust immediately before the income interest ends. In this case, the undistributed income that may be revoked must be added to corpus. Without this exception, Section 303 of the 1997 Act would apply to a revocable living trust whose grantor is the mandatory income beneficiary during lifetime, even if the will provides that all of the assets in the probate estate are to be distributed to the trust.

If a trust permits the beneficiary to withdraw all or a part of the trust principal after reaching a specified age and the beneficiary reach that age but fails to withdraw all of the principal that she is permitted to withdraw, a trustee is not required to pay the beneficiary's estate the undistributed income attributable to the portion of the principal left in the trust. The assumption underlying this rule is that the beneficiary has either provided for the disposition of the trust assets (including the undistributed income) by exercising a power of appointment that was given or has not withdrawn the assets because the beneficiary is willing to have the principal and undistributed income be distributed under the terms of the trust. If the beneficiary has the power to withdraw 25% of the trust principal, the trustee must pay to the beneficiary's estate the undistributed income from the 75% that cannot be withdrawn.

If the beneficiary was receiving a fixed annuity or unitrust payment, the trustee shall prorate the final payment to the extent required by applicable law to accomplish the appropriate tax requirements.

Example of Accrued Periodic Payments. Harry is the income beneficiary of the trust. When Harry dies, Sue will become the new income beneficiary. A periodic payment of rent that is due on July 20 has not been paid when Harry dies on July 31. Sue's interest begins on July 31. The rent payment that was due on July 20 is paid on August 3. The July 20 payment is added to the principal when received. The entire rent payment due on August 20 is income when received by the trust. Neither Harry nor his estate are entitled to any part of either the July 20 or the August 20 payments because neither one was received before Harry's income interest ended on July 30. The same principles apply to expenses of the trust.

Accrued Income

Some assets are transferred to a trust with accrued income. A periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities, and disbursements such as the interest portion of a mortgage payment, are not apportioned when paid after the trust owns the asset generating the payment. An item of income is due on the date the payer is required to make a payment. If a payment is not stated, there is no due date. Dividends are deemed due on the date fixed by the board of directors or if no date is fixed, on the declaration date for the dividend.

Interest on an obligation that does not provide a due date for the interest payment, such as interest on an income tax refund, would be apportioned to principal to the extent it accrues before a person dies or an income interest begins unless the obligation is specifically given to a devisee or remainder beneficiary, in which case all of the accrued interest passes to the person who receives the obligation. The same rule applies to interest on an obligation that has a due date but does not provide for periodic payments. If there is no stated interest on the obligation, such as a zero coupon bond, and the proceeds from the obligation are received more than one year after it is purchased or acquired by the trustee, the entire amount received is principal.

Receipts from Entities. As discussed later, when a trust owns an interest in a business entity, no allocations are made until the trust receives a distribution from the entity. Distributions are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. This rule applies for corporations, partnerships, and limited liability companies.

Accrued Income Example. During his life, Bob transfers a bond to a trust (the type of trust is irrelevant). The bond had interest of $200 due but not paid on the transfer date. The entire $200 is allocated to principal when paid. The same rule would apply if the same bond was transferred to his estate at his death. At Bob's death, he owned another bond. The payment date of the bond is after his death. The entire interest payment is allocated to income, even though part of the interest accrued before his death.

Dispositions of Property

Other than sales of underproductive property, sales proceeds are allocated to principal under all three UPIAs. When trust or estate assets are sold by the fiduciary, principal is converted from one form (property) to another (cash or receivable). The fiduciary entity may realize a capital gain or loss on the disposition (for tax purposes), but the substance of the transaction has been a change in the composition of principal. Except for the income tax effect associated with such gains or losses and costs related to the disposition, the current value of the assets remaining for eventual distribution to the remaindermen is unchanged. Likewise, the income beneficiaries did not have an interest in the property either before or after the sale. Therefore, unless the governing document requires otherwise, capital gains and losses and the associated income tax burdens and benefits are allocated to principal.

By allocating sales proceeds to principal, the UPIA removes allocation issues from management decisions. If a fiduciary had to be concerned about allocating sales proceeds to income, all investment decisions would be subject to review by the beneficiaries. Income beneficiaries would generally want the fiduciary to sell high-gain assets while remaindermen would want low gain assets sold. Each could argue that the fiduciary should have sold a different asset, since they would be benefited or harmed by the particular asset sold. The UPIA avoids this second-guessing by the beneficiaries by requiring allocation of all proceeds, including any gains or losses, to principal. This yields the same result as if no property was sold before the fiduciary entity terminated. In that case, the remaindermen would receive the assets, including any built-in gains. After property dispositions occur, income beneficiaries will receive any income earned on the reinvested proceeds. While they may not benefit initially, they would generally realize an increase in income from proper asset management.

Example of Capital Gains Recorded to Principal. According to the trust document of the Bill Hartman Testamentary Trust, all of the income is to be distributed to Joel, during his lifetime. Upon Joel's death, the principal will be distributed to the remaindermen. During the year, the trust recognized a $125,000 long-term capital gain from the sale of stock. The trust instrument is silent as to whether capital gains are treated as income or as principal.

The applicable local law should always be consulted if there is any doubt as to whether an item is principal or income. The accountant consults the principal and income act applicable under local law and determines that the $125,000 long-term capital gain is not included in fiduciary accounting income. The gain is an addition to trust principal because it is "consideration received on the sale or other transfer of principal."

Unproductive Property. Under Section 413 of the 1997 Act, all of the proceeds from the sale of an asset are allocated to corpus. This applies whether the asset produced income while held by the trust or not. In the case of a marital deduction trust, if the trust consists of substantial assets that do not provide the spouse with sufficient income, the spouse may require the trustee to make the assets productive, convert the assets within a reasonable time, or exercise the power to adjust. The trustee can decide which action to take to generate more income for the spouse.

In order to implement the Uniform Prudent Investor Act, Section 413 of the 1997 Act abolishes the right to receive delayed income from the sale proceeds of an asset that produces little or no income. The Section does allow a spouse, who is an income beneficiary, to compel the trustee to make property productive of income. As the law continues to develop in this area, the duty to make property productive of current income in a particular situation should be determined by taking into consideration the performance of the portfolio as a whole and the extent to which a trustee makes principal distributions to the income beneficiary under the terms of the trust and adjustments between principal and income under Section 104 of the 1997 Act.

Under the 1962 Act, a portion of the net proceeds of the sale of an asset that had not produced an average net income of at least 1% of its inventory value for more than a year (including as income the value of any beneficial use of the property by the income beneficiary) is treated as delayed income to the income beneficiary. The 1931 Act includes a similar, although not identical, provision. The amount allocated to the income beneficiary (i.e., included in fiduciary accounting income) under the 1962 Revised Act is the sum of:

a. The difference between the net proceeds and the amount which, had it been invested at simple interest at 4% per year while underproductive, would have produced the net proceeds; and

b. Any carrying charges plus any expenses previously charged against income while the property was underproductive, less any income from the property received by the income beneficiary, and less the value of any beneficial use by the income beneficiary.

Example Allocation upon Disposition of Unproductive Property—1962 Act. Trust A, a testamentary trust, owned 100 acres of unimproved land. The inventory value of the land was $100,000. The land has produced no income for the five years it has been owned by the trust. Property taxes during that period totaled $1,500. The land was recently sold for $125,000. The property is located in a state that has adopted the 1962 Revised Uniform Principal and Income Act. The trustee needs to determine how much of the proceeds should be allocated to income under the 1962 Act.

The net proceeds are computed as follows:

Gross proceeds	$ 125,000
Less: Expenses incurred in disposition (commission)	(7,500)
Capital gains tax [20% × ($125,000 − $100,000 − $7,500)]	(3,500)
Expenses previously incurred (property taxes)	(1,500)
Net proceeds	$ 112,500

Using the 4% simple interest rate included in the provisions of the 1962 Act for the five years the land was underproductive, the amount of proceeds allocated to income is computed as follows:

Net proceeds	$ 112,500
Investment required to produce net proceeds:	
{112,500 ÷ [1 + (5 years × .04)]}	93,750
Difference	18,750
Carrying charges (property taxes)	1,500
Delayed income to beneficiary	$ 20,250

Therefore, $20,250 of the sales proceeds is included in fiduciary accounting income in the year the property is sold. If the trust instrument requires all "income" to be distributed currently, the trustee should add $20,250 to the current income amount to be distributed to the current income beneficiary of the trust.

Because a number of states have adopted one of the UPIAs and then modified certain provisions, it is important that accountants consult local law. Furthermore, some states allow a portion of the gain from the sale of underproductive property, not just the sales proceeds, to be allocated to current income beneficiaries. Such modifications to the UPIAs underscore the need for accountants to review the statute in effect in their jurisdictions.

Insurance Proceeds. Section 407 of the 1997 Act provides that insurance proceeds (including life and property) are allocated to principal unless the insurance was purchased to protect the trust from loss of income. If it was purchased to protect the trust from loss of income, then the proceeds are allocated to income. Dividends paid on a policy are allocated to income if income was used to pay the premiums and to principal if principal was used to pay the premiums. This section does not apply to insurance used to fund a deferred compensation plan, which is discussed below.

Investments in Business Activities—1997 Act

Article Four, Part 1 of the 1997 Act contains the allocation of returns from investments in business activities. Section 401 of the 1997 Act applies to: a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, and any other organization in which the trustee has an interest excluding another trust or estate, a sole proprietorship, or an asset-backed security.

Business Entities. Generally, nothing is allocated unless the trustee receives a distribution from the entity. Merely receiving a Schedule K-1 from a partnership or S Corporation would not result in an allocation for accounting purposes. A cash distribution is allocated to income. The following distributions are allocated to corpus:

a. Property other than money,

b. Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity (a liquidation),

c. Money received in total or partial liquidation of the entity, and

d. Money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Money is received in a partial distribution to the extent the entity indicates that the distribution is in partial liquidation or the total amount received is greater than 20% of the entity's gross assets, as shown on the entity's financial statements immediately before the distribution. A distribution shall not be a partial liquidation if the amount received does not exceed the income tax owed by the entity on the taxable income allocated to the trust.

Under the IRC, a "capital gain dividend" from a mutual fund or REIT is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. Since a capital gain dividend does not include any net short-term capital gains, cash received due to a short-term capital gain is allocated to income, not principal. Reinvesting the ordinary dividends does not change the character of the dividend or the newly purchased stock. The dividend is still income and the stock is principal.

Example of Allocation of Dividends, Capital Gains, and Noncash Distributions. The Bagwell Trust has the following investments: 100 shares of AT&T, 100 shares of XYZ mutual fund, and a 25% interest in a closely-held partnership. During the year, the Trust receives the following distributions from its investments: a $100 cash dividend on the AT&T stock; a $25 cash dividend from the XYZ mutual fund, which includes $10 in short-term capital gains; a $150 cash capital gain dividend from the XYZ mutual fund; and 5 acres of land, valued at $500, from the partnership. The Trust also received a Schedule K-1 from the partnership allocating $250 in ordinary income to the Trust. The Trust's accounting income from the investments would be:

Dividend income (AT&T)	$ 100
Dividend income (XYZ)	25
Total accounting income	$ 125

Since the XYZ mutual fund classified the short-term capital gain as ordinary dividends, the $10 short-term capital gain would be accounting income. Capital gain dividends and the noncash partnership distribution are allocated to corpus. While the Trust would have taxable income of $250 from the partnership, no entry would be made on the Trust's accounting books to record the taxable partnership income allocated to the Trust.

A trustee may rely on a statement from the entity about the source or character of a distribution if the statement is made at or near the time the distribution is made by the entity's governing body.

Trust or Estate. If the trust is a beneficiary of an estate or trust, Section 402 of the 1997 Act provides that the trust shall allocate distributions based on the character of the distribution as determined by the estate or trust. For example, if the trust makes a principal distribution, the trustee should allocate the distribution to principal. In cases where the trust makes an investment in a trust, the investment should be treated as an entity described above or as an asset-backed security.

Sole Proprietorship. When the trust owns certain assets in sufficient quantity, the trust may treat the investments as a separate activity/business instead of including the assets as part of the trust's general assets. This can occur when the trust owns:

a. Retail, manufacturing, service, and other traditional business activities,

b. Farming,

c. Raising and selling livestock and other animals,

d. Management of rental properties,

e. Extraction of minerals and other natural resources,

f. Timber operations, or

g. Derivatives and options.

Under Section 403 of the 1997 Act, the trustee has the election of accounting for these assets as part of the trust's general assets, where the allocation is discussed below, or to treat these activities as a sole proprietorship. The trustee can elect to account for certain activities separately and others as part of the general assets. If treated as a sole proprietorship, the receipts and disbursements are accounted for separately. Since the activity is treated as a separate business entity, income retained by the business for current or future operational needs is not allocated. Income not needed for operational purposes can be allocated to income or corpus. Proceeds from assets sold outside the normal course of business and not needed for future operational purposes are allocated to corpus.

If a trustee operates a business as a sole proprietorship, the 1997 Act affords more flexibility than under the 1962 Act. The trustee would account separately for the business instead of accounting for it as part of the trust's general accounting records. Only cash in excess of the reasonable foreseeable needs of the business could be allocated to income and only to the extent the trustee decides to allocate excess cash to income. There is no requirement that the trustee must allocate any or all of the excess cash to income, but can use her discretion when allocating the excess cash between principal and income. Assets sold outside the normal course of business would be allocated to principal, but only if the net cash proceeds were not required for business operations. Under the 1997 Act, net profits/losses and net proceeds from asset sales are not recorded on the fiduciary books and allocated between principal and income until a distribution is made by the business to the fiduciary accounts. As long as the amounts are needed for business operations, no entry is recorded on the fiduciary books. As with partnerships, this could cause a difference between taxable income and accounting income. All net profits and asset sales would be currently taxable while nothing is recorded in the accounting income.

How the transferor accounted for a particular type of income has no bearing on how the entity should account for the same type of income. Even if the transferor accounted for a certain type of income as income from business operations (a Schedule C item on his Form 1040), if a particular Section of the 1997 Act applies to the income, the particular Section will determine its allocation, not the transferor's previous accounting treatment. A general rule of law states, *"The specific controls over the general."* A specific Section will always control over a general Section. When making the election to account for an activity as a sole proprietorship, the trustee must make the election on what is best for the trust and not according to the method selected by the transferor.

Example of Accounting for a Sole Proprietorship. The Allen Trust operates a farm, which was transferred to the trust at the death of Mr. Allen. During the year, the farm produced a profit of $50,000. The trustee used tax accounting to compute the farm's profit. Due to future operational needs, the trustee only transferred $10,000 to the trust's checking account. Although the trust has $50,000 in taxable income, only $10,000 is added to the trust's accounting income for the year.

Real Estate. When the trust owns several rental properties, the trustee has the option of accounting for the rental properties as a sole proprietorship. If the rental activities are accounted for as a sole proprietorship, the net result will be significantly different than if the rental properties are accounted for as trust assets, which is discussed below. When treated as a sole proprietorship, the rental activity's net income is computed independently and general financial accounting rules applicable to sole proprietorships are used. Depreciation would be a normal charge in determining net income, since financial accounting rules generally required sole proprietorships to reduce net income for normal wear. Trust accounting income would be increased only when the rental activity has net income and then only if cash from the rental activity is deposited in the trust's account. Losses would not reduce trust accounting income. If the rental activity is included with the other trust assets, positive cash income will normally increase trust accounting income while negative cash income will decrease accounting income. It is perhaps more equitable not to treat rental activities as sole proprietorships even when the trust owns several rental properties. By not treating the rental properties as a sole proprietorship and electing not to depreciate the rental properties, net rental cash income can be allocated to accounting income, while the appreciation can be allocated to corpus on sale. If a rental property is depreciating in value, the trust should consider selling the property and reinvesting the proceeds in more productive assets. This way all beneficiaries can benefit from the trust's ownership of rental properties.

Example Allocation of Rental Activities. The Cordell Trust owns several rental properties. During the year, the rental properties collected cash revenues of $150,000, had $125,000 in cash expenses, and $30,000 in depreciation. If accounted for as a sole proprietorship, the rental activities would have a $5,000 loss, so there would be no trust accounting income. If the rental properties were included with the other trust assets and no depreciation was taken, trust accounting income would be $25,000 ($150,000 − $125,000).

Not Accounting as a Sole Proprietorship. If the trustee elects not to account for the seven items listed previously as a sole proprietorship, the 1997 Act provides a separate allocation system for rentals, minerals, timber and derivatives. It is generally assumed that retail, manufacturing, service, and farming operations will be accounted for as a sole proprietorship.

Rental Activity. Section 405 of the 1997 Act provides that receipts from rental property, to the extent not separately accounted for as a sole proprietorship, are income. This would include amounts received for the cancellation or renewal of a lease. Security deposits are corpus unless forfeited. Any directly related cash expenses associated with the rental activity would be allocated to income, also.

Minerals, Water, and Other Natural Resources. The conservation of principal is an overriding concern in the 1997 Act, and the area of natural resources presents some problems. The length of the trust and the depletion of resources will eventually result in the remaindermen having nothing remaining at the end of the trust. To prevent this occurrence, part of the current inflows must be attributed to corpus. The following allocations apply if the entity is not accounting for the activity as a sole proprietorship.

Rent and extension payments are allocated to income. Production payments are income to the extent the agreement provides that part of the payment is for interest or its equivalent; otherwise, production payments are principal. All other forms of payments are divided equitably between income and principal. Under Section 411 of the 1997 Act, 90% of the net receipts are allocated to principal and the remaining 10% is allocated to income. Allocating a larger percentage to principal enables the trustee to acquire other income-producing assets to replace the mineral reserves, which are being exhausted. Not all states adopted the 1997 Act's 90% allocation to principal. A discussion of certain state modifications to this provision of the UPIA is found later in this lesson. For trusts owning mineral interests before enactment of the 1997 Act, the trustee may continue using the same allocation method previously used, but for interest acquired after enactment, the previously explained rules must be used.

Receipts for water that is renewable must be allocated to income, while receipts for water that is not renewable must be allocated 90% to principal and 10% to income.

Under the "open mine doctrine," the trustee could not allocate any interest to the income beneficiaries unless the decedent or grantor had leased the minerals prior to transferring the interest to the trust. Under Section 411(d) of the 1997 Act, the open mine doctrine is abolished and the trustee can allocate receipts to the income beneficiaries whether the decedent or grantor had previously leased the minerals or not.

Timber. The rules in Section 412 of the 1997 Act are intended to apply to net receipts from the sale of trees and by-products from harvesting and processing trees without regard to the kind of trees that are cut or whether the trees are cut before or after a particular number of years of growth. The rules apply to the sale of trees that are expected to produce lumber for building purposes, trees sold as pulpwood, and Christmas and other ornamental trees. The Section is not intended to prevent a tenant in possession of the property from using wood that he cuts on the property for personal, noncommercial purposes, such as a Christmas tree, firewood, mending old fences or building new fences, or making repairs to structures on the property.

Net receipts from timber and related products are allocated as follows:

a. To income to the extent the timber removed does not exceed the rate of growth of the timber during the accounting periods in which the beneficiary has a mandatory income interest.

b. To corpus to the extent the amount of timber removed exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber.

c. Between income and corpus, using the rules in (a) and (b) above, if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by the trust.

d. To corpus, if not previously allocated.

In determining net receipts, the trustee shall deduct an amount for reasonable depletion. The method of determining the amount of timber removed and the rate of growth is up to the trustee, based on methods customarily used for the kind of timber involved. Amounts can be allocated to the income beneficiary even if the decedent or grantor had never leased or cut timber from the land before transferring the land to the trust. For trusts owning timber interest before enactment of the 1997 Act, the trustee may continue using the same allocation method previously used, but for interest acquired after enactment, the previously explained rules must be used.

Derivatives and Options. A *derivative* is a contract or financial instrument or a combination of contracts and financial instruments which gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or group of assets, or changes in a rate, an index of prices or rates, or other market indicator for an asset or a group of assets. According to Section 414 of the 1997 Act, all receipts from derivative transactions are allocated to corpus. All option transactions are to be allocated to corpus. Marking to market transactions do not create an accounting allocation. Only cash transactions affect income and corpus.

It is difficult to predict how frequently and to what extent trustees will invest directly in derivative financial instruments rather than participating indirectly through investment entities that may utilize these instruments in varying degrees. If the trust participates in derivatives indirectly through an entity, an amount received from the entity will be allocated under Section 401 of the 1997 Act and not Section 414. If a trustee invests directly in derivatives to a significant extent, the expectation is that receipts and disbursements related to derivatives will be accounted for as a sole proprietor under Section 403. When the trustee chooses not to account under Section 403, Section 414(b) provides the default rule that all amounts are corpus. Certain types of option transactions in which trustees may engage are dealt with in subsection 414(c) to distinguish those transactions from ones involving options that are embedded in derivative financial instruments.

Options to which subsection 414(c) of the 1997 Act apply include an option to purchase real estate owned by the trustee and a put option purchased by a trustee to guard against a drop in value of a large block of marketable stock that must be liquidated to pay estate taxes. Subsection (c) would also apply to a continuing and regular practice of selling call options on securities owned by the trust if the terms of the option require delivery of the securities. It does not apply if the consideration received or given for the option is something other than cash or property, such as cross-options granted in a buy/sell agreement between owners of an entity.

Investment in Business Activities—1962 Act

Corporate Distributions. Not all corporate distributions (e.g., dividends) are income items. There are two types of returns an investor can anticipate from any stock investment:

- Income (e.g., dividends).
- Appreciation, also known as capital gains.

Normally, the fiduciary allocates dividends to the income beneficiary and appreciation is attributed to the remaindermen. However, the general rule does not always apply. While certain distributions are labeled as dividends, they are in reality disguised distributions or reallocations of principal. Section 6 of the 1962 Act provides for the allocation of corporate distributions between income and principal.

Prior to the 1997 Revised Act, corporate distributions in the form of extraordinary dividends or taxable stock dividends that are included in taxable income are not fiduciary accounting income if the fiduciary, acting in good faith, determines that the distributions are allocable to principal under the terms of the governing document and applicable local law. Nontaxable stock dividends and stock splits are clearly considered receipts of principal and do not fall under this good faith rule. In addition, a corporate distribution of cash or property that is the result of a total or partial liquidation of the corporation is also an addition to principal for fiduciary accounting purposes. (Neither the Internal Revenue Code nor the regulations provide a definition of *extraordinary* dividends. Therefore, *extraordinary* in this context appears to refer to a corporate distribution other than an "ordinary" dividend that clearly belongs to accounting income as defined by the governing document or applicable local law.)

Example of Extraordinary Dividend Allocated to Principal. Jack Jones established three trusts, one for the benefit of each of his three children. To each trust, Jack contributed one-third of the outstanding stock of Jonesco, Inc., a closely held corporation founded by Jack. Thereafter, the three trusts owned 100% of the outstanding stock of Jonesco. The terms of each trust instrument were identical, requiring all income to be distributed currently. In 2003, the corporation declared a $1 million prorata cash dividend following the sale of certain appreciated real estate. The dividend represented approximately 15% of the value of the entire company. The 1962 Revised Act applies to the trusts.

The trustee, acting in good faith, determined that the dividend was an extraordinary dividend that should be allocated to principal. Therefore, since the dividend was principal and not income, no distributions were made to the three children.

Unless stated differently in the document, distributions made from ordinary income, including short-term capital gains by a mutual fund or a real estate investment trust (REIT), are income. Other distributions from a mutual fund or a REIT, including capital gain distributions, are principal under the 1962 and 1997 Revised UPIAs. Mutual fund and REIT distributions are not addressed in the original Act, but the same logic should apply in those states where the original Act is still in effect.

Corporate distributions are normally classified as income. The exceptions are those items discussed in the preceding paragraphs and pertain to stock distributions, liquidating dividends, and extraordinary dividends. Receipt of a Schedule K-1, Shareholder's Share of Income, Credits, Deductions, etc., from an S Corporation does not create fiduciary accounting income. Distributions are not recorded on the fiduciary entity's books until the actual distribution is received. When a distribution is received, it is allocated like any other corporate distribution, with dividends (corporate surplus) being allocated to income and any return of basis being allocated to principal.

Partnership Distributions. One problem that trustees face is accounting for partnerships. If the grantor is a general partner and transfers the general partnership interest to a trust, the trust allocates its general partner's share of income/loss in the same manner as a sole proprietorship. The trust records its share of the net profits as income and its share of the net loss as principal, regardless of whether a distribution is made. No carryback or carryforward of net loss is made by the trust.

Significant issues exist when the trust invests in a partnership, either as a general or a limited partner, or the trust acquires an interest in a limited partnership, either from the grantor or through purchase. The 1962 Act offers no specific guidelines on how to make partnership allocations in these situations. Since no specific guidelines exist, any allocation must be "reasonable and equitable in view of the interests of those entitled to income and to principal" (Section 2). In the case of a general partnership, the allocation will be based on either the rules applicable to a general partnership interest contributed to the trust by the grantor (discussed below) or the rules applicable to a limited partnership interest (discussed above). Either a trustee will allocate its share of the net profits/losses between income or principal, regardless of whether a partnership allocation is made, or the trustee will make an allocation upon receiving a distribution from the partnership.

Example Partnership Allocation. The Trustee invested in Big Deal Partnership as a 50% general partner. For the year, the Partnership had net income of $100,000, of which $50,000 was apportioned to the Trust's capital account. No distribution of any profits was made by the Partnership to any partner. The Trustee must decide whether to allocate the entire $50,000 to income or to defer allocation until the trust receives a distribution from the partnership.

Normally, equity will dictate that an allocation be made to principal if the partnership investment represents a significant percentage of the trust's assets. To allocate nothing to principal could be viewed as a breach of the trustee's duty of impartiality. Since the trustee made the investment in the partnership, the trustee has created the allocation issue. If the partnership investment had not been made, the trust would have invested in assets that would have produced principal inflows, allowing the remaindermen to benefit from the trust's investments. By investing a large portion of the trust's assets in the partnership, the trustee has effectively removed these assets from the normal allocation system. If the trustee allocates all partnership income (whether or not it has been received) to trust income and all losses to principal, the trustee would be favoring the income beneficiaries. To avoid this problem, the trustee should make allocations only after receiving a distribution from the partnership. This approach follows the method of allocating income and distributions from a limited partnership, discussed below.

If the partnership investment represents only a small portion of the trust's assets, allocating all of the partnership income to income may be "reasonable and equitable," since the trust would have other assets that would benefit the remaindermen. Allocating all partnership income to income and all net losses to principal would not be inconsistent with the "reasonable and equitable" standard applied in these situations, because some inflows would still be allocated to principal from the other assets under the normal allocation system.

As a limited partner, the fiduciary entity is not actively involved in the partnership's operations. As such, the fiduciary is not able to compel distributions or influence managerial decisions. Since the entity's relationship with the partnership is different when the entity is a limited partner, a limited partnership interest takes on a new character, whether the partnership interest was contributed to the entity by the creator or purchased by the entity. Under the "reasonable and equitable" standard, a limited partnership interest is more like a stock investment than an investment in a sole proprietorship or general partnership. As an investment, the fiduciary should record the entity's limited partnership interest as a single line item at the appropriate carrying value. Since the fiduciary generally maintains the entity's records on a cash basis, nothing is recorded on the entity's records until a distribution from the limited partnership is received. When the limited partnership makes a distribution, the fiduciary must allocate the distribution between income and principal. Using the method for allocating corporate distributions between dividends and capital to allocate the limited partnership distribution between income and principal would be reasonable and equitable.

Under the cost method of accounting for investments in stock, if the amount distributed is equal to or less than the owner's share of total earnings, the entire amount would be a dividend. However, if the distribution exceeds the owner's share of total earnings, the excess is a return of capital. Cash dividends are allocated to income for fiduciary accounting purposes. If the limited partnership interest is considered similar to a stock investment, to the extent the limited partnership distributions do not exceed the total earnings allocated to the entity's interest, (a) the entire amount would be allocated to income (just like dividends), and (b) once the distributions exceeded the total earnings, the excess would be allocated to principal. When the partnership interest is sold, any gain or loss is attributed to the remaindermen (principal).

It is often difficult for a trustee not to allocate anything to accounting income until a distribution is made. However, fiduciary accounting is not like accrual-based GAAP for business enterprises or tax accounting. When amounts are allocated to income, there must be assets that the fiduciary can distribute. Until an actual limited partnership distribution is made, the fiduciary does not have assets to distribute to the income beneficiaries. It would be inequitable for the fiduciary to record income and make distributions before receiving any assets from which to make the distributions. While the limited partnership interest may have increased in value, any increase is unrealized until the interest is sold. Similarly, an increase in stock value would not be recorded until the stock is sold for held-to-maturity stocks. From the income beneficiaries' perspective, not receiving any of the limited partnership distribution would be inequitable.

Generally, the accounting treatment discussed in the preceding paragraphs satisfies all of the requirements of the 1962 Act. If the trust is an active general partner in a partnership contributed by the creator, the fiduciary should record operations like a sole proprietorship. If the trust is not actively involved, the fiduciary should record operations like a stock investment. In situations where the fiduciary invests in a general partnership, the proper accounting treatment would depend on the proportion of the partnership investment to total investments. When the partnership investment represents a significant amount of the entity's total investments, the fiduciary should record operations like a stock investment, otherwise, the partnership's operations would be recorded as a sole proprietorship. This approach (a) is consistent with the cash method of accounting, (b) does not favor one type of beneficiary over another, and (c) provides for a proper distribution of assets. Receipt of a Schedule K-1 does not create fiduciary accounting income.

Receipts from Pass-through Entities. Neither the original nor the 1962 Revised UPIA provides specific guidance concerning the classification of distributions from pass-through entities. Under the conventional treatment, when a trust or estate holds shares in an S corporation or an interest in a partnership or another fiduciary (e.g., another trust), any undistributed income currently taxable for federal income tax purposes generally is not fiduciary accounting income until received by the fiduciary. However, if the fiduciary has a unilateral right to compel distribution of the pass-through entity's income, the undistributed income is fiduciary accounting income.

Income for fiduciary accounting purposes refers to cash or other property received for the use of the entity's assets. Therefore, trusts and estates are essentially on a cash basis for fiduciary accounting purposes. When a partnership, S corporation, or other fiduciary makes a distribution, the cash or other property distributed is fiduciary accounting income to the extent the distribution represents earnings, and principal if the pass-through entity distributes assets.

Sole Proprietorships. Net income from a business or farm that uses the assets of the trust or estate in the business or farming activity is included in fiduciary accounting income. The accounting for a business owned by the estate or trust is generally maintained in a separate set of books and is not combined with the accounting records of the estate or trust. The income or loss is computed using generally accepted accounting principles, according to the 1962 Revised UPIA. The 1931 Act simply provides that net income be computed in accordance with the customary practice of such business.

If the business or farming operations results in a loss, the loss is charged to principal in the year incurred under both the original and the 1962 Revised Acts. Such losses are not carried over or back to be netted against fiduciary accounting income in other accounting periods. Thus, if the business has net income, all the income is allocated to the income beneficiaries. Conversely, if the business has a net loss, the entire net loss is allocated to the remaindermen. Because a net operating loss is not carried forward to future years to reduce net income, each year is a separate transaction and any net income/loss is fully accounted for in the current year. A farm, including the raising of animals or a nursery, is treated like any other business.

How the transferor accounted for a particular type of income has no bearing on how the entity should account for the same type of income. Thus, even if the transferor (i.e., the decedent or grantor) accounted for a certain type of income as income from business operations (e.g., a Schedule C item on his Form 1040), if a particular section of the UPIA applies to the income, that section will determine its allocation, not the transferor's previous accounting treatment. A general rule of law states, *"The specific controls over the general."* So, a specific section will always control over a general section. Therefore, even if a transferor accounted for his oil and gas operations or rental activity as a business—since a specific section details how oil and gas and net rental income is allocated—that section should be used to determine the proper allocation to principal and income (i.e., not the section dealing with business and farming operations).

Rental Activities. There are different viewpoints in practice about whether rental activities should be treated as a business. Section 3(a)(1) of the 1962 Act indicates that the receipt of rent on real or personal property, including sums received for cancellation or renewal of a lease, is income. However, no reference is made to rental losses in the 1931 or the 1962 Revised Act. Some practitioners believe that a rental operation incurring expenses (including required additions to a depreciation reserve) in excess of rental income should be treated as a business as long as the fiduciary exhibits regular, continuous, and substantial activity in relation to the property's management. If the rental activity is viewed as a business, rental losses should be charged against principal.

Other practitioners believe that rental activity should not be treated as a business. They point to the reference in Section 3 of the 1962 Act that indicates receipts from rentals are income. Because of the general rule that specific expenses reduce specific income items (in the absence of other specific guidance), they believe that losses from rental activities are allocable to income. In addition, some practitioners have a different viewpoint on the argument that rental income should be treated as a business as long as the fiduciary exhibits regular, continuous, and substantial activity in relation to the property's management. Instead, they see that position as transferring the material participation concepts that are used in the Internal Revenue Code relating to passive activity losses to the fiduciary accounting concept of determining fiduciary accounting income and the proper allocation between principal and income.

Minerals, Water, and Other Natural Resources. The area of natural resources presents several issues when determining allocations between principal and income since the length of the trust and the depletion of the resource will eventually result in the remaindermen having nothing at the end of the trust. To prevent this occurrence, part of the current inflows must be attributed to principal. Classification of amounts received by an estate or trust for the removal of natural resources from land or mineral rights owned by the fiduciary entity generally depends on the nature of the agreement with the payor.

Receipts representing rent on a mineral lease or extension payments on a lease are income. In states where the 1962 Revised UPIA or comparable statute is in effect, if the amount received is a royalty, overriding royalty, or working interest, a portion is credited to principal (as a depletion reserve) and the remainder is income. Dry hole costs of drilling unproductive wells, intangible drilling costs, and purchase of equipment of productive wells are principal charges. The portion credited to principal is 27.5% of the gross receipts, not to exceed 50% of the net receipts remaining after payment of all expenses, direct and indirect, computed without allowance for depletion. The balance of the gross receipts, after payment of all expenses, direct and indirect, is income for fiduciary accounting income purposes. Under the original Act, consideration received, whether royalties or otherwise, for the permanent severance of such natural resources from the land is principal.

Example Allocation of Oil and Gas Income. The Olga Thompson Family Trust owns a royalty interest in an oil well. During the year, the trust received royalty checks totaling $9,250. This represented gross royalties of $10,000 reduced by $750 of severance, or production taxes withheld by the purchaser. The trust paid $500 of ad valorem tax in 2003 on the real property from which the oil was produced. The property is located in a state that adopted the 1962 Revised Uniform Principal and Income Act.

The amount allocated to principal is 27.5% of $10,000, or $2,750. The remainder, after payment of the severance tax and ad valorem tax (and any indirect expenses), is considered income for fiduciary accounting income purposes.

The 50% of net income limitation does not apply. The depletion for federal income tax purposes is $1,500 (i.e., 15% of $10,000).

The fiduciary accounting income in the example is calculated as:

Gross receipts	$ 10,000
Depletion reserve	(2,750)
Severance tax	(750)
Ad valorem tax	(500)
Fiduciary accounting income	$ 6,000

Timber. Timber is given special treatment under the 1962 Act. Timber is treated as a wasting asset, just like other natural resources. The fiduciary has the duty to preserve the principal of the trust or estate if it contains wasting assets. This prevents the fiduciary from using other 1962 Act sections to allocate all net income from timber operations to income and all net losses to principal. Thus, unlike oil and gas and other natural resources, a specific percentage is not considered principal. In the case of timber, the 1962 Revised Act provides that receipts are allocated to the income and remainder beneficiaries in accordance with what is "reasonable and equitable." The exact allocation will be on a case-by-case basis; however, some amount should be allocated to both income and principal.

Derivatives and Options. The 1931 and 1962 Acts do not have a specific allocation system for derivatives and options.

Interest Income, Including Bond Premium and Discount

1997 Act. Section 406 of the 1997 Act provides that all interest is allocated to income with no premium amortization. For interest-bearing instruments purchased at a discount, if the bond matures in one year or less, the amount in excess of the purchase price is allocated to income. If the discounted instrument matures more than one year after purchase, the entire proceeds are allocated to principal. This sections does not apply to interest received on IRAs, minerals, timber, derivatives, or asset-backed securities, which are covered in other sections of this lesson.

1962 Act. Interest earned on money lent is generally considered fiduciary accounting income. However, what may be considered interest for federal income tax purposes is not necessarily interest for fiduciary accounting purposes. The most obvious example is interest earned from obligations of state and local governments (e.g., municipal bonds). While such interest income is exempt for income tax purposes, it is includable in fiduciary accounting income. Another example is imputed interest income, which is essentially the amortization of original issue discount taxable under IRC Sec. 1274, but not included in fiduciary accounting income.

With the exception of zero coupon bonds discussed in the next paragraph, a bond or any other type of obligation for the payment of money is initially classified as a principal item (at its inventory value) and the proceeds from the sale of a bond are also allocated to principal. The 1931 and the 1962 UPIAs both generally provide that amortization of bond premiums or discounts is not included in fiduciary accounting income. However, different rules apply in the case of zero-coupon bonds.

For zero-coupon bonds, absent a special election, the fiduciary entity will recognize for tax purposes all income from the bonds in the year the bonds are redeemed or sold. However, when computing fiduciary accounting income (assuming the fiduciary entity is located in a state that follows the 1962 Revised Act or has a similar statute), the annual increment in the value of the bonds is income. If the income is distributed to current income beneficiaries under the terms of the trust, the amount distributed that is attributable to the increment in value of the bonds is reimbursable to the principal of the trust when the bonds are redeemed or sold.

Liquidating Assets

1997 Act. A *liquidating asset* is an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. The term includes a leasehold, patent, copyright, royalty right, and right to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. This definition would include lottery payments, but would not include payments under a deferred compensation arrangement, minerals, timber, asset-backed securities, or depreciable assets. Under Section 410, 10% is allocated to income and the rest is allocated to corpus.

1962 Act. Leaseholds, patents, copyrights, and royalties are property rights whose value is reduced over time. Since these are wasting assets, some protection is provided to the remaindermen. Under the 1962 Act, only 5% of the inventory value of the property is considered income and the balance is principal. The 1931 Act makes a distinction on the treatment of other property subject to depletion based on whether the trustee or tenant in possession of such assets is under a duty to change the form of the investment assets of the trust or estate. The treatment of such assets is discussed in Section 10 of the 1931 Act.

Retirement Plans and Individual Retirement Accounts

1997 Act. Many trusts are named as beneficiaries of decedents' qualified retirement plans and individual retirement accounts (IRAs). Proper allocation between income and principal is required to ensure that the correct amounts are distributed to the appropriate beneficiaries. If the entire plan benefits are distributed to a trust at the participant/owner's death, its date-of-death value plus all post-death gains are allocated to principal while any post-death income would be allocated to income. Since most retirement plans are not fully distributed at death, periodic distributions must be properly allocated between principal and income to ensure proper allocation between beneficiaries. This allocation is independent of how the periodic distributions are taxed for income tax purposes. Further, no transactions are recorded on the trust books until the trustee receives a periodic distribution from the plan. All activity within the plan is ignored for trust accounting purposes until a distribution is received.

Section 409 of the 1997 Act applies to amounts received under contractual arrangements that provide for payments to a third-party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 410 of the 1997 Act, these payment rights are covered separately in Section 409 because of their special characteristics.

Section 409 of the 1997 Act applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the grantor has made contributions, just as it applies to an annuity policy that the grantor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and private annuities arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock.

Section 409(b) of the 1997 Act applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest. For example, some deferred compensation plans hold debt obligations or stock of the plan's sponsor in an account for future delivery to the person rendering the services, and they provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with "phantom" shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 409(b), payments of dividends, interest, or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal. Section 409(b) does not apply to an IRA or an arrangement with payment provisions similar to an IRA.

The focus of Section 409(c) of the 1997 Act is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction. An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 409(c), which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the required payment is allocated to income and any excess payment is allocated to principal. Any discretionary or lump sum payment is to be allocated 100% to principal.

Section 409(d) of the 1997 Act and Revenue Ruling 2006-26. One requirement a trust must meet before qualifying for the estate tax marital deduction is a provision entitling the surviving spouse to all of the trust's accounting income. While trust income, as defined by the governing instrument and applicable state law, is generally sufficient to meet this requirement, one exception applies to the allocation between principal and income. Only allocations that provide for a reasonable apportionment of the trust's total return for the year between income and remainder beneficiaries will be sufficient for the trust to qualify for the marital deduction. The IRS has taken the position that a trust and an IRA payable to the trust are two separate trusts for marital deduction purposes. The spouse must be entitled to all of the accounting income from both the trust and the IRA before the marital deduction is allowed. In effect, the IRA's income must be computed independently of the trust's income and the spouse must be allowed to receive all of the trust's and IRA's income.

As originally enacted, Section 409(d) of the 1997 Act allowed the trustee to make a greater allocation to income than provided by Section 409(c), if necessary, to preserve the marital deduction. When combined with Section 409(c), it was thought the two sections would meet the IRS's apportionment requirement. However, in Revenue Ruling 2006-26, the IRS ruled the 10% allocation to income, standing alone, was not a reasonable allocation since the 10% did not reflect a reasonable apportionment of the trust's total return. Further, the ruling held the provision of Section 409(d), allowing the trustee to allocate more to the spouse to prevent a loss of the marital deduction, may not be sufficient to save the marital deduction, since saving clauses ineffectively reform a trust for estate tax purposes. The ruling did hold that using a unitrust amount to determine the trust's and IRA's income would qualify as a reasonable allocation for marital deduction purposes.

Based on Revenue Ruling 2006-26, Section 409(d) was amended in October 2008 and Sections 409(e), (f), and (g) were added to the 1997 Act. These sections apply to martial deduction trusts only. If a trust is not a marital deduction trust, Sections 409(b) and (c) still apply in determining the portion of a plan distribution that is accounting income.

Survivor annuities payable only to the surviving spouse are given automatic marital deduction treatment. Under Section 409(e), if a survivor annuity for the benefit of the surviving spouse is payable to a martial deduction trust, the payment is allocated totally to income and the provisions of Section 409(f), and (g) do not apply.

Under Section 409(f), the trustee computes the plan's/IRA's income using the rules under the 1997 Act. This computation is done separately for each plan/IRA included in the trust. If requested by the spouse, the trustee is to remove the plan's/IRA's income and allocate it to the trust's income and then distribute the trust's income. The trust's income from the other trust assets is computed independently from the plan's/IRA's income using the applicable 1997 Act provisions. The plan's/IRA's income might be more or less than the minimum required distribution for the year. If the plan's/IRA's income is less than the minimum required distribution, the excess distributed amount is allocated to principal. If the plan's/IRA's income is more than the minimum required distribution, the spouse can request principal be added to income to the extent the amount distributed is less than the plan's/IRA's income.

Revenue Ruling 2002-2 allowed a trust to take the marital deduction, even if the plan's/IRA's income was not actually distributed, if the spouse had the right to demand the plan's/IRA's income be distributed. When combined with Section 409(f), the trustee is to compute the income of each plan/IRA separately from the other plan's/IRAs and the other trust assets. While the minimum required distribution must be made, it might be more or less than the plan's/IRA's income. To the extent the plan's/IRA's income is more than the minimum required distribution, the excess income can remain in the plan/IRA without losing the marital deduction provided the spouse has the right to demand a distribution. Any plan/IRA income actually distributed from the plan/IRA plus any income from the trust's other assets must be distributed to the spouse for the trust to qualify for the marital deduction. Instead of distributing the plan/IRA income in excess of the minimum required distribution, the spouse can allow the excess plan/IRA income to remain in the plan/IRA and have principal added to the trust's income instead. When the plan's/IRA's income is less than the minimum required distribution, the amount distributed in excess of the plan's/IRA's income is allocated to principal.

In situations where the trustee cannot compute the plan's/IRA's income, Section 409(g) allows a unitrust approach to be used to compute the plan's/IRA's income. A trustee should generally have sufficient records to compute an IRA's income, but might lack adequate information to compute the plan's income. Based on the most recent valuation statement, the trustee would allocate between three and five percent of the plan's value to income. Where value information is not available, as in the case of annuity payments, the plan's income is based on the product of the interest rate and present value of the expected future payments using the Section 7520 rate for the month preceding the accounting period for which the computation is being made.

By making these changes, the 1997 Act is attempting to allow a marital deduction trust, which relies on state law to compute accounting income, to comply with the Internal Revenue Code's marital deduction provisions. It is unclear how Revenue Ruling 2006-26 will affect existing trusts or trusts that come into existence before the changes discussed in this section are adopted by the various states that have adopted the 1997 Act. If the estate tax return has already been filed, accepted, and the martial deduction allowed, exactly how the IRS could retroactively reopen the case and disallow the marital deduction is unknown. Prospectively, until the state amends its laws to conform to the changes discussed in this section, all marital deduction trusts that receive IRA or qualified plan payments must be drafted to clarify the surviving spouse's entitlement to both the trust's and IRA's income. Whether income is computed under either the general allocation method or a unitrust approach, the spouse must be entitled to both the trust's and IRA's income before the marital deduction will be allowed.

How a retirement plan or IRA distribution is allocated for trust accounting purposes does not change the way it is taxed for income taxation purposes. Unless a portion of the distribution is a return of a nondeductible contribution or is a qualified distribution from a Roth IRA, the distribution would be recorded as ordinary income on the trust's income tax return. Whether the taxable income could be allocated to the beneficiaries would depend on the type of trust distributions allowed. If only fiduciary accounting income distributions were allowed, the portion of the plan or IRA distribution allocated to principal would be taxed at the trust level. The distribution is included in DNI regardless of whether it is considered principal or income for fiduciary accounting purposes. However, since actual distributions are limited to fiduciary accounting income, not all of the DNI can be allocated to the beneficiaries, and thus the trust must pay taxes on the portion of DNI retained by the trust.

1962 Act. If the trust document does not provide an allocation method for IRA distributions, state law should be followed. Both the 1931 and 1962 Acts consider retirement plans and IRAs as "Other Property Subject to Depletion" and allocate receipts not in excess of 5% of the IRA's inventory value to income with the remainder to principal. In most cases, the inventory value would be the date-of-death value; so only 5% of the IRA's date of death value would be income and would remain unchanged even though the amount received by the trust increases or decreases.

Example of IRA Distribution Allocation. Trust A is the designated beneficiary of Joe's IRA. At Joe's death, the IRA was valued at $1,000,000, with $500,000 in bonds and $500,000 in growth mutual funds. Joe was a resident of a state that has adopted the 1997 UPIA. During the year following death, the bonds earned $30,000 in interest and the mutual funds produced long-term capital gains of $50,000 and dividends of $20,000. No separate accounts were maintained by the IRA trustee. Under the minimum required distribution rules, a timely distribution of $50,000 was made by December 31. On the trust's books, the transaction is not recorded until the $50,000 distribution is actually received. When the $50,000 is received, $45,000 is debited to principal cash ($50,000 × 90%), $5,000 is debited to income cash ($50,000 × 10%), $5,000 is credited to an income account (closed to trust income) and

$45,000 is credited to the IRA asset account. The IRA's internal growth would not be shown on the trust's books, but could be accounted for in the notes. The entire $50,000 would be subject to income taxation and whether it could be allocated to the beneficiaries would depend on the amount of distributions allowed by the governing document.

Income in Respect of a Decedent

Income in respect of a decedent (IRD) is income to which the decedent was entitled, but due to his death was not includible in his taxable income. An example of IRD is salary earned but not paid to a cash basis taxpayer. Although the taxpayer had earned the salary, since it was not paid until after his death, it could not be included on his final income tax return. Because the income was never subject to income tax, someone must pay income taxes on it when received. Note that no step-up in basis exists for IRD at death.

IRD must be included in the income of the party that receives the IRD in the year of receipt. Therefore, if an estate receives the IRD, it must include it in income. However, if the beneficiary receives the IRD directly, the beneficiary is taxed on it. Whoever collects the IRD is entitled to any deductions associated with the IRD. The character of IRD is the same as if the decedent had received the property before death.

When money or property is received after an individual's death, but as a result of predeath activities, the receipts are considered principal. Such receipts could take the form of periodic payments such as rent or interest, or may take some other form such as a lump-sum distribution from a qualified retirement plan. (The 1997 Act allocates 90% of deferred compensation receipts to principal and 10% to income.) For fiduciary accounting purposes, if such an asset has been transferred to the estate or trust, the transfer of the asset represents a receipt of principal, not the receipt of income. The fact that the receipts are taxable as income in respect of a decedent (IRD) does not affect their classification for fiduciary accounting purposes.

Allocations Covered in the 1997 Act But Not in Either the 1931 or 1962 Acts

In the 35 years between the 1997 and 1962 Acts, the world of investments had changed substantially. Several provisions were added to the 1997 Act that had no corresponding provision in either the 1931 or 1962 Acts.

Insubstantial Amounts. Sometimes the trustee receives small inflows from a particular investment. Requiring the trustee to allocate the small amount to income creates an accounting burden. Section 408 of the 1997 Act allows a trustee to allocate insubstantial amounts to corpus unless to do so would be a violation of one of the provisions preventing an adjustment under Section 104(c) of the 1997 Act. This prohibition mainly exists to prevent claims that allocating small income amounts to corpus would have an adverse tax consequence. The same provisions that allow a co-trustee to exercise a power to adjust and the ability to release a power of adjustment apply to this power, also. The ability to allocate insubstantial amounts to corpus applies to inflows from deferred compensation, liquidating assets, minerals, timber, and asset-backed securities.

Asset-backed Securities. Under Section 415 of the 1997 Act, an "asset-backed security" means an asset whose value is based on the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security. The term includes an asset that gives the owner the right to receive from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset to which the entity rules under Section 401 or the deferred compensation rules under Section 409 of the 1997 Act apply.

The portion of the payment identified by the payer as interest or other current return shall be allocated to income, with the rest of the payment being allocated to corpus. If the trust's entire interest is liquidated in a single accounting period, all of the payments are allocated to corpus. Liquidating payments spread over two or more accounting periods are allocated 10% to income and the rest to corpus.

Typical asset-backed securities include arrangements in which debt obligations such as real estate mortgages, credit card receivables, and auto loans are acquired by an investment trust and interests in the trust are sold to investors. The source for payments to an investor is the money received from principal and interest payments on the underlying debt. An asset-backed security includes an "interest only" or a "principal only" security that permits the investor to receive only the interest payments received from the bonds, mortgages, or other assets that are the collateral for the asset-backed security, or only the principal payments made on those collateral assets. An asset-backed security also includes a security that permits the investor to participate in either the capital appreciation of an underlying security or in the interest or dividend return from such a security, such as the "Primes" and "Scores" issued by Americus Trust. An asset-backed security does not include an interest in a corporation, a partnership, or an investment trust described in the Comment to Section 401 of the 1997 Act, whose assets consist significantly or entirely of investment assets. Receipts from an instrument that do not come within the scope of this section or any other section of the Act would be allocated entirely to principal under the rule in Section 103(a)(4) of the 1997 Act, and the trustee may then consider whether and to what extent to exercise the power to adjust in Section 104 of the 1997 Act, taking into account the return from the portfolio as whole and other relevant factors.

Principal. Section 404 of the 1997 Act allocates the following items to principal:

a. Unless allocated to income by another section, assets received from a grantor during the grantor's lifetime, a decedent's estate, a trust with a terminating interest, or a payer under a contract naming the trust or its trustee as beneficiary;

b. Money or other property received from the sale, exchange, liquidation, or change in form of a corpus asset, including realized profit;

c. Amounts recovered from third parties to reimburse the trust for environmental disbursements;

d. Proceeds from property taken by eminent domain, less any amount specifically stated as loss income where the trust has a mandatory income interest; and

e. Net income received in an accounting period during which there is no beneficiary to whom the trustee may or must distribute income.

State Modifications to the 1997 UPIA

Most states have adopted a form of one of the three Uniform Principal and Income Acts (UPIA), which were drafted with the intent to provide a fair allocation between principal and income. Within broad limits, these Acts are controlling only if the instrument is silent or ambiguous on a specific topic covered by the Acts. It is important for fiduciaries and accountants to remember that fiduciary accounting rules vary from state to state because each has adopted its own set of guidelines. Some of the modifications that states have made to the 1997 UPIA upon adoption by the state are highlighted in the paragraphs that follow.

Business Entities—Partial Liquidations. As discussed earlier, money received in total or partial liquidation of an entity is allocated to principal under the 1997 UPIA. Money is received in a partial distribution to the extent the entity indicates that the distribution is in partial liquidation or the total amount received is greater than 20% of the entity's gross assets, as shown on the entity's financial statements immediately before the distribution. A distribution shall not be a partial liquidation if the amount received does not exceed the income tax owed by the entity on the taxable income allocated to the trust.

While the 20% test for partial liquidations might seem straightforward, a California appeals court gave it an interesting interpretation. Although the corporation made a distribution exceeding 20% of its assets, since the trust's share of the distribution did not exceed 20% of the corporation's assets, the Court ruled that the entire distribution was income. In response to the ruling, the California legislature amended its statute to clarify that a partial liquidation exists if the corporation's entire distribution to all shareholders exceeds 20% of its assets.

Of the states that have adopted the 1997 UPIA, most, like California, adopted the 20% test as expressed in the model act. With the California court's interpretation of the model act's 20% test, a beneficiary could challenge a trustee's allocation of a large corporate distribution to corpus. No other case exists defining the 20% test, so a court could use the California case as a basis for its ruling. If a grantor wants to make clear when a partial liquidation occurs, a provision in the governing document should be added.

Example Allocation of Partial Liquidation. The Gilliam Trust is a 25% partner in a partnership, which has gross assets of $750,000. During the year, the partnership distributes $200,000 to its partners. Since the distribution is more than 20% of its gross assets, the distribution qualifies as a partial liquidation. Thus, the Gilliam Trust will allocate its $50,000 to corpus.

Minerals, Water, and Other Natural Resources. One of the overriding concerns in this area is maintaining a balance between the interests of the income and principal beneficiaries, Section 411 of the 1997 Act, allocates 90% of the net receipts to principal and the remaining 10% is allocated to income. Allocating a larger percentage to principal enables the trustee to acquire other income-producing assets to replace the mineral reserves, which are being exhausted. For trusts owning mineral interest before enactment of the 1997 Act, the trustee may continue using the same allocation method previously used, but for interest acquired after enactment, the previously explained rules must be used.

Not all states adopted the 1997 Act's 90% allocation to principal. Kansas, Montana, New York, and Oklahoma allocate 15% to principal, Wyoming allocates 27.5% to principal, and Pennsylvania allocates $66^{2}/_{3}$% to principal. New Mexico allocates the amount allowed for federal tax depletion to corpus. Texas provides for an equitable allocation between income and principal, but provides that an allocation based on federal tax depletion is equitable. All states allow the trustee to continue using the allocation rates in effect before the 1997 Act was passed for all interests owned before the effective date of the new rules.

Retirement Plans and Individual Retirement Accounts. Many trusts are now being named as beneficiaries of decedents' qualified retirement plans and individual retirement accounts (IRAs). Proper allocation between income and principal is required to assure that the correct amounts are distributed to the appropriate beneficiaries. Under the 1997 UPIA, if the entire plan benefits are distributed to a trust at the participant/owner's death, its date-of-death value plus all post-death gains are allocated to principal while any post-death income would be allocated to income. Since most retirement plans are not fully distributed at death, periodic distributions must be properly allocated between principal and income to assure proper allocation between beneficiaries.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 409(c), which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the required payment is allocated to income and any excess payment is allocated to principal under the 1997 UPIA. Any discretionary or lump sum payment is to be allocated 100% to principal.

Nine states (Alaska, Indiana, Missouri, New Jersey, Oregon, Pennsylvania, Texas, Washington and Wisconsin) that adopted the 1997 Act either modified the 10% to income allocation for mandatory distributions provision or did not adopt the 10% provision." Texas, Washington and Wisconsin adopted a form of unitrust approach to plan distributions. While each state's method varies slightly from the other, in general, the trustee determines the fair market value of the plan benefits each year. To the extent the plan distributions are equal to or are less than 4% of the fair market value, the distributions are allocated to income. Any distributions in excess of 4% of the fair market value are allocated to principal.

Example Allocation of IRA Distribution. The Salter Trust, a Texas trust, is a beneficiary of an IRA. The IRA's total assets at the beginning of the year equal $950,000. A $80,000 IRA distribution is made for the year. $38,000 ($950,000 × 4%) would be allocated to income while $42,000 ($80,000 − $38,000) would be allocated to corpus. If the trust was a QTIP trust, this allocation would comply with the requirements of Revenue Ruling 2006-26.

INCOME AND PRINCIPAL CHARGES

To determine fiduciary accounting income, cash disbursements must be analyzed to determine whether they should be charged against current income, thereby reducing the amount available for distribution to current income beneficiaries, or against principal, in which case the cost is ultimately borne by the remaindermen.

The fiduciary's primary source of guidance in classifying a disbursement as a charge against income or a charge against principal is the governing document, such as a will or trust agreement, to determine the creator's intention as to who (income beneficiary or remainderman) should bear the cost. If the instrument fails to provide guidance, the fiduciary should look to the law of the particular state to provide guidance. State law may take the form of the original or one of the revised Uniform Principal and Income Acts. However, many individual states have modified the provisions of the acts prior to adoption. Exhibit 1-3 presents some common classifications of charge transactions. These items and more are discussed in detail in the following paragraphs.

Charges under the 1997 Act

Disbursements from Income. If the document does not provide otherwise, Section 501 states that the following expenditures are charged to income, except in the case of the following estates and terminating income interests:

a. Half of the regular trustee's compensation and for any person providing investment advisory or custodial services.

b. Half of all expenses for accounting, judicial proceedings, or other matters that involve both the income and remainder interests.

c. All of the other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against trust corpus, and expenses of a proceeding or other matter that concerns primarily the income interest.

d. Recurring premiums on insurance covering the loss of a corpus asset or the loss of income from or use of the asset.

Exhibit 1-3

Common Classifications of Charge Transactions

Income	Principal
Interest expense on estate or trust liabilities	Cost of investing and reinvesting principal assets
Income taxes attributable to estate or trust income	Cost of preparing property for rental or sale
Property taxes	Taxes levied on gains or profits allocated to principal
Insurance premiums	Costs incurred in maintaining or defending any action to protect the estate, trust, estate property, or trust property
Ordinary repairs	
Ordinary expenses in connection with the administration, management, or preservation of the estate or trust property	

* * *

The regular compensation of a trustee or the trustee's agent includes compensation based on a percentage of either principal or income or both. The reference in item d to "recurring" premiums is intended to distinguish premiums paid annually for fire insurance from premiums on title insurance, each of which covers the loss of a principal asset. Title insurance premiums would be a principal disbursement under Section 502(a)(5). The reference to "regularly recurring taxes assessed against principal" includes all taxes regularly imposed on real property and tangible and intangible personal property.

The treatment of fiduciary and administration expenses for federal income tax purposes does not affect the allocation for fiduciary accounting purposes. For example, the portion of fiduciary fees allocated to tax-exempt income is not deductible for income tax purposes, but this allocation has no effect on the charging of fiduciary fees against income or principal for fiduciary accounting purposes.

Disbursements from Principal. When the document is silent, Section 502 states that the following expenditures are charged to principal:

a. Half of the regular trustee's compensation and, for any person providing investment advisory or custodial services, half of all expenses for accounting, judicial proceedings, or other matters that involve both the income and remainder interests.

b. All of the trustee's commission calculated on corpus as a fee for acceptance, distribution, or termination and disbursements made to prepare property for sale.

c. Principal payments made on trust debts.

d. Expenses of a proceeding that concerns primarily corpus, including a proceeding to construe the trust or to protect the trust or its property.

e. Insurance premiums not allocated to income on policies owned by the trust.

f. Estate, inheritance, and other transfer taxes, including penalties apportioned to the trust.

g. Disbursements related to environmental matters.

Transfers from Income to Principal for Depreciation. For fiduciary accounting purposes, depreciation of property held by the fiduciary in a trade or business or for the production of income is not merely a noncash expense or journal entry. If the governing document or local law requires the fiduciary to maintain a reserve for depreciation (or depletion) or a reserve is permitted and the fiduciary actually maintains one, a portion of current income in the amount of the depreciation is credited to principal.

According to Section 503 of the 1997 Act, whether the trustee charges depreciation is totally within the trustee's discretion, except in the following circumstances, when no depreciation may be charged:

a. When real estate is used or available for use by a beneficiary as a residence or tangible personal property held or made available for the personal use of a beneficiary.

b. During the administration of an estate.

c. When the trustee is treating the activity as a sole proprietorship.

If the trustee is accounting for the activity as a sole proprietorship, a separate depreciation charge would not be available, but in computing the net income from the sole proprietorship, depreciation would be allowed if permitted under normal financial accounting rules.

The purpose of a reserve is to preserve the principal for the remaindermen so that, at the end of the asset's useful life, the fiduciary will have accumulated the funds to replace the asset. Therefore, depreciation for fiduciary accounting purposes involves an actual transfer of cash from current income to principal. When depreciation is charged against income, it reduces the amount distributable to the income beneficiaries. When an asset is appreciating, the remaindermen would be enriched twice if depreciation is charged. Not only would the remaindermen receive the depreciation but they would also receive the entire appreciation on sale. An overriding goal of the 1997 Act is an equitable allocation of a trust's total return between both income and remainder beneficiaries. Although depreciation is a normal charge for financial accounting, depreciating an appreciating asset conflicts with the equitable purpose of fiduciary accounting. Even if depreciation is not charged for accounting purposes, depreciation can still be taken for tax reasons, if allowed by the tax code, so tax motivations should not be the basis for reducing accounting income for depreciation. Since charging depreciation is totally within the fiduciary's discretion (unless required by the document), a fiduciary should not reduce accounting income for depreciation unless necessary to equitably allocate the trust's total return between the beneficiaries.

The amount of depreciation is computed under generally accepted accounting principles. Typically, this is straight-line depreciation over the useful life of the asset, although a different recovery method and period can be used if that more accurately reflects the asset's useful life. However, since the depreciation charge reduces income causing a reduction in the income beneficiaries' distribution, using straight-line depreciation results in a more uniform reduction and is easier to explain to the beneficiaries when they ask why their distributions are lower. While depreciation is used to maintain an economic balance between the beneficiaries, beneficiaries are adverse to unnecessary reductions in their current distributions. Accelerated depreciation, while allowed for taxation, would probably not be well received by the income beneficiaries due to the increased reduction in their distributions in the early years. Remember, the depreciation method used for trust accounting does not determine the depreciation method used for tax purposes.

The governing document is often silent as to the establishment of depreciation or depletion reserves. In addition, most statutes do not convey the power to establish reserves to a fiduciary in the absence of fairly explicit wording in the governing document. However, a direction to the fiduciary to preserve trust or estate principal is sometimes sufficient to permit the establishment of reserves. Other jurisdictions require a more explicit statement in the document requiring or permitting reserves. It is important for fiduciaries and accountants to examine the governing document as well as the law of the particular jurisdiction to determine the proper treatment of depreciation.

Example of No Depreciation Reserve Required. The John Wilkes Testamentary Trust owns a rent house. The trust instrument requires fiduciary accounting income to be computed without a depreciation deduction and to be distributed to the income beneficiary at least annually. Since there is no reserve for depreciation at the trust level, no cash transfer from income to principal is required. Therefore, the distribution to the income beneficiary is not reduced by depreciation. It should be noted that the income tax depreciation deduction is apportioned on the basis of fiduciary accounting income allocated to the beneficiary and to the trust.

Example of Depreciation Reserve Required. Assume the same facts as in the preceding example, except the trust instrument requires a reserve for depreciation to be maintained. The addition to the reserve, determined under generally accepted accounting principles, is $10,000. As a result, the trustee must transfer $10,000 from income to principal, thereby reducing fiduciary accounting income and the amount of distribution to the income beneficiary. The income tax depreciation deduction is apportioned to the trust to the extent of the reserve. If the tax depreciation exceeds the required reserve, the excess is apportioned between the trust and the beneficiary based on fiduciary accounting income apportioned to each.

Transfers from Income to Principal to Reimburse Principal. Sometimes the trustee will need to make a large disbursement on behalf of the income interest before income is sufficient to cover the disbursement. In these cases, the trustee can reimburse the principal for the prepaid income expenditure. If the trustee anticipates a substantial future income expenditure, the trustee can reduce income currently to establish a sinking fund for the future payment. This allows the trustee to spread the reduction of income over several periods and avoid a substantial reduction of income in a single year. The trustee can continue the reimbursement even if the specific beneficiary receiving the income interest changes.

According to Section 504, the following disbursements can be reimbursed unless the trustee anticipates being reimbursed by a third party:

a. An amount chargeable to income but paid from corpus because it is unusually large, including extraordinary repairs.

b. A capital improvement to an asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments.

c. Disbursements made to prepare property for rental, including tenant allowances, leasehold improvements, and broker's commissions.

d. Periodic payments on an obligation secured by an asset to the extent depreciation charges are less than the payment.

e. Environmental expenses.

Income Taxes. Estate, inheritance, and transfer taxes are charges against principal. According to Section 505 (which was amended in October 2008), a tax paid on receipts allocated to income is paid from income and a tax paid on receipts allocated to principal is paid from principal, regardless of how the tax is labeled by the taxing authority. If the trust owns an interest in an entity whose income flows through to the trust, taxes are allocated based on how the receipts are allocated:

- If allocated to income, the taxes are allocated to income.
- If allocated to principal, the taxes are allocated to principal.
- If the receipts are allocated to both income and principal, the taxes are proportionately allocated to both income and principal.
- If the total taxes on the entity's income exceed the total receipts, any excess tax is allocated to principal.

After performing the allocation, the tax allocation is adjusted for any taxes saved due to the income tax distribution deduction. This increases what the beneficiary receives by the amount of taxes saved because there was a distribution deduction.

The income tax rules under Section 505 can cause some challenging computational issues if the trust owns a flow-through entity. As discussed earlier, only cash distributions are considered income, so if the trust is allocated taxable income in excess of its distributions, an income adjustment will have to be made to account for the taxes payable by the trust. When computing the adjustment, any taxes saved through the income distribution deduction must be taken into consideration. Most often, the flow through allocation issues will apply to entities taxed as partnerships, since generally, trusts cannot own S Corporation stock. S Corporation stock can be owned by a testamentary trust for two years after transfer to the trust and a revocable trust can own S Corporation stock for two years after the decedent dies. After the two years, the trust must either distribute the stock or make an appropriate election to protect the S Corporation status. Only Qualified Subchapter S Trusts and Electing Small Business Trusts may own S Corporation stock after the two year period. Probate estates may own S Corporation stock for the period of administration.

<u>Example when a Partnership Allocates Taxable Income but Makes No Distribution.</u> The trust's share of the partnership income is $500,000, but makes no distribution. The trust will pay the tax on the entire partnership income and the tax will be paid from principal.

<u>Example when a Partnership Allocates Taxable Income and Makes a Distribution that is Less Than the Taxes Owed on the Partnership Income.</u> The trust's share of the partnership income is $500,000, and the partnership distributes $100,000. Assuming the trust is in the 35% tax bracket, the trust will owe $175,000 in taxes. Since the taxes are required to be paid by the trust and are more than the partnership distribution allocated to income, the trustee must reduce the income to zero. Anytime the income allocation of an entity's distribution is less than the amount of tax the trust owes on its share of the entity's taxable income, the income allocation will be reduced to zero. The $75,000 excess of the tax liability over the distribution received is paid from principal.

<u>Example when a Partnership Allocates Taxable Income and Makes a Distribution Equal to the Taxes Owed on the Partnership Income.</u> The trust's share of the partnership income is $500,000, and the partnership distributes $175,000 in taxes. Assuming the trust is in the 35% tax bracket, the trust will owe $175,000. As with the example in the preceding, since none of the partnership distribution is allocated to income, all of the taxes must be paid from the income allocation. The partnership distribution represents taxes required to be paid by the trustee on income receipts, so income is reduced to zero.

<u>Example when a Partnership Allocates Taxable Income and Makes a Distribution Greater than the Taxes Owed on the Partnership Income.</u> The trust's share of the partnership income is $500,000, and the partnership distributes $250,000. Assuming the trust is in the 35% tax bracket, the trust will owe $175,000 in taxes. The income beneficiary's distribution is net of the income's share of the taxes owed, but the taxes owed are computed after subtracting

the income distribution deduction, which is based on the income beneficiary's distribution. To compute the income beneficiary's distribution, the following equation must be used:

$$D = [C - (R \times K)]/(1 - R)$$

D − the amount payable to the beneficiary
C − the cash distributed to the trust
R − the trust's ordinary tax rate
K − the partnership's taxable income allocated to the trust

Based on the formula, the beneficiary will receive $115,385, which is calculated as follows:

D = [$250,000 − ($500,000 × .35)]/(1 − .35)
D = ($250,000 − $175,000)/.65
D = $75,000/.65
D = $115,385

If the calculation is done properly, the distribution to the beneficiary, reduced by the Trust's tax liability, will be the same amount:

Taxable income	$ 500,000
Less: Income beneficiary's distribution	(115,385)
Taxable income	$ 384,615
Tax ($384,615 × 35%)	$ 134,615
Partnership distribution	$ 250,000
Less: Trust's tax liability	(134,615)
Income beneficiary's distribution	$ 115,385

<u>Example when a Partnership Allocates Taxable Income and Makes a Distribution Greater than the Taxes Owed on the Partnership Income and Taxable Income Includes Both Ordinary and Capital Gain.</u> The trust's share of the partnership income is $500,000, but $250,000 is from ordinary income and $250,000 is from capital gains. The partnership distributes $250,000. Assuming the trust is in the 35% tax bracket for ordinary income and 15% for capital gains, the trust will owe $125,000 in taxes. Since the capital gains cannot increase the trust's income distribution deduction, the trustee must withhold the entire capital gains tax from the income beneficiary's payment. The income beneficiary's distribution may only be increased by the taxes saved through the income distribution deduction. To compute the beneficiary's distribution, the following algebraic equation must be used:

$$D = [C - G - (R \times K)]/(1 - R)$$

D − the amount payable to the beneficiary
C − the cash distributed to the trust
G − the trust's capital gains tax liability
R − the trust's ordinary tax rate
K − the partnership taxable income allocated to the trust

Based on the formula, the beneficiary will receive $192,308:

D = [$250,000 − $37,500 − ($250,000 × .35)]/ (1 − .35)
D = ($212,500 − $87,500)/.65
D = $125,000/.65
D = $192,308

If the calculation is done properly, the distribution to the beneficiary, reduced by the Trust's tax liability, will be the same amount:

Taxable income	$ 500,000
Less: Income beneficiary's distribution	(192,308)
Taxable income	$ 307,692
Tax on capital gains ($250,000 × 15%)	$ 37,500
Tax on ordinary income ($250,000 − $192,308) × 35%	20,192
Total tax owed	$ 57,692
Partnership distribution	$ 250,000
Less: Trust's tax liability	(57,692)
Income beneficiary's distribution	$ 192,308

Adjustments between Corpus and Income because of Taxes. Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these—

- A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return.
- A distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income.
- A trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain.

204.25If a trust is an Electing Small Business Trust (ESBT), it pays all taxes on the trust's share of S Corporation income and cannot take an income tax deduction for any S Corporation income distributed to the trust's beneficiaries. While the S Corporation's distributions would be classified as dividends for accounting income, the ESBT withholds the trust's tax liability from the corporate distributions and distributes the excess to the income beneficiaries. When the S Corporation does not pay dividends sufficient to pay the trust's tax liability on the S Corporation's profits, all of the corporate distributions are used to pay the trust's taxes and any remaining tax liability is paid from corpus.

Section 506(a)(3) of the 1997 Act applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a prorata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

Another situation when the trustee might make an equitable adjustment under Section 506(a)(3) is when a flow-through entity has taxable income in one year and makes the distribution in another year. For example, a partnership allocates taxable income but makes no distribution. In Year 1, the trust's share of the partnership income is $500,000, but the partnership makes no distribution. The trust will pay the tax on the entire partnership income and the tax will be paid from principal. In Year 2, the partnership has no taxable income, but makes a $500,000 distribution. Since the trust has no taxable income in Year 2, the income beneficiary will receive the $500,000 income distribution tax-free. While the trustee is under no duty to make the adjustment, the trustee can reduce the income beneficiary's distribution for the taxes paid in Year 1.

Section 506(b) of the 1997 Act provides for a mandatory adjustment from income to principal to the extent needed to preserve an estate tax marital deduction or charitable contributions deduction. It is derived from New York law, which requires principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration expenses on an income tax return instead of the estate tax return. Unlike the New York provision, Section 506(b) limits a mandatory reimbursement to cases in which a marital deduction or a charitable contributions deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. Because a fiduciary will elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For example, If the income tax benefit from the deduction is $30,000 and the estate tax benefit would have been $20,000, principal will be reimbursed $20,000 and the net benefit to the income beneficiaries will be $10,000.

Under IRC Secs. 671–679 (the "grantor trust" provisions), a person who creates an irrevocable trust for the benefit of another person may be subject to tax on the trust's income or capital gains, or both, even though the grantor is not entitled to receive any income or principal from the trust. Because this is now a well-known tax result, many trusts have been created to produce this result, but there are also trusts that are unintentionally subject to this rule. The Act does not require or authorize a trustee to distribute funds from the trust to the grantor in these cases because it is difficult to establish a rule that applies only to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended. Grantors who intend this tax result rarely state it as an objective in the terms of the trust, but instead rely on the operation of the tax law to produce the desired result. As a result it may not be possible to determine from the terms of the trust if the result was intentional or unintentional. If the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the grantor to reimburse the grantor for taxes paid on the trust's income or capital gains, such a provision should be placed in the terms of the trust. In Revenue Ruling 2004-64, the Internal Revenue Service determined that if the grantor is required to be reimbursed for taxes paid, all of the trust's assets will be included in the grantor's gross estate. If the trustee is unrelated to the grantor and has a discretionary power to make reimbursements, none of the trust's assets will be included in the grantor's gross estate, even if the power is exercised.

Charges under the 1931 and 1962 Acts

Trustee Fees and Administration Expenses. Ordinary expenses incurred in connection with the administration, management, or preservation of trust property, including property taxes, insurance premiums, interest, and repairs, are usually charged against income. However, the governing document controls, and may allocate such expenses to principal. For example, if the creator desired the income to be distributed to a current income beneficiary without being reduced by any expenses.

Regular or Recurring Fiduciary Fees. Regular or recurring fiduciary fees are charged against income in some jurisdictions, against principal in others, and half against income and half against principal in other jurisdictions. The fiduciary may even be given complete discretion to make a reasonable allocation of fiduciary fees between income and principal. Although regular or recurring fiduciary fees may be handled in a certain way, a fiduciary's commission computed as an acceptance, distribution, or termination fee is usually charged to principal. The treatment of fiduciary and administration expenses for federal income tax purposes does not affect the allocation for fiduciary accounting purposes. For example, the portion of fiduciary fees allocated to tax-exempt income is not deductible for income tax purposes, but this allocation has no effect on the charging of fiduciary fees against income or principal for fiduciary accounting purposes.

Court Costs, Attorney's Fees, and Accounting Fees. Court costs, attorney's fees, and accounting fees are usually handled in the same manner as recurring fiduciary fees. An exception included in the 1962 Act to this general rule is legal fees paid to defend title to an asset.

Example of Charging Trustee Fees against Income and Principal. Assume the trustee of the Bill Bailey Testamentary Trust charged 1% of the trust assets' fair market value as an annual trustee fee. In addition, the trustee charged a larger percentage termination fee based on the market values of assets distributed. The trust terminated in December 2006. In January 2007, the trust paid the annual trustee fee of $4,500, and upon termination the trust paid the trustee a termination fee of $20,000.

The trust is located in a state that adopted the 1962 Revised Uniform Principal and Income Acts, and the trust instrument is silent regarding allocation of trustee fees. The 1962 Revised Uniform Principal and Income Acts stipulate that half of the trustee's regular compensation is charged against income and half against principal. Therefore, $2,250 of the annual trustee fee is charged against income and $2,250 against principal. The entire $20,000 termination fee is also charged against principal. It should be noted that for trusts located in states governed by the 1931 Act, a trustee's compensation based on income is charged against income, and commissions computed on principal are charged against principal.

Income and Estate Taxes. Estate, inheritance, and transfer taxes are charges against principal. Similarly, income taxes would logically seem to be chargeable against income. However, if the fiduciary incurs income taxes attributable to capital gains, which are normally not considered income in the fiduciary accounting sense (but a conversion of principal), those taxes should be charged against principal, absent a provision to the contrary in the governing document. The same treatment should apply to income taxes levied upon other receipts allocated to principal.

Income taxes paid in connection with items of fiduciary accounting income may reduce the fiduciary accounting income available for distribution to income beneficiaries. This happens by requiring principal to be reimbursed for the income taxes if the governing document is silent or gives the fiduciary discretion to make such an adjustment.

Depreciation. Under the 1962 Act, when the governing document is silent, the general rule was not to depreciate assets contributed to the trust or estate and to depreciate assets purchased by the fiduciary entity. Following the "majority rule," no depreciation was charged in states that adopted the 1931 Act, except in cases of a sole proprietorship. Under both Acts, depreciation is never charged against a house used as a residence by a beneficiary.

Unusual Charges

The 1931, 1962, and 1997 UPIAs permit a trustee to "regularize distributions" if charges against income are unusually large. However, the 1997 Act is more specific than the other Acts regarding the circumstances in which this authority may be used (1997 Revised Act, Section 504). The Acts do not define the term *unusually large*. The definition of this term is left up to the professional judgment of the trustee. However, these charges would typically be for single occurrence items, whose costs would make a significant difference to the amount of cash that is available for distribution to the beneficiaries. The opportunity to set up a reserve or a deferred charge gives the trustee the ability to allocate the charges for these unusually large items over several years, rather than having to reduce the amount available for distribution in a single year. Items qualifying as unusual charges typically include extraordinary repairs, capital improvements to principal assets, and disbursements made to prepare property for rental.

Charitable Contributions

Charitable contributions are not charged against current income when determining fiduciary accounting income. A charity is considered a beneficiary for FAI. No distribution can be made to a charity unless the governing document provides for charitable distributions. If the beneficiaries request the fiduciary to make a charitable contribution when one is not provided for in the governing document, the result is a distribution to the beneficiaries and a charitable contribution by the beneficiaries. Just as the fiduciary can only make distributions to persons named in the governing document, they cannot make a distribution to an unnamed charity. Charities are allocated income in the same manner that fiduciary accounting income is allocated to other income beneficiaries. Thus, no distinction is made between charities and other beneficiaries for accounting purposes.

Example of How Charitable Contributions Do Not Reduce Fiduciary Accounting Income. Assume that under the terms of the Anne Pope Testamentary Trust, half of the income is to be distributed to Melissa, Anne's daughter. The other half, at the trustee's discretion, may be paid to designated charities or accumulated. At Melissa's death, the trust will terminate and the principal will be payable to Patrick, Anne's grandson. The trust had the following income and deductions in the current year:

Taxable interest income	$ 25,000
Dividend income	10,000
Long-term capital gains	10,000
Trustee fees allocated to income	1,200
Trustee fees allocated to principal	800

Fiduciary accounting income is computed as:

Interest	$	25,000
Dividend income		10,000
Less: Trustee fees allocated to income		(1,200)
Fiduciary accounting income	$	33,800

The trustee distributes $16,900 (half) of the income to Melissa and at his discretion distributes $5,000 to a designated charity. The amount available for distribution to a charity is determined after computing the required distribution (half of fiduciary accounting income) to Melissa. The remaining income of $11,900 [$33,800 – ($16,900 + $5,000)] is accumulated as principal for Patrick.

Deductions in Respect of a Decedent

When an individual dies, certain expenses for which he was liable at the date of death are referred to as deductions in respect of the decedent (DRD). The Internal Revenue Code provides that these expenses generally are deductible when paid either by the decedent's estate or by the person who acquires property subject to liability from the decedent. Although such expenses are paid after an individual's death, they are the result of predeath activities and the disbursement is considered a principal transaction. This treatment is similar to that of income in respect of a decedent.

ALLOCATIONS WITHIN AN ESTATE

The administration of estates is different from trusts. While both have the same basic characteristics, the purpose of an estate is different from a trust. A trust is managed for the benefit of the income beneficiaries and remaindermen and has various life horizons. A trust can last from a few months to many years. In contrast, an estate is designed to terminate once all the assets have been collected, all the debts have been paid, and the remaining assets have been distributed to the appropriate beneficiaries. Therefore, existence of an estate is limited and the role of the personal representative is much more defined.

Many of the allocations rules applicable to trusts have very little relevancy when applied to an estate. The need to maintain the distinction between income beneficiaries and remaindermen is not as important in an estate, since all the assets are subject to the debts of the decedent. Once the debts have been paid, the remaining assets are distributed directly to the beneficiaries or to a trust where the distinction between income beneficiaries and remaindermen becomes clear.

While the reasons for allocating inflows and outflows between income and principal are more clearly defined in the administration of a trust, there is still a need to have some allocation within an estate. For example, during estate administration, probate assets may continue to earn income. In addition, assets may be sold, requiring an allocation between income and principal. The 1962 Act, Section 5, addresses income earned during the administration of an estate.

The rules applicable to trusts in determining what type of inflow is allocated to income and principal are the same for an estate. Therefore, cash dividends are allocated to income while stock dividends are allocated to principal. Unless provided for differently in the governing document, estate settlement costs are allocated against principal. Settlement costs are those costs incurred to transfer the probate estate even if no income is earned during administration. Examples of settlement costs include funeral expenses, death taxes, family living expense allowances, attorney's fees, executor's commissions, court costs, and appraisal fees. Outflows incurred to generate the inflows during estate administration are allocated using the same rules applicable to trust administration. The general rule is that directly related expenses reduce directly related inflows.

There are three types of bequests in an estate administration:

a. Specific

b. General

c. Residuary

A *specific bequest* is a gift of a particular item of property, which can be distinguished and identified from the other property in the estate. Often a decedent wants to leave a particular item of sentimental value to a beneficiary. Most specific bequests consist of jewelry, furniture, and other personal property; however, some specific bequests generate income, like land, stocks, and other similar assets. Normally, a cash bequest is not considered a specific bequest.

A *general bequest* is a gift payable out of the general assets of the estate, but it is not a specific item. A pecuniary bequest meets the definition of a general bequest. The executor is able to satisfy a pecuniary bequest from any of the estate's assets, provided the fair market value of the assets distributed equals the amount of the pecuniary bequest. Any cash bequest would meet the definition of a general bequest, since the executor can sell assets to generate the funds needed. If a particular certificate of deposit (CD) was gifted under the will, then the gift would be a specific bequest, since the beneficiary is entitled to that particular CD only. If the decedent had redeemed the CD, the beneficiary would not be entitled to any distribution from the estate.

A *residuary bequest* consists of the remainder of the estate once all of the specific and general bequests have been made. Under normal circumstances, the residuary bequest is the largest of the three types of bequests.

Sections 201 and 202 of the 1997 Act determine how much net accounting income an estate had and how to distribute the income. These rules are also used to determine how much must be allocated when an income interest ends.

Beneficiaries of specific bequests are to receive the net income attributed to the specific bequest. In determining the net income, the executor is to use the trust rules. General overhead expenses, under Sections 501 and 502 of the 1997 Act, are not deducted when computing net income attributed to a specific bequest. In addition, when paying debts and expenses, specific bequests are used last. All other bequests must be fully dissipated before any recipient of a specific bequest loses their inheritance. The same rule applies to the net income allocated to a specific bequest. The net income attributed to a specific bequest cannot be used to pay any debts or expenses until all other bequests and the associated income has been fully used leaving only specific bequests and related net income to pay any remaining debts or expenses.

Beneficiaries of a pecuniary bequest normally receive only the specific dollar amount; however, if the beneficiary does not receive the bequest within a certain period of time, interest is due. Unless provided for under the document, any interest paid on the pecuniary amount shall be at the legal rate provided by state law. Interest begins after a period of time following the decedent's death or one year after the income interest ends. It does not matter if the pecuniary amount is payable outright or into trust. Any interest payable is paid from the net income available to the residuary beneficiaries, or corpus if insufficient income exists.

Using the rules applicable to trusts, the executor determines the net income available to be distributed to the residuary beneficiaries. The net income is computed ignoring any amounts payable to the specific or pecuniary bequests. Any income from property used to discharge liabilities is allocated to accounting income. The executor has the discretion to use either income or corpus to pay settlement expenses, but may not make an allocation that would cause the loss of either the marital or charitable deductions. Any other expenses and all debt payments are allocated to corpus.

Once the net income is computed, it is allocated to the residuary beneficiaries based on their fractional interest in the undistributed assets. In computing a beneficiary's share of the income, the following rules are applied:

a. The beneficiary is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the undistributed assets immediately before the distribution date, including assets that later may be sold to pay debts.

b. The fractional interest must be calculated on the basis of the aggregate value of the assets without reducing the value by any unpaid debts.

c. The distribution date may be the date the fiduciary makes the calculation, if the date is reasonably near the date on which the assets are actually distributed.

d. If the fiduciary does not distribute all of the collected income, the fiduciary must maintain records showing the interest of each beneficiary in the undistributed income.

If a charity is a residuary beneficiary, the charity shall receive as income any amount allowed as a tax deduction for income payable to a charitable organization. Such amount paid shall not be reduced for income taxes. For example—

- T gifted a certain rent house to her son B. During estate administration, the rent house earned net income of $500. Since a rent house would be a specific bequest, the entire $500 would be distributed to B.

  or

- T gifted $^{1}/_{3}$ of his residuary estate to each of his two children ($^{2}/_{3}$ total). During administration, the estate earned net income of $3,000. The children would be entitled to their proportionate share of the $3,000 based on a ratio determined by dividing the value of their interest by all of the undistributed property of the estate when the executor distributes the income. If the total of the estate's assets, less any specific bequests, is $300,000, each child would be entitled to $1,000.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Concerning classification of receipts and expenditures, if governing documents and jurisdictional law are silent, the fiduciary is required to:

   a. Exercise discretionary care when classifying these transactions.

   b. Allocate all such receipts to income.

   c. Allocate all such expenditures to principal.

   d. Consider income tax ramifications before making allocations.

9. In implementing the Uniform Prudent Investor Act, the 1997 UPIA departs from the requirements of the 1931 and 1962 Acts in that:

   a. Proceeds from sales of high income-producing property are not allocated to corpus.

   b. Proceeds from sales of underproductive property are allocated to income and corpus.

   c. Delayed income is not allocated on sales of underproductive property.

10. Article Four Part 1 of the 1997 UPIA is concerned with allocations of returns from investments in business activities involving:

    a. Limited liability companies.

    b. Sole proprietorships.

    c. Asset-backed securities.

    d. Another trust or estate.

11. How should cash received from a REIT as the result of a short-term capital gain be allocated to principal and income under the 1997 Act?

    a. Proportionately based on total trust values.

    b. Allocated to income.

    c. Allocated to principal.

    d. Based on present value calculations.

12. When the trustee operates the business as a sole proprietorship, which of the following is true?

    a. The trustee has more flexibility under the 1962 Act than under the 1997 Act.

    b. The trust must account for an item of income in the same fashion as the transferor.

    c. The trustee must allocate excess cash to fiduciary income.

    d. Business net profit is entered to the fiduciary accounts based on distribution date.

13. Under Section 412 of the 1997 Act, net receipts from commercial timber operations are allocated:

    a. If the species of commercial timber grown meets criteria.

    b. Regardless of the end product for which the commercial timber is sold.

    c. Based on the rate of commercial timber harvesting.

    d. Based on the number of years the commercial timber is grown prior to harvesting.

14. Which of the following is correct concerning trust receipts of mineral rights royalties?

    a. Under the 1962 Act, such receipts are income in the year of the actual royalty distribution.

    b. Under the 1962 Act, principal allocation is limited to 27.5% of modified net receipts.

    c. Under the 1931 Act, such receipts are principal in the year of the actual royalty distribution.

    d. Under the 1931 Act, principal allocation is limited to 50% of the modified net receipts.

15. Under the 1997 Act, which of the following trust charges is charged entirely to principal?

    a. Monthly fire insurance premiums against loss of corpus.

    b. Regular trustee compensation and for investment advisory services.

    c. Title insurance premiums against loss of corpus.

    d. Costs of judicial proceedings involving both income and principal.

16. Which of the following charges are **not** included in Section 504 of the 1997 Act as reimbursable to principal from income?

    a. Extraordinary repairs to trust property.

    b. Quarterly trust property management fees.

    c. Environmental expenses related to trust property.

17. Allocation of income earned during the administration of an estate is addressed by:

    a. Section 501 of the 1997 UPIA.

    b. Section 504 of the 1997 UPIA.

    c. Section 10 of the 1931 UPIA.

    d. Section Five of the 1962 UPIA.

18. According to the text, a pecuniary bequest normally belongs to which of the following types of bequest made in an estate administration?

    a. Specific.

    b. General.

    c. Residuary.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Concerning classification of receipts and expenditures, if governing documents and jurisdictional law are silent, the fiduciary is required to: **(Page 15)**

   a. Exercise discretionary care when classifying these transactions. [This answer is incorrect. Fiduciary obligation in such situations is prescribed, and fiduciary discretion is not an option.]

   b. Allocate all such receipts to income. [This answer is incorrect. Such an approach could have undesirable effects on amounts available to tenants and remaindermen, and could also have undesirable income tax consequences.]

   c. Allocate all such expenditures to principal. [This answer is correct. The fiduciary has no discretion in the matter, nor are income tax ramifications considered.]

   d. Consider income tax ramifications before making allocations. [This answer is incorrect. Income tax ramifications are not considered when classifying receipts and disbursements for administration purposes.]

9. In implementing the Uniform Prudent Investor Act, the 1997 UPIA departs from the requirements of the 1931 and 1962 Acts in that: **(Page 18)**

   a. Proceeds from sales of high income-producing property are not allocated to corpus. [This answer is incorrect. All three Acts would require an allocation to corpus from such a sale.]

   b. Proceeds from sales of underproductive property are allocated to income and corpus. [This answer is incorrect. The 1931 and 1962 Acts include such a requirement.]

   c. Delayed income is not allocated on sales of underproductive property. [This answer is correct. Because all such proceeds are allocated to principal, an income-beneficiary spouse may under certain circumstances compel the trustee to make underproductive property productive of income, convert it, or make adjustment.]

10. Article Four Part 1 of the 1997 UPIA is concerned with allocations of returns from investments in business activities involving: **(Page 19)**

    a. Limited liability companies. [This answer is correct. Corporations, partnerships, and LLCs are all business activities that fall under Article Four Part 1 of the 1997 UPIA.]

    b. Sole proprietorships. [This answer is incorrect. Sole proprietorships are one of several business activities that do not fall within Article Four Part 1 of the 1997 UPIA.]

    c. Asset-backed securities. [This answer is incorrect. Interests in asset-backed securities are not included in the scope of Article Four Part 1 of the 1997 UPIA.]

    d. Another trust or estate. [This answer is incorrect. Article Four Part 1 of the 1997 Act does not include business activities by another trust or estate in its scope.]

11. How should cash received from a REIT as the result of a short-term capital gain be allocated to principal and income under the 1997 Act? **(Page 19)**

    a. Proportionately based on total trust values. [This answer is incorrect. Total trust income and principal do not play a role in the trust allocation of cash received as the result of a short-term gain.]

    b. Allocated to income. [This answer is correct. This is because such a gain is not considered part of a capital gain dividend.]

    c. Allocated to principal. [This answer is incorrect. Such a gain is not included for purposes of determining the capital gain dividend.]

    d. Based on present value calculations. [This answer is incorrect. The 1962 Act performs certain calculations to determine delayed income; the 1997 Act does not include similar calculations.]

12. When the trustee operates the business as a sole proprietorship, which of the following is true? **(Page 20)**

    a. The trustee has more flexibility under the 1962 Act than under the 1997 Act. [This answer is incorrect. The 1997 Act provides the greater flexibility.]

    b. The trust must account for an item of income in the same fashion as the transferor. [This answer is incorrect. The trustee must determine what is best for the trust and is not bound by the transferor's earlier methods.]

    c. The trustee must allocate excess cash to fiduciary income. [This answer is incorrect. The trustee is not required to allocate anything to income in these circumstances.]

    d. Business net profit is entered to the fiduciary accounts based on distribution date. [This answer is correct. No entry is made to the fiduciary books while the business retains profits for foreseeable operational needs.]

13. Under Section 412 of the 1997 Act, net receipts from commercial timber operations are allocated: **(Page 22)**

    a. If the species of commercial timber grown meets criteria. [This answer is incorrect. Although tree species can be a factor for certain trustee determinations, Section 412 of the 1997 Act does not impose criteria as to the species of commercial timber grown.]

    b. Regardless of the end product for which the commercial timber is sold. [This answer is incorrect. Section 412 of the 1997 Act is aimed at timber sales for certain commercial purposes such as building construction and Christmas trees.]

    c. Based on the rate of commercial timber harvesting. [This answer is correct. In general, net receipts are allocated to income if rate of harvest does not exceed rate of growth; otherwise, net receipts are allocated to principal. Determination of both rates relies upon trustee judgment.]

    d. Based on the number of years the commercial timber is grown prior to harvesting. [This answer is incorrect. Age of commercial timber prior to harvest is not a consideration of Section 412 of the 1997 Act.]

14. Which of the following is correct concerning trust receipts of mineral rights royalties? **(Page 26)**

    a. Under the 1962 Act, such receipts are income in the year of the actual royalty distribution. [This answer is incorrect. Under the 1962 Act, such receipts are allocated to principal and income.]

    b. Under the 1962 Act, principal allocation is limited to 27.5% of modified net receipts. [This answer is incorrect. The 1962 Act limits the principal allocation to 50% of modified net receipts.]

    c. Under the 1931 Act, such receipts are principal in the year of the actual royalty distribution. [This answer is correct. Consideration received for permanent severance of natural resources from the land is allocated to principal per the 1931 UPIA.]

    d. Under the 1931 Act, principal allocation is limited to 50% of the modified net receipts. [This answer is incorrect. There is no comparison to modified net receipts for mineral royalties received under the 1931 Act.]

15. Under the 1997 Act, which of the following trust charges is charged entirely to principal? **(Page 34)**

    a. Monthly fire insurance premiums against loss of corpus. [This answer is incorrect. These charges are covered under Section 501 of the 1997 UPIA, and should be allocated to income.]

    b. Regular trustee compensation and for investment advisory services. [This answer is incorrect. Per Section 501 of the 1997 Act, one half of these charges should be allocated to income.]

    c. Title insurance premiums against loss of corpus. [This answer is correct. Such premiums are covered under Section 502(a)(5) of the 1997 Act.]

    d. Costs of judicial proceedings involving both income and principal. [This answer is incorrect. One half of such charges should be allocated to income in accordance with Section 501 of the 1997 UPIA.]

16. Which of the following charges are **not** included in Section 504 of the 1997 Act as reimbursable to principal from income? **(Page 34)**

    a. Extraordinary repairs to trust property. [This answer is incorrect. Extraordinary repairs are not synonymous with normal maintenance charges; they are likely a one-time occurrence and may be unusually large. As such, they may be paid from trust principal and can be reimbursed by income under Section 504 of the 1997 UPIA.]

    b. Quarterly trust property management fees. [This answer is correct. Quarterly management fees would be a recurring expense allocable to income under Section 501 of the 1997 UPIA.]

    c. Environmental expenses related to trust property. [This answer is incorrect. Under Section 502 of the 1997 UPIA, charges for environmental matters are to be allocated to principal.]

17. Allocation of income earned during the administration of an estate is addressed by: **(Page 42)**

    a. Section 501 of the 1997 UPIA. [This answer is incorrect. Section 501 of the 1997 Act addresses expenditures allocable to trust income.]

    b. Section 504 of the 1997 UPIA. [This answer is incorrect. This section addresses reimbursement to trust principal from trust income.]

    c. Section 10 of the 1931 UPIA. [This answer is incorrect. [Section 10 of the 1931 Act addresses liquidating, or "wasting," assets.]

    d. Section Five of the 1962 UPIA. [This answer is correct. This section addresses allocations of inflows and outflows occurring during probate.]

18. According to the text, a pecuniary bequest normally belongs to which of the following types of bequest made in an estate administration? **(Page 43)**

    a. Specific. [This answer is incorrect. Although pecuniary gifts could be specific bequests in certain situations, this is not normally the case.]

    b. General. [This answer is correct. Pecuniary bequests are financial in nature and are payable from the general estate assets.]

    c. Residuary. [This answer is incorrect. Pecuniary gifts are normally addressed before residuary bequests.]

THE 1962 AND 1931 UNIFORM PRINCIPAL AND INCOME ACTS—DIFFERENCES

The main goal of the 1962 revision of the UPIA was to provide some clear and uniform standards to assist fiduciaries in the allocation between income and principal. The 1931 Act was very general in scope. In addition, many new forms of investments were developed between 1931 and the 1962 revision. As a result, fiduciaries needed additional guidance in making principal and income allocations. The purpose of the 1962 Act was to create simplicity and convenience during administration while maintaining fairness. The 1931 Act did not contain provisions relating to principal and income allocations during estate administration. In addition, the 1931 Act did not include guidance when no specific section of the Act dealt with a particular issue. The 1962 Act rectified this situation. The 1962 Act clarified some of the 1931 Act provisions and provided guidance where the 1931 Act was silent. Some of the differences between the 1931 and 1962 UPIAs are discussed in the following paragraphs

Receipts and Charges

Both Acts maintained the focus that the creator's intent is the guiding principle controlling all dispositions of receipts. While the 1931 Act refers to income beneficiaries as "tenants," the 1962 Act refers to "income beneficiaries." Rentals, cash dividends, and interest are classified as income under both Acts. Sales proceeds are allocated to principal under both Acts. As with the 1962 Act, any rent or other form of periodic payment earned, but not paid before transfer to the entity, is allocated to principal while the periodic payment earned after transfer is allocated according to the type of payment received. The 1962 Act clarified the type of corporate distributions that are income and principal. Under the 1931 Act, mutual fund distributions were not specifically mentioned and the provision pertaining to mergers, consolidations, and reorganizations was confusing given the variety of new types of reorganizations allowed between 1931 and 1962. While premiums and discounts on bonds were ignored under the 1931 Act, original issue discount interest is allocated to income under the 1962 Act. Expenses are handled similarly under both Acts, except the 1962 Act provides a clearer explanation of the treatment of disbursements.

Business and Farming Operations

If a fiduciary entity operates a sole proprietorship, net income or loss is allocated the same under both Acts. However, computation of net income or loss was performed differently under the 1931 Act. Businesses that bought or sold property computed net profits by subtracting the expenses during the period along with the beginning inventory value from the gross returns and ending inventory value. All other businesses determined net profits by using the customary practice of similar businesses. While farming operations were included within the definition of business under the 1931 Act, if a fiduciary entity owned animals and did not operate a farm, proceeds from the sale of animals were allocated to principal (to maintain the initial value of the animals) with all other amounts being allocated to income. The 1962 Act stated that GAAP was to be used for all businesses and clarified that businesses included not only sole proprietorships but also general partnerships. In addition, animals were added to the definition of a farm.

Natural Resources

Natural resources were also allocated differently under the 1931 Act. Amounts received as rentals were allocated to income while all other amounts were allocated to principal. This allocation included timber. The 1962 Act changed the method of allocating income related to natural resources. While the 1962 Act maintained the allocation of income received as rentals, all other amounts received are allocated by a specific percentage. The lesser of 27.5% of the gross receipts or 50% of the net proceeds (after payment of expenses) are allocated to principal while the remainder is allocated to income. Timber was removed from this allocation and is allocated under the 1962 Act according to the fiduciary's discretion.

THE UNIFORM PRINCIPAL AND INCOME ACT—1997 REVISIONS

The second revision of the Uniform Principal and Income Act occurred in 1997. While each section of the 1997 Act is not specifically covered in this course, this section emphasizes the main differences between the various acts. Unless a difference is noted, the item is handled similarly in the 1962 and 1997 Acts. Previous discussions of allocation of principal and income also mention some of the key changes in allocating different property and transaction types.

Objectives of the 1997 UPIA

The National Conference of Commissioners on Uniform State Laws (NCCUSL) adopted a new version of the UPIA in 1997 to amend the 1962 Act. The two primary objectives of the 1997 UPIA are to:

a. Add provisions to facilitate the adoption of investment techniques associated with modern portfolio theory permitted by the 1994 Uniform Prudent Investor Act.
b. Revise the 1962 Act.

The most significant change is the 1997 UPIA's acceptance of modern portfolio management concepts (including investing for "total return") and its revised standard of fiduciary conduct designed to redefine the "Prudent Man Rule" of the 1962 revision (see earlier discussion). Before recent changes to the Prudent Investor Act, fiduciaries had to analyze each investment by weighing issues relating to its risk and return. If an investment was deemed too risky for a given entity, a fiduciary could not invest in that particular investment. The 1994 Uniform Prudent Investor Act made the following changes to the former criteria for prudent investing:

a. The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments.

b. The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration.

c. All restrictions on types of investments have been rescinded. The trustee can invest in anything that:

    (1) plays an appropriate role in achieving the risk/return objectives of the fiduciary entity and

    (2) meets the other requirements of prudent investing.

d. The former requirement that fiduciaries diversify investments has been integrated into the definition of prudent investing.

e. The former rule forbidding the trustee from delegating investment and management functions has been reversed. Delegation is now permitted, subject to safeguards.

The traditional system of income/principal allocation refers to previous common practice, which considers allocation guidance under the governing document, prior UPIAs (1931, 1962), applicable state law, etc. With the passage of the 1994 Uniform Prudent Investor Act and the development of modern portfolio theory, tension developed between the traditional system of income/principal allocation and modern investment theory. The 1997 UPIA attempts to minimize this tension. However, the traditional system of allocation does not necessarily change under the 1997 UPIA. For example, if (a) trust investments have been prudently invested under a portfolio concept using the traditional allocation system, and (b) such investments carry out the grantor's intent, the 1997 UPIA has little or no effect. However, the 1997 Act helps trustees, who have made prudent modern portfolio-based investment decisions, make adjustments when the assets' return is skewed in favor of one group of beneficiaries over another. Given the power to reallocate a trust's return, the trustee is able to make appropriate income distributions even though he is not making investment decisions based on the amount of current income a particular investment can generate. (Although the terminology in the 1997 UPIA refers to *trusts* and *terms of the trust*, its provisions also apply to estates. In general, modern portfolio theory has less applicability to estates because of their anticipated short-term nature.)

Summary of Changes

The prefatory note to the 1997 UPIA highlights issues addressed by some of the more significant new rules as well as clarifications and other changes relating to matters addressed in the 1931 and 1962 Acts. These changes are summarized in Exhibit 1-4.

Exhibit 1-4

Summary of Changes in the 1997 Uniform Principal and Income Act

New Rules—issues addressed include:

- The application of the probate administration rules to revocable living trusts after the grantor's death. This new rule also applies to other terminating trusts.
- The payment of interest or some other amount on the delayed payment of an outright pecuniary gift made pursuant to a trust agreement, instead of a will, when the agreement or state law does not provide for such a payment.
- The allocation of net income from partnership interests acquired by the trustee other than from a decedent.
- An "unincorporated entity" concept has been added to deal with businesses operated by a trustee, including farming and livestock operations, and investment activities in rental real estate, natural resources, timber, and derivatives.
- The allocation of receipts from discount obligations such as zero-coupon bonds.
- The allocation between principal and income of receipts from derivatives, options, and asset-backed securities.
- Disbursements made because of environmental laws.
- Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships.
- The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply.

Clarifications and Changes in Existing Rules—issues addressed include:

- An income beneficiary's estate is entitled to receive only net income actually received by a trust before the beneficiary's death and not items of accrued income.
- Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions.
- Distributions from corporations and partnerships that exceed 20% of the entity's gross assets will be principal, regardless of whether the entity intended a partial liquidation.
- Guidance relating to deferred compensation is expanded and included in its own section.
- The 1962 Act rule for "property subject to depletion," (i.e., patents, copyrights, royalties, and the like), which provides that a trustee may allocate up to 5% of the asset's inventory value to income and the balance to principal, has been replaced by a rule that allocates 90% of the amounts received to principal and the balance to income.
- The percentage used to allocate amounts received from oil and gas holdings has been changed to 90% of receipts allocated to principal and the balance to income.
- The unproductive property rule has been eliminated for trusts other than marital deduction trusts.
- It is no longer mandatory to charge depreciation against income. Instead, the allocation is left to the discretion of the trustee.

* * *

Changes to the General Principles of Allocation. The 1997 UPIA modified the general provision concerning fiduciary entity allocation. According to Section 103 of the 1997 Act, the following is the general rule:

- Allocations follow the governing document, even if the 1997 Act states differently.
- A fiduciary may exercise any discretionary power of administration given in the document, even if the exercise of the discretionary power produces a result different from a result required or permitted by the Act.
- If the governing document is silent and the fiduciary has no discretionary power of administration, then the provisions of the Act shall be followed.
- If both the governing document and the Act are silent, and the fiduciary has no discretionary power of administration, any inflow or outflow is allocated to principal.
- In exercising any power given in the governing document or by the 1997 Act, the fiduciary must administer a fiduciary entity impartially based on what is fair and reasonable to all of the beneficiaries, except to the extent the terms of the document clearly manifest an intention that the fiduciary favor one or more beneficiaries. A fiduciary is presumed to act fairly and reasonably when following the provisions of the 1997 Act.

The 1962 Act provides that if both the governing document and the 1962 Act are silent, a fiduciary should use ordinary prudence in determining what is fair and equitable in allocating an item. This "prudent man rule" was removed from the 1997 UPIA because the NCCUSL believed persons of ordinary prudence do not normally think in terms of the interests of successive beneficiaries.

Trustee's Power to Adjust Income and Principal

The major addition to the 1997 UPIA, and a major departure from previous acts, is the trustee's power to adjust income to principal and vice versa. Since a trust may cover consecutive generational beneficiaries, a trustee must invest trust assets so the trust can provide a benefit to current and future beneficiaries. Following the prudent investor approach to trust investments, a trustee manages the entire portfolio, not individual investments. Proper prudent management might dictate a trustee invest primarily in principal producing assets, which would cause little if any income to be available for distribution to the income beneficiaries. Section 104 of the 1997 UPIA allows the trustee to shift principal to income in order to provide the income beneficiaries an adequate return from the trust. So that timely and appropriate distributions can be made, this section of the 1997 UPIA gives the trustee the ability to maintain an optimal return on all assets without being concerned about having to invest in certain assets.

Exactly when can the adjustment be made? According to the 1997 Act, the adjustment is made after the trust's accounting income is computed under the normal allocation rules. It is generally impossible to determine if an adjustment is required until after year end when all required information is obtained. Further, a special trustee might need to be appointed to make the adjustment if the primary trustee is a beneficiary. In *Whittier Trust Co. v. Getty* 179 P3d 562 (Nev. S.Ct. 2008), the Nevada Supreme Court ruled a corrective adjustment could be made for the current year based on prior year's information. In effect, the current year income could be increased to take into account an adjustment required from a prior year. The ruling allows the trustee time to make a proper determination concerning whether an adjustment is needed without subjecting the trustee to a strict, arbitrary deadline.

Coordination with the Prudent Investor Rule. Over the years, modern portfolio theory has been gaining acceptance as the foundation of trust investment law. Both the Prudent Investor Rule and the Uniform Prudent Investor Act incorporate the concepts of modern portfolio theory and have helped shift the focus away from the suitability of each separate investment to the modern approach of considering the portfolio as a whole. Under the current Prudent Investor Act, stocks, bonds, and other trust assets that form the entire portfolio are viewed as interrelated pieces of a complete investment program. The total return of the whole portfolio at an appropriate risk level is paramount over the isolated performance of each investment.

The modern investment approach clashes with the traditional structuring of trusts. The familiar design of a trust is to give the current beneficiary a right to the net income earned by the trust and to give the remaindermen what is left once the income interest ends. The interests of the beneficiaries are dependent on what is considered income and what is considered principal. Under the old investment standards, where the trustee could focus on each investment in isolation, the trustee felt free to invest in safe investment vehicles that produced reasonable income, but relatively little capital appreciation. Under the old standards, although the total return of the entire portfolio may have suffered, the trustee was able to point to the propriety of each investment.

With the shift in emphasis to the performance of the whole portfolio, there is a tension between investing for total return and meeting the traditional income and principal allocations. In periods of moderate-to-low interest rates, a strategy of investing for total return may not generate income of an amount that traditionally has been accorded an income beneficiary. Section 104 of the 1997 UPIA gives the trustee the ability to move principal to income and vice versa in order to make up insufficiencies resulting from investment choices made pursuant to the Prudent Investor Act.

Ground Rules for Exercising the Power to Adjust Income and Principal. The 1997 UPIA set forth the circumstances under which a trustee may exercise its power to adjust. A trustee may make an adjustment between income and principal if all of the following apply:

- The trustee invests and manages trust assets in accordance with the prudent investor rules;
- The trust instrument describes the income beneficiary's distribution rights in terms of fiduciary accounting income; and
- The trustee is unable, without exercising the power to adjust, to administer the trust impartially or to achieve the degree of partiality required or permitted by the governing instrument.

The first condition will be met in situations where the terms of the trust require investing in accordance with the prudent investor rule or where controlling state law requires the same. The second condition is met when the governing document requires the trustee to distribute the income to a beneficiary or among a number of beneficiaries. The third condition requires the trustee to proceed through several steps. First, the trustee must apply the principal and income allocations provided in the document or, if silent, under state law. Second, the trustee must determine whether the trust terms call upon the trustee to favor one or more beneficiaries. Finally, the trustee must conclude that it is unable to administer the trust impartially or achieve the degree of partiality required or permitted, without exercising the power to adjust.

In deciding whether and how much to adjust, the fiduciary shall consider all factors relevant to the trust, including the following factors to the extent they are relevant:

a. the nature, purpose, and expected duration of the trust;

b. the intent of the grantor;

c. the identity and circumstances of the beneficiaries;

d. the needs for liquidity, regularity of income, and preservation and appreciation of capital;

e. the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the grantor;

f. the net amount allocated to income under the other sections of this [Act] and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

g. whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

h. the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

i. the anticipated tax consequences of an adjustment.

Power to Adjust Prohibited in Certain Circumstances. Even if the three conditions discussed previously are met, a trustee will not be permitted to exercise its power to adjust in a number of circumstances, including:

- A trustee may not exercise its power to adjust where such an exercise (a) would reduce the income interest of a surviving spouse under a QTIP or marital trust, (b) would reduce the actuarial value of a trust income interest where the intent is to qualify for the gift tax exclusion, or (c) would change the amount payable to the current beneficiaries under a private or charitable annuity trust or unitrust. A trustee may not make an adjustment if that adjustment would reduce an amount permanently set aside for charitable purposes unless both the income and principal are set aside for such purposes.

- An individual trustee will not have a power to adjust if possessing such a power will cause the individual to be treated as the owner of all or part of the trust for income tax purposes. Moreover, an individual who can remove and/or appoint a trustee will not have a power to adjust if possessing or exercising the power will cause all or part of the trust assets to be included in the individual's estate for estate tax purposes and the assets would not have been included in the estate otherwise.

- A trustee cannot exercise a power to adjust if he is a beneficiary of the trust, whether or not possession of the power may have adverse tax consequences. No adjustment is allowed when it would benefit the trustee directly or indirectly, even if the trustee is not a beneficiary. If there is more than one trustee, a co-trustee to whom the above provisions do not apply may make adjustments unless prohibited by the document.

The power to adjust can be made by a co-trustee, if the co-trustee is not covered by the provisions that would otherwise prevent an adjustment. The trustee may release a power to adjust permanently or for a specific period, if the trustee believes possessing or exercising the power might cause one of the prohibited results. Nothing in the trust document will prevent the trustee from making an adjustment unless the document specifically prohibits the trustee from making an adjustment.

Examples of How the Power to Adjust Might Be Used. T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. After considering the factors in Section 104, T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

As a second example, assume T is the trustee of a trust that requires the income to be paid to the grantor's son C for life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is allocated to income under Section 406, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer part of the interest to principal.

As a third example, assume T is the trustee of a trust that requires the income to be paid to the grantor's sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. E's income from her social security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit T to invade principal to provide for E's health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce very little dividend income. Even though it is not necessary to invade principal to maintain E's accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

Fiduciary Liability. With the new ability to make equitable adjustments, cautious fiduciaries were concerned about how courts might review their actions, whether they made an adjustment or not. In response to these concerns, the

1997 Act was amended to add Section 105, "Judicial Control of Discretionary Power." According to Section 105, a court cannot change a fiduciary's decision to use or not use the equitable adjustment power, unless such decision was an abuse of fiduciary discretion. Whether a court would have made the adjustment or not cannot be a basis for finding abuse.

If a court determines that an abuse existed, either the fiduciary must (a) make a larger distribution if the distribution was too small, (b) withhold future distributions or obtain repayment from a beneficiary if the distribution was too large, or (c) have the fiduciary make payment out of the fiduciary's own funds. A fiduciary can petition a court to decide if a proposed use of the adjustment power would be an abuse of discretion. If the fiduciary produces sufficient information to establish the results of and reasons for a proposed adjustment, the burden will be on the beneficiary to prove that the proposed exercise of the adjustment power would be an abuse of discretion.

Unitrust. Instead of giving the trustee the power to adjust, some states are opting to provide for a unitrust definition of income. A unitrust defines income as a specific percentage of the trust's assets, which are recalculated annually. Effectively, all beneficiaries share in the trust's total investment returns freeing the trustee to invest in a manner that achieves the best overall return. Several of the states that adopted Section 104 of the 1997 Act modified the section to act more like a unitrust. The 2001 IRC Sec. 643(b) regulations allow for a unitrust definition of income. Most states that have adopted a unitrust approach to defining accounting income have included a characterization system that defines the income sources of the percentage distribution. Unless provided otherwise, distributions shall be treated as being made from the following sources in order of priority: (1) net accounting income determined as if the trust was not a unitrust; (2) ordinary accounting income not allocable to net accounting income; (3) net realized short-term capital gains; (4) net realized long-term capital gains; and (5) principal.

State law should be consulted concerning whether an existing trust can be converted from a standard income trust to a unitrust. While a new trust can adopt the unitrust approach to defining accounting income, most states do not allow existing trusts to convert to a unitrust. If allowed by state law, a conversion made in compliance with state law should not result in any negative income tax consequences (Ltr. Rul. 200702013). A trust must define income using Section 104 or as a unitrust. A hybrid approach is not allowed.

Whether a trust uses Section 104 of the 1997 Act or a unitrust approach to defining income, each method has been adopted to remove the inherent conflict that exists between the 1962 Act's way of computing accounting income and the 1994 Prudent Investor Act. The 1962 Act focused on investments that generated a cash flow to meet the income beneficiaries' needs. As more investment decisions are being made to achieve an optimum portfolio return, as required by the 1994 Investor Act, cash flow requirements are secondary, which can cause a problem when using the 1962 Act's allocation methodology. By allowing a trustee to adjust amounts between income or corpus or just defining income as a percentage of assets, trust law is attempting to take the allocation issue out of the investment decisions and reduce the potential for unnecessary litigation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Which of the following statements is correct concerning the 1931 and 1962 UPIA?

    a. The 1931 Act is specific concerning allocations made during estate administration.

    b. The 1962 Act refers to income beneficiaries of a trust as "tenants."

    c. Both Acts assert local law as controlling in the disposition of trust receipts.

    d. The 1931 Act did not specifically address bond premiums.

20. Which of the following statements is correct concerning UPIA guidance and a business operated as a sole proprietorship by a trust?

    a. The 1931 Act allocates net income differently than does the 1962 Act.

    b. The 1931 Act specified that GAAP should be used to record business activities.

    c. The 1962 Act is more inclusive than the 1931 Act in its definition of farm animals.

    d. Both the 1931 and 1962 Acts limit the term "business" to sole proprietorships.

21. The 1997 UPIA accommodates investment techniques made permissible by the 1994 Uniform Prudent Investor Act. Which of the following is one of the provisions of the Uniform Prudent Investor Act?

    a. The standard of prudence is applied to each investment individually.

    b. Types of trustee investments are further restricted to ensure preservation of principal.

    c. Trustees are no longer required to diversify investments.

    d. Trustee delegation of the investment function is now permitted.

22. Which of the following statements is correct concerning the unitrust approach to defining trust income and making trust distributions?

    a. Trust assets are recalculated semiannually for purposes of determining income.

    b. Principal is normally the fourth priority-ordered distribution source.

    c. The trustee can use a hybrid approach involving Section 104 of the 1997 UPIA.

    d. The approach seeks to reconcile the UPIA with the Uniform Prudent Investor Act.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Which of the following statements is correct concerning the 1931 and 1962 UPIA? **(Page 50)**

    a. The 1931 Act is specific concerning allocations made during estate administration. [This answer is incorrect. The 1931 Act is silent as to allocation of estate income and corpus during estate administration.]

    b. The 1962 Act refers to income beneficiaries of a trust as "tenants." [This answer is incorrect. The 1931 Act uses the term "tenants" to describe income beneficiaries.]

    c. Both Acts assert local law as controlling in the disposition of trust receipts. [This answer is incorrect. Both Acts assert the wishes of the creator as controlling. Under normally circumstances, local law is considered when the governing documents are silent.]

    d. The 1931 Act did not specifically address bond premiums. [This answer is correct. The 1931 Act ignored bond premiums and discounts.]

20. Which of the following statements is correct concerning UPIA guidance and a business operated as a sole proprietorship by a trust? **(Page 50)**

    a. The 1931 Act allocates net income differently than does the 1962 Act. [This answer is incorrect. Net income and loss from the trust-operated sole proprietorship are allocated in the same fashion under both acts.]

    b. The 1931 Act specified that GAAP should be used to record business activities. [This answer is incorrect. The 1962 Act specified GAAP for recording business activities.]

    c. The 1962 Act is more inclusive than the 1931 Act in its definition of farm animals. [This answer is correct. The 1931 Act distinguishes between farm animals and animals owned by a fiduciary entity that does not operate a farm.]

    d. Both the 1931 and 1962 Acts limit the term "business" to sole proprietorships. [This answer is incorrect. The 1962 Act includes general partnerships in its definition of the term "business."]

21. The 1997 UPIA accommodates investment techniques made permissible by the 1994 Uniform Prudent Investor Act. Which of the following is one of the provisions of the Uniform Prudent Investor Act? **(Page 51)**

    a. The standard of prudence is applied to each investment individually. [This answer is incorrect. The standard of prudence is now applied to the total portfolio, not on the basis of each investment individually.]

    b. Types of trustee investments are further restricted to ensure preservation of principal. [This answer is incorrect. Subject to certain criteria, trustee investment choices are now unrestricted.]

    c. Trustees are no longer required to diversify investments. [This answer is incorrect. The requirement that fiduciaries diversify investments has now been integrated into the definition of prudent investing.]

    d. Trustee delegation of the investment function is now permitted. [This answer is correct. Trustees are now permitted to delegate investment and management functions, subject to safeguards.]

22. Which of the following statements is correct concerning the unitrust approach to defining trust income and making trust distributions? **(Page 56)**

    a. Trust assets are recalculated semiannually for purposes of determining income. [This answer is incorrect. Trust assets are recalculated annually under the unitrust approach.]

    b. Principal is normally the fourth priority-ordered distribution source. [This answer is incorrect. Unless provided otherwise, principal is fifth in the priority-ordered sources for trust distributions.]

    c. The trustee can use a hybrid approach involving Section 104 of the 1997 UPIA. [This answer is incorrect. Hybrid approaches are not allowed, and most states do not allow conversion of existing trusts to a unitrust approach.]

    d. The approach seeks to reconcile the UPIA with the Uniform Prudent Investor Act. [This answer is correct. Both Section 104 of the 1997 Act and the unitrust approach seek to overcome inherent conflicts between the method of computing income under the 1962 Act and the 1994 Uniform Prudent Investor Act.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (AETTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. How many Uniform Principal and Income Acts (UPIA) are there?

   a. 1.

   b. 2.

   c. 3.

   d. 4.

2. Under normal circumstances, which of the following is controlling for determining and allocating fiduciary accounting income?

   a. Federal income tax law.

   b. Governing documents.

   c. State law defining income.

   d. Uniform Principal and Income Acts.

3. Under IRC Section 641(b), complex trusts are taxed as individuals for income tax purposes.

   a. True.

   b. False.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

4. Which of the following is used to allocate DNI and depreciation?

   a. Gross income.

   b. Taxable income.

   c. Fiduciary accounting income.

   d. Undistributed income.

5. Which UPIA adopted the "Prudent Man" rule?

   a. 1931.

   b. 1959.

   c. 1962.

   d. 1997.

6. Which of the UPIA is specifically aimed at ensuring trustee flexibility to handle modern investment vehicles and practices?
   a. 1931 and 1962.
   b. 1962 and 1997.
   c. 1962.
   d. 1997.
7. Which of the UPIA allows the trustee to recharacterize income and principal in certain cases?
   a. 1931.
   b. 1931 and 1962.
   c. 1962 and 1997.
   d. 1997.
8. Which of the following receipt transactions is commonly classified for allocation to principal?
   a. Liquidating dividends.
   b. Cash dividends.
   c. Rents.
   d. Lease renewal fees.
9. Under the 1962 Act, delayed income on underproductive property is calculated using a simple interest rate of:
   a. 1%.
   b. 2%.
   c. 4%.
   d. 6%.
10. Under Article Four Part 1 of the 1997 Act, which of the following is allocated to income?
    a. Office equipment, in distribution from a partnership.
    b. Cash received in liquidation of the trust's interest in a partnership.
    c. Cash received in liquidation of a corporation.
    d. A cash distribution received from a corporation.
11. The trustee of a trust owning substantial investments in a timber operation may elect to treat those investments as:
    a. A sole proprietorship.
    b. A limited liability company.
    c. A partnership.
    d. A corporation.

12. The 1997 UPIA provides a separate allocation system for which of the following?

    a. Manufacturing activity.

    b. Rental activity.

    c. Service operations.

    d. Farming operations.

13. According to Section 414 of the 1997 Act, receipts from derivative transactions are allocated:

    a. After adjustment using mark-to-market rules.

    b. To principal.

    c. To income.

    d. Differently from those of option transactions.

14. Trust receipts from which of the following is given special treatment under the 1962 UPIA?

    a. Timber.

    b. Farming.

    c. Options.

    d. Derivatives.

15. Under the 1997 Act, which of the following trust charges is allocated entirely to income?

    a. Legal proceedings to construe the trust.

    b. Estate taxes and related penalties.

    c. Charges related to preservation of trust property.

    d. Charges related to environmental issue.

16. Under all three UPIA, 50% of accounting fees are allocated to income.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

17. Which of the following is **not** a type of bequest in an estate administration?

    a. General.

    b. Specific.

    c. Residuary.

    d. Ordinary.

18. Which type of bequest is normally the largest?

    a. General.

    b. Specific.

    c. Residuary.

    d. Ordinary.

19. The 1962 Act specifically addresses original issue discount interest while the 1931 Act does **not.**

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

20. Which of the following is correct concerning the 1931 and 1962 UPIA and allocations related to natural resources of a trust?

    a. The 1931 Act allocates rent receipts to principal.

    b. The 1931 Act distinguishes allocations of income from timber operations.

    c. The 1962 Act allocates up to 50% of the gross receipts to income.

    d. The 1962 Act allocates timber operations income according to fiduciary discretion.

21. Which of the Uniform Principal and Income Acts specifically accommodates techniques permitted by the Uniform Prudent Investor Act?

    a. 1931.

    b. 1962.

    c. 1994.

    d. 1997.

22. The 1997 UPIA includes which of the following effects concerning trust investments and allocation of returns from those investments?

    a. The trustee has more freedom to adjust beneficiary income allocations.

    b. The trustee is more restricted in the types of investments permitted.

    c. Investments must be individually screened for entity-specific risk acceptability.

    d. Trust investment diversification is no longer required.

Lesson 2: Accounting for Estates and Trusts

INTRODUCTION

The accounting records of an estate or trust must be maintained in a manner that allows fiduciaries to present an accountability of funds in the form of financial statements or financial presentations. Such presentations are normally intended to meet the requirements of a probate court or the beneficiaries of the estate or trust. One of the first issues to address is what basis of accounting to use in the accounting records and in financial presentations. Unfortunately, little authoritative guidance exists to help accountants select a basis of accounting for a fiduciary entity. In addition, the accounting issues for estates and trusts are different from those of a typical corporate entity.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the accountant's role and describe GAAP principles concerning fiduciary accounting.
- Summarize accounting concepts for accounting for estates or trusts.
- Identify considerations related to specifying and using OCBOA to account for estates and trusts.

Basis of Accounting

Since authoritative literature does not directly address fiduciary accounting, best practices indicate that accountants and fiduciaries may have latitude when selecting the basis of accounting to use for fiduciary accounting purposes. Fiduciary entities may use any of the following bases of accounting:

- *Generally Accepted Accounting Principles (GAAP).* Many accountants believe the fact that most states have adopted one of the versions of the Uniform Principal and Income Acts, the accounting and reporting guidance (formal or implied) included in state probate code and trust law, the report issued by the National Fiduciary Accounting Standards Project Committee, and other literature has created an adequate body of accounting knowledge that allows accountants to conclude that GAAP exists for fiduciary accounting. However, some accountants question the potential lack of consistency among entities due to the ability of the governing document and varying state laws to establish different accounting treatments for various items.

- *Agreed-upon Basis Specified in an Agreement.* Although most governing documents are silent about the basis of accounting that should be used, some documents (more likely trusts than estates) actually specify a basis of accounting that can be considered an acceptable basis of accounting without characterizing it as GAAP or an OCBOA.

- *Cash Basis.* While pure cash basis is seldom used, the basis of accounting for estates and trusts may be labeled modified cash basis. Fiduciary accounting principles, regardless of whether accountants characterize them as GAAP, essentially provide for an accounting on the modified cash basis. The modified cash basis of accounting appears to be predominantly used in practice and is often labeled as GAAP for reporting purposes.

- *Tax Basis.* Because estates typically have a short duration and common probate reporting requirements, they seldom use the tax basis. However, some fiduciary entities may choose to use the tax basis.

Generally, each alternative, at the present stage of development of authoritative literature, can be justified. However, due to the nature and purpose of fiduciary accounting, accountants should carefully consider the selection of a basis of accounting. Some choices of basis of accounting can be generally more appropriate than others. Accountants should remember several factors that affect selection of the basis of accounting:

- A basis specified in the governing document should be followed. Accountants may find that the basis can be characterized as GAAP, depending on the circumstances. The governing document is the first level of authority in determining how transactions should be accounted for. Accountants may choose to characterize fiduciary accounting as GAAP, even if the GAAP basis of accounting is not specified in the governing document.

- Fiduciary accounting income must be determined according to the rules in Exhibit 2-1, regardless of the basis of accounting specified, since it is necessary for tax purposes.
- The accounting records should be maintained on a basis that allows fiduciaries to easily present their accountability for funds. Most presentations required by the courts, beneficiaries, or other interested parties are more concerned with showing how the fiduciary discharged his responsibility than (a) measuring financial position and operating results similar to a business enterprise or (b) reflecting fiduciary assets and transactions on a tax basis (even though tax basis amounts are readily available to facilitate preparation of tax basis presentations). Note that the use of the tax basis of accounting will generally result in financial presentations that include assets for which the fiduciary is not responsible (e.g., nonprobate assets). For liability purposes, the fiduciary (who may also be the accountant) should be focused on demonstrating that he fulfilled his fiduciary responsibility to the various classes of beneficiaries and the courts, among others.
- If accountants must choose between the cash and tax basis, using the tax basis eliminates the need to evaluate the appropriateness of modifications to the pure cash basis, which can be troublesome for estates and trusts. However, use of the tax basis would rarely be appropriate for court accountings, unless such basis was specified in the governing document.

Regardless of which basis of Accounting is used, best practices encourage preparers to include a comprehensive note disclosure that explains the basis of accounting and particular accounting conventions used by the estate or trust.

Exhibit 2-1

Rules Governing Allocations between Principal and Income

Level of Authority	Treatment
1. Governing Document	Whatever the governing document defines as principal and income must be allocated as specified under the terms of the governing document.
2. Trustee's Discretion	The governing document may grant the trustee discretion as to how allocations are made even if the trustee's allocation produces a result different from state law. Any allocation must be done impartially.
3. Applicable Local (i.e., State) Law	If the governing document is silent and does not grant the trustee discretion, the provisions of state law must be followed.
4. Allocate to Principal	If the governing document is silent and does not grant the trustee discretion and state law is silent, then any inflow or outflow should be charged to principal.

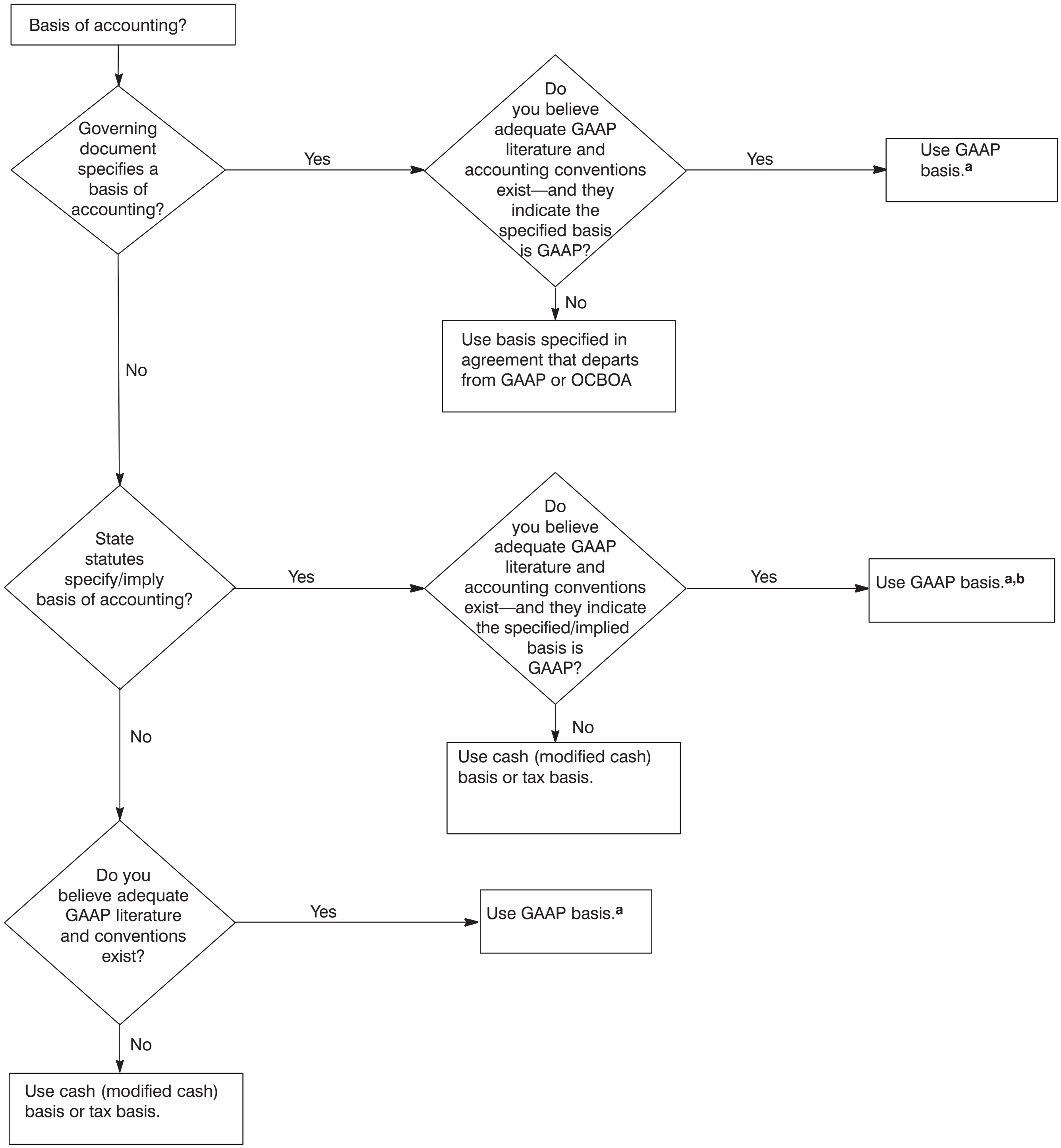
* * *

If no accounting requirements are included (or implied) in the governing document or state law, that increases the options available to practitioners in choosing a basis of accounting for reporting purposes. While the modified cash basis (whether labeled as GAAP or an OCBOA) is frequently used in practice, if the governing document or state law does not preclude the accrual or tax basis, the accrual or tax basis of accounting may still be used. However, as a practical matter, use of the tax basis should be rare in accountings for the court since the court is generally not interested in tax basis information. Likewise, accrual-based statements would be of limited use to a court of law. When selecting a basis of accounting, it is extremely important for accountants to understand how fiduciary accountings will be used.

The flowchart in Exhibit 2-2 helps summarize the complex alternatives when selecting a basis of accounting. Each of these bases of accounting, including accounting issues and appropriate responses are discussed in detail in this lesson.

Exhibit 2-2

Determining the Appropriate Basis of Accounting for Fiduciary Entities



Notes:

[a] The basis of accounting may be labeled as GAAP if the accountant believes adequate GAAP literature and conventions exist.

[b] It may be necessary to use the tax basis of accounting if there is (a) a need for tax basis financial presentations, and (b) a photocopy of the tax return will not be adequate.

* * *

Organization of This Lesson

This lesson discusses the purpose and general issues that characterize fiduciary accounting, including differences from commercial accounting. In addition, this lesson reviews the alternatives relating to selection of a basis of accounting, including a review of fiduciary accounting conventions that may be characterized as GAAP, and provides recommendations. It also provides comprehensive case studies that illustrate accounting for an estate and a trust from the beginning to the end of the administration period. The term *accounting convention*, as used in this section, refers to (a) general principles or procedures or (b) the basic principles or procedures that are accepted as being correct. This is distinguished from the terms (a) *accounting principle*, which generally refers to rules or regulations established or communicated by an authoritative body to establish GAAP, and in some cases, a nonauthoritative body, and (b) *accounting practice*, which refers to the way something is commonly accounted for.

This lesson focuses on considerations that are unique to estates and trusts.

THE ACCOUNTANT'S ROLE IN FIDUCIARY ACCOUNTING

Some accountants view accounting for estates and trusts as a new method of accounting that requires knowledge of new accounting principles. Other accountants prefer to view fiduciary accounting as similar to commercial accounting, with a few differences. Neither opinion is incorrect. Accounting for estates and trusts does have many similarities to accounting for commercial business enterprises. However, significant differences do exist. Such differences primarily stem from the fundamental difference in the function of estates or trusts from that of commercial entities.

Some of the challenges facing accountants involved with accounting for estates and trusts include:

- Understanding the purpose of fiduciary accounting and how it affects accounting conventions.
- Determining the appropriate accounting standards to follow due to a lack of specific standards addressing fiduciary accounting.
- Understanding how or when to apply fiduciary accounting principles in creating and maintaining the accounting records of an estate or trust.

What Is Fiduciary Accounting?

The term *fiduciary accounting* has different meanings, depending on the context in which it is used. In a broad sense, it refers to the entire process whereby a fiduciary communicates information to interested parties about the administration of a trust or estate and periodically reports the status of this administration. The term fiduciary accounting also refers to accounting for the different classes of beneficiaries of an estate or trust. This includes both accounting principles and accounting systems for fiduciary entities. In a more narrow sense, fiduciary accounting also refers to the actual reporting or "accounting" that fiduciaries prepare for courts and/or other parties. This lesson focuses on the second meaning—accounting for the different classes of beneficiaries of an estate or trust. In this course, fiduciary accounting is used to refer to accounting for an estate or trust.

Accountant's Role in Fiduciary Accounting

The executor/trustee/personal representative (the fiduciary), as designated in the will or trust document, is responsible for the administration of the estate or trust. While in some cases the fiduciary is a CPA or accountant, more often the estate will be administered by an attorney, professional fiduciary (such as a bank trust department), or other party. Regardless of their background, fiduciaries may obtain professional assistance in the preparation of estate or trust accountings. This may include creating and maintaining the accounting records of the fiduciary entity, preparing financial presentations, or reporting on the fiduciary's presentations.

Fiduciary versus Commercial Accounting

Commercial Accounting. Accounting and financial presentations of fiduciary entities have a different purpose than financial accounting and reporting for commercial business enterprises. Financial accounting and financial statements for commercial enterprises are necessary to provide information about a business to investors and creditors. As such, the accounting and resulting financial statements are focused on presenting a company's financial position and results of operations. This allows the statements to be used for two major purposes—to determine solvency and to evaluate profitability. When accounting for businesses, the standard accounting equation below applies:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

The underlying accounting records for commercial businesses are maintained in a manner that facilitates the accumulation of information about the amounts of, and the changes in, these three elements of financial condition.

Fiduciary Accounting. The fiduciary of an estate or trust is entrusted with the safekeeping, management, and disposition of assets on behalf of others. As a result, that fiduciary is accountable to various parties, including the courts, beneficiaries, taxing authorities, and other interested parties. The fundamental fiduciary accounting equation on which the accounting records are based is:

$$\text{Assets} = \text{Accountability}$$

Instead of being concerned with the presentation of the complete financial position of the trust or estate, the fiduciary seeks to show who has rights to the assets of the entity and how he has discharged his fiduciary responsibility. In addition, because beneficiaries may be entitled to different interests under the provisions of the trust agreement or will, the accountant must account for the rights of each beneficiary separately. The accounting should be performed in a manner that differentiates among the interests of beneficiaries.

FIDUCIARY ACCOUNTING AND GAAP

While most accountants have spent years learning about GAAP applicable to for-profit, nonprofit, and governmental entities, they have generally spent little time learning fiduciary accounting conventions. In addition, one of the challenges facing accountants involved with accounting for estates and trusts is determining the appropriate accounting standards to follow due to a lack of specific standards addressing fiduciary accounting. This section discusses (a) the issues that create difficulties in determining what GAAP is for estates and trusts, (b) existing and emerging literature addressing fiduciary accounting, and (c) whether GAAP exists for fiduciary accounting. In the following sections, a survey is presented of existing and emerging literature relating to fiduciary accounting principles and a discussion of the applicability of state statutes.

Why Is GAAP for Fiduciary Accounting Not Clear-cut?

The determination of GAAP related to fiduciary accounting can be a challenging task. This is especially true because:

a. An authoritative body such as the FASB or AICPA has not issued a pronouncement or other guidance dealing with fiduciary accounting. Likewise, there are no AICPA Industry Audit or Accounting Guides, and no AICPA Statements of Position that address fiduciary accounting.

b. The determination of how to account for an estate or trust normally depends upon, or is subject to, the proper interpretation of a governing document (the will or trust instrument) and the laws of the state having jurisdiction.

Because of these difficulties, there is some logic to an argument that GAAP does not exist for fiduciary accounting, however, the absence of an official FASB or AICPA pronouncement does not necessarily mean that a sufficient body of conventions, rules, and procedures does not exist that can be categorized as GAAP.

The FASB Accounting Standards Codification. The *FASB Accounting Standards Codification* (the Codification) is now the authoritative source of GAAP for nongovernmental entities. As a result, the hierarchy of GAAP for nongovernmental entities consists of only two sources—authoritative and nonauthoritative. Where the former GAAP Hierarchy ranked every type of accounting pronouncement based on its relative degree of authority, all guidance within the Codification carries the same level of authority. If an entity cannot find appropriate guidance within the

Codification, the entity is permitted to consider authoritative guidance for similar transactions. If no appropriate authoritative guidance exists the entity is permitted to consider guidance from nonauthoritative sources.

302.5Nonauthoritative literature is described in the Codification at FASB ASC 105-10-05-3. Such guidance includes—

- Widely recognized industry practices.
- FASB Concepts statements.
- AICPA Issues Papers.
- International Reporting Standards of the International Accounting Standards Board.
- Pronouncements of professional associations or regulatory agencies (the latter being less applicable to fiduciary entities).
- AICPA Technical Practice Aids.
- Accounting textbooks, handbooks, and articles.

In determining whether the nonauthoritative guidance is appropriate in the circumstances, the accountant should consider the following:

a. Is the guidance relevant in the circumstances?

b. Is the guidance specific enough to apply in the circumstances?

c. Is the source of the guidance regarded as an authority?

d. How widely used is the guidance?

The following paragraphs discuss existing practices and literature that can be identified as generally accepted for fiduciary accounting.

Uniform Principal and Income Acts. The starting point when surveying accounting practices that apply to fiduciary engagements is to review the accounting rules required by state law. This would be an impractical task if each state had unique accounting rules. Fortunately, most states have adopted, in some form, the basic accounting conventions of the Uniform Principal and Income Act (UPIA).

According to the UPIA, the first source of accounting authority for a fiduciary transaction is the governing document (the will or trust agreement). If the governing instrument is silent regarding a particular transaction and does not grant the trustee discretion in making allocations between income and principal, the accountant looks next to state law. If state law is silent, the 1997 UPIA states that any inflow or outflow should be charged to principal. The UPIA then discusses in detail how to account for various receipts and expenditures and determine what transactions normally affect corpus (i.e., the principal balances) versus income. It should be noted that many states only adopted parts of the UPIA or have adopted the entire UPIA but modified portions of it. Thus, accountants must be familiar with the UPIA and other governing state laws when engaged to prepare an accounting of an estate or trust.

The UPIA creates an interesting paradox—on one hand, it establishes a body of accounting guidance that can be consistently applied in most states; but on the other hand, by making the governing instrument the overriding authority for each fiduciary engagement, it creates an inconsistent situation where potentially no two estates or trusts are accounted for in the same manner. This potential inconsistency in accounting and the ability of the governing instrument to establish unique accounting principles are the main reasons that some accountants believe GAAP does not exist for fiduciary engagements. Accountants who agree with this reasoning conclude that the basis of accounting used by an estate or trust is not GAAP, but instead is the basis defined in an agreement (the governing instrument). As a practical matter, many governing documents are silent as to the accounting and presentation methods required for the trust or estate.

Many accountants believe the paradox relating to consistency can be explained by understanding the main difference between fiduciary and financial accounting. As discussed earlier, financial accounting attempts to provide information about a business so that investors and creditors can analyze and compare the business with other similar businesses. Fiduciary accounting attempts to determine who has a claim to the assets of the entity. No comparison among fiduciary entities is anticipated or desired. Determining if the entity has been properly managed and who has rights to the assets of the entity are the main goals of fiduciary accounting, so consistent accounting treatment between entities is not needed.

State Statutes. The state's version of the Uniform Principal and Income Act, other laws relating to allocation of principal and income, and statutes relating to fiduciary entities (e.g., state probate code and trust law), play a large part in determining what is "generally accepted" in a particular state. In most instances, state statutes, and not the will or trust instrument, define the accounting and reporting requirements. In addition, some states have incorporated the fiduciary accounting principles into their state laws. Although a basis of accounting may not be formally specified, state statutes often use language such as "receipts," "receipts during the period," "cash receipts," and "cash disbursements." In addition, the reporting guidance in state statutes may provide guidance on what is "generally accepted" for accounting and reporting purposes. For example, some statutes provide that:

- Fiduciary accountings include all *cash and property transactions* since the date of the last accounting or, if none, from the commencement of administration.

- Model formats for accountings (required or recommended) reflect a financial presentation that begins with assets on hand at the beginning of the period, *receipts* and *disbursements* during the period, and ends with assets on hand at the end of the period (i.e., a statement that closely resembles a statement of cash flows included as a basic financial statement of most commercial entities).

Many practitioners strongly believe, absent requirements in the governing document to the contrary, that the language adopted in state statutes establishes GAAP for such accountings. Those practitioners argue that state statute defines what is "generally accepted" for fiduciary accounting purposes. They believe such language indicates that the cash or modified cash basis of accounting is GAAP for fiduciary entities. An informal survey of practitioners specializing in the area of fiduciary accounting has found support for this argument. The majority of the surveyed practitioners prepared fiduciary accountings using the modified cash basis, which in most instances was considered to be GAAP in the relevant jurisdiction. If such basis is predominantly used in practice, there is a strong argument that the cash or modified cash basis of accounting constitutes the prevalent "industry" practice for fiduciary entities. If the practitioner believes, based on appropriate circumstances, that the modified cash basis of accounting is GAAP, such financial presentations should be reported as such. If no accounting or reporting requirements are included (or implied) in the governing document or state law, there are a number of other basis of accounting options available to practitioners for presentation purposes.

Committee on National Fiduciary Accounting Standards. Recognizing that much could be accomplished to improve the general administration of estates and trusts and that in many jurisdictions there was a lack of clarity or consistency in accounting, the American Bankers Association Trust Division; American Bar Association Section on Real Property, Probate and Trust Law; American College on Probate Counsel; American Institute of Certified Public Accountants; National Center for State Courts; and National College of Probate Judges jointly formed in 1972 a National Fiduciary Accounting Standards Project Committee. Eight years later, the committee issued its report in May 1980 titled *Uniform Fiduciary Accounting Principles and Model Account Formats* (UFAP). Various technical changes were incorporated in a later May 1984 version, the *National Fiduciary Accounting Standards and Model Account Formats*, which was approved in 1988.

The Committee (in its report) provided a basic objective of fiduciary accounting and six fiduciary accounting principles, which are sometimes referred to as the uniform principles. Many states have incorporated the uniform principles into state law. The fiduciary accounting principles do not attempt to address the issue of how to account for the recording and classification of individual transactions incurred during the reporting period. However, they provide guidance for preparation of statements and address some accounting issues. The guidance in the UFAP is discussed in detail in the following paragraphs.

According to the Basic Objectives and General Standards of Fiduciary Accounting section of the Committee Report:

> The fundamental objective of an account should be to provide essential and useful information in a meaningful form to the parties interested in the accounting process. It is also important that the account should be sufficiently simple to enable its preparation without unreasonable expense to the fund or undue distraction from the on-going administration of the estate. Finally, although the parties should understand the nature of the accounting process and the need to protect their interests, the relationship of trust and confidence existing between the fiduciary and beneficiaries is itself important and the account should not be presented in an adversary format that will unnecessarily impair this relationship.

Overview of Fiduciary Accounting Standards. A fiduciary entity results from the division of legal and beneficial interests in property. The fiduciary is responsible for managing assets placed under his care for the benefit of the beneficiaries. The managerial process places on the fiduciary various duties and obligations.

Determining how well the fiduciary carried out his duty is a goal of fiduciary accounting. Through the preparation of certain reports, the fiduciary is able to describe to the beneficiaries the results of his activities and allows the beneficiaries to judge if the fiduciary has been a good steward. There are two main objectives of fiduciary accounting:

- Performance accounting.
- Discharge accounting.

Performance accounting provides an "analysis of the investment performance of a fund," according to the Scope of the Project section of the *Uniform Fiduciary Accounting Principles and Model Account Formats* (UFAP). The fiduciary is responsible for investing the assets of the trust or estate, so the assets can generate a return allowing the entity's purpose to be achieved. Even if the entity has a short duration, maintaining the current value of the fund is important to assure that sufficient assets are present to achieve the overall purpose of the entity. By analyzing the investment policy, the fiduciary and beneficiaries can determine if changes need to be made to that policy to maintain the entity's viability.

Discharge accounting is based on the relationship between the fiduciary and the beneficiaries. Eventually, the entity must be dissolved and the fiduciary released from liability. However, before the fiduciary can be discharged from liability, there must be a means by which the actions of the fiduciary can be reviewed. Discharge accounting provides this review. Through periodic and final reports, the fiduciary notifies the beneficiaries of the activities of the entity. These reports allow the beneficiaries to review the actions of the fiduciary. After sufficient time (based on the laws of the applicable jurisdiction) has passed, the fiduciary will be discharged from all liability based on the activities reflected in the reports.

While performance accounting is important to the analysis of the entity, the main focus of the fiduciary accounting standards, as stated in the UFAP, is on discharge accounting. Performance accounting requires greater flexibility and less need for uniformity than discharge accounting. The standards discussed in this course focus on discharge accounting, since most governmental and court ordered reports are concerned with the relationship between the fiduciary and the beneficiaries.

Principles of Discharge Accounting. There are six principles stated in the Fiduciary Accounting Principles section of the UFAP. The objectives of these principles are to provide for:

- maximum clarity,
- full disclosure, and
- complete description and explanation of all events.

However, meeting all of these objectives can be difficult. For example, clarity can be obscured by too much detail and full disclosure of all information may make the reports cumbersome and unlikely to be read by interested parties.

The purpose of the six principles of fiduciary accounting is to provide reports that protect the appropriate parties while permitting the fiduciary flexibility based on the circumstances. Since the principles are not hard and fast rules, not all fiduciary accounts will be identical. The principles provide a degree of uniformity, but do not force accountants to abide by any particular format. Depending on the circumstances, accountants could use a variety of approaches within the same and between different entities. However, accountants should remember that the goal of fiduciary accounting is to account for the fiduciary's stewardship and management of the assets under his control.

I. *Accounts should be stated in a manner that is understandable by persons who are not familiar with practices and terminology peculiar to the administration of estates and trusts.*

Readers of fiduciary reports include: judges, attorneys, accountants, bankers, and beneficiaries. Each has a specific degree of knowledge concerning fiduciary accounts and terms; therefore, the reports must be prepared so each group can understand them. While the reports cannot address every group's lack of knowledge, the Fiduciary Accounting Principles section of the UFAP states that the reports must be understood by "*a person of average intelligence, literate in English and familiar with basic financial terms who has read [the report] with care and attention*." Care should be taken to eliminate jargon from the final report. The use of such language is difficult to comprehend by anyone not versed in the field.

II. *A fiduciary account shall begin with a concise summary of its purpose and content.*

The summary section of the fiduciary report should state the following:

- The time period involved.
- The entity being accounted for.
- The name of the fiduciary.

Normally, the summary takes the form of a cover letter. Included with the cover letter is a statement that the information should be reviewed and where additional information can be obtained. The relationship of the particular reader to the entity does not have to be provided, since the reader should be able to obtain this information from other sources. Finally, a table of contents should be included to allow the reader easy access to specific information that might be of interest.

III. *A fiduciary account shall contain sufficient information to put the interested parties on notice as to all significant transactions affecting administration during the accounting period.*

One of the differences between fiduciary accounting and financial accounting is the format of the presentation of information. In summary, discharge accounting should provide the reader a review of the fiduciary's activities related to managing the entity. As a result, a composite review of the activities of the entity is required every time a fiduciary report is prepared.

Because the fiduciary's actions start when the entity is created, and ends when the entity is dissolved, a complete financial picture of how a fiduciary has discharged his duty must be reflected in the report. This is accomplished by starting with the beginning balance for each asset showing the changes during the period and stating the ending balance. The ending balance then becomes the beginning balance for the next period. A first and final accounting incorporates every transaction since the beginning of the entity.

Because a major concern noted in the principles is that the reports be read and understood by the interested parties, preparers should keep the final product concise enough so the parties will actually read it, without sacrificing adequate disclosure. Transactions should be described in sufficient detail to provide notice of their purpose and effect. Because certain activities can be consolidated (e.g., dividends received on a particular security), the accountant has some flexibility in creating statements that are more readable and understandable. Generally, extensive detail of routine activities (e.g., maintenance expenses) should be avoided, with a summary of all similar activities aggregated.

IV. *A fiduciary account shall include both carrying values—representing the value of the asset at acquisition by the fiduciary—and current values at the beginning and end of the accounting period.*

Carrying value is the value of the asset at the time the fiduciary acquired the asset. Assets received from a decedent (estate) are carried at their date-of-death value, while assets received from a grantor (trust) are carried at the date of transfer value. Those carrying values are generally the market values at the time the assets became part of the estate or trust and may often be obtained from the estate and gift tax returns, respectively. When an exact determination of the carrying value cannot be made, or circumstances indicate that the use of another value is appropriate, the value used for the carrying value of the asset should reflect a thoughtful determination by the fiduciary. If the carrying value of an asset is not based on the market value when acquired, the market value and the basis for the carrying value used should be shown in the fiduciary's account.

An asset's carrying value is rarely changed during the administration of the entity. However, if the entity is audited by a taxing authority, the carrying values can be adjusted to reflect the changes determined from the audit. In addition, where appropriate under applicable local practice, a successor fiduciary may adjust the carrying value of assets to reflect market values at the start of his or her administration. Such an adjustment allows the successor's account to more accurately reflect the successor's performance.

Carrying value should *not* be confused with tax basis. While carrying value may often be obtained from tax returns, it is not synonymous with tax basis. For gift tax purposes, the fair market value (FMV) on the date of gift is used to determine the amount of gift tax; however, the donee's tax basis is not the FMV, but is the donor's tax basis, adjusted for any gift tax paid on the appreciation. In this case the carrying value would be the FMV of the asset. A fiduciary should keep records of each asset's tax basis, but disclosure of tax basis need not be included in the reports.

To permit the evaluation of investment performance during the accounting period, a fiduciary's account should include both carrying values and current values for the assets at the beginning and end of the accounting period. Current values at the beginning of the administration do not need to be separately stated if the carrying value is based on the market value as of the date the asset was received by the fiduciary. The date on which subsequent current values are determined should be the date of the close of the accounting period, or a date as close to that date as reasonably possible. Current values can be shown in a column parallel to the column of carrying values with both columns totaled.

A major goal of the valuation process for gift and estate tax purposes is to determine the carrying value (i.e., value of the assets at the date of transfer), and thus the tax liability for the estate or trust. If valuation issues are important to the client's goals in a lifetime transfer situation (e.g., in establishing a family partnership), the client and advisers should begin with the assumption that the valuation will be challenged by the IRS. Quite often, the credibility of the client's valuation experts will be a key determinant of whether the valuation is upheld. A credentialed appraiser should be retained to protect against possible legal challenge. However, for the purposes of accounting for the estate or trust, while the technical competency of the fiduciary is vital to the generation of accurate financial information, the concern of a challenge to the current values reported is not at issue.

The current values of financial assets are relatively easy to obtain if the investments have a ready market. Those would include assets such as publicly traded equities, debt instruments, or limited partnership interests. Collectibles will likely require the opinion of an expert or may be obtained by comparison to like items sold in an auction. Other assets such as rental property and business entities require analysis and judgment. Valuation methods for these types of assets are discussed briefly in the paragraphs that follow. A good starting point is to refer to the valuation method used to calculate the carrying value (value at acquisition by the fiduciary) for the gift or estate tax return.

The value of a productive asset, or group of assets that comprise a business, depends on the stream of future benefits that will be reaped by the owners of that asset or business. However, those benefits cannot be measured with certainty. Businesses have different risks and earnings characteristics. Their owners' goals and expectations vary. No single formula can be used to determine the value of every business in every situation. Therefore, different fundamental valuation approaches have been developed. For each fundamental approach, there are various valuation methods that have evolved for estimating future benefits and the resulting values of businesses.

The three basic approaches that form the framework for specific valuation methods are (a) the income approach, (b) the market approach, and (c) the asset-based approach. Exhibit 2-3 displays the three approaches and corresponding methods used to value a business.

Exhibit 2-3

Valuation Approaches and Methods

Approaches	Methods
Income—value is determined by estimating future ownership benefits and discounting them to present value.	Discounted future returns • Discounted net cash flow • Discounted future earnings Capitalized returns • Capitalization of earnings • Capitalization of net cash flow
Market—value is determined by analyzing recent sales of interests in comparable companies.	Value multiples using guideline company data or transactions • Price/earnings • Price/dividends • Price/gross cash flow • Price/book value • Price/revenues • Price/net asset value • Multiple of discretionary earnings • Rules of thumb • Company specific methods
Asset-based—value of a business is based on the values of its individual assets.	Underlying assets • Net asset value • Liquidation value • Excess earnings

* * *

If the current value of an asset cannot be readily determined, the fiduciary should make a good faith estimate to determine a realistic value and state the basis for the valuation in the accounting. The fiduciary should not incur expenses for appraisals or other valuation methods when there is no reason to expect that the resulting information will benefit the estate or trust parties. For example, a real estate property held for the use of a beneficiary with no intention of ever being sold, would not warrant the cost of an appraisal.

Only assets included in the decedent's probate estate are included in the accounting. Nonprobate assets, while included in the gross estate for tax purposes, are not subject to the fiduciary's control and; therefore, they are not part of the estate for accounting purposes. With the first accounting, the fiduciary should list all the assets included in the gross estate and designate those that were transferred outside of probate. This should protect the fiduciary from liability for those assets.

FASB ASC 820-10 (formerly SFAS No. 157, *Fair Value Measurements*) provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and expands the disclosures about fair value measurements.

V. *Gains and losses incurred during the accounting period shall be shown separately in the same schedule.*

The ultimate disposition of assets is of vital importance in the proper management of the entity. Inclusion of a separate schedule showing the effect of asset disposition provides the reader with a means to track the fiduciary's handling of these assets. This schedule allows the reader to know the entity's investment performance and which assets produced the particular gain or loss.

VI. *The account shall show significant transactions that do not affect the amount for which the fiduciary is accountable.*

Certain transactions (i.e., receipt of a stock split or a change in corporate name) do not affect the aggregate amount under control of the fiduciary; however, they do change the particular assets under the fiduciary's control. To comprehend the entity's administration, a reader should be able to determine how the asset mix has changed. Through the schedule showing gains and losses, and a detail of transactions that alter the asset mix, the reader will have a better understanding of the fiduciary's administration of the entity.

A Recap of Emerging Principles That Can Be Categorized as GAAP. Many accountants believe that the UPIA, UFAP, and other literature have created an adequate body of accounting knowledge to conclude that GAAP exists for fiduciary accounting engagements. Proponents of this view are not concerned that each governing document can establish accounting conventions (especially for the determination of principal/corpus and income) that may be completely different for each estate or trust. They point out that (unlike the case with commercial entities) the users of financial statements of an estate or trust are not concerned about a potential lack of consistency in the accounting for one estate versus another. Said another way, the users of fiduciary financial statements (the executors, trustees, beneficiaries or courts) are not trying to measure performance, credit risk, or investment potential of one fiduciary entity in relation to another.

The primary accounting conventions that have emerged in recent years that could be categorized as generally accepted fiduciary accounting principles are as follows:

a. The assets under the fiduciary's (executor/trustee/personal representative) control should be accounted for in accordance with the governing instrument and/or state law. Normally, such accounting pertains to the determination of transactions that affect the interests of various classes of beneficiaries.

b. Assets over which the fiduciary has no management and control, either through contractual arrangements, operation of law, or lack of exercise of management and control by the fiduciary are excluded from any statements prepared. (Note that this would not necessarily be true of financial statements prepared on the income tax basis.) (SSARS No. 1 states that "A financial statement may be, for example, that of . . . an estate or trust . . ." Therefore, based on that excerpt, the lesson sometimes refers to financial accounting prepared by the fiduciary as "financial statements." The term *estate* might have different meanings when used in a different context. For example, the *administrative estate* and the *taxable estate* may include different property. A taxable estate may include gifts made before death that are still considered taxable property of the estate. Such gifts would not be part of the administrable estate. Consequently, care should be exercised to identify the financial statements as being presented on the income tax basis of accounting.)

c. Assets are not recognized until there is a passage of legal title, other indications of ownership, or the asset has been converted to cash. Thus, receivables are not recognized unless there is written evidence of their existence. Accrued interest and dividends may be assets for estate tax purposes, but not for fiduciary accounting purposes.

d. Liabilities existing at the date of death and disbursements are not recognized until there is a payment by transferring cash or another asset of the entity. This is a departure from the usual practice (even in a tax or cash basis entity) of recognizing liabilities when assets are acquired. For example, the assets of an estate might include a farm with a related mortgage payable. The financial statements would disclose the current value of the farm but not the related mortgage debt. Only the cash payments on such debt (or other claims) are reflected in the financial presentation. Many accountants are uncomfortable with this accounting convention and encourage the executor/trustee to disclose in a note (or parenthetically on the face of the statement) the related debt. For trusts, liabilities related to assets transferred to the trust are generally recorded. The use of cash basis recognition principles creates another potentially confusing issue. Some accountants believe that the term GAAP is synonymous with accrual accounting, and thus they believe it would be incorrect to imply that the accounting of an estate or trust is in accordance with GAAP. Therefore, they would characterize the accounting as being in accordance with the cash basis.

e. There is one principal financial statement, called the "Summary of Account," that is supported by subsidiary schedules and notes explaining items on the statement. The statement most closely resembles the "Statement of Cash Flows" as included in other entities' financial statements. It begins with assets on hand at the beginning of the period, shows receipts and disbursements during the period, and ends with assets on hand at the end of the period. (There are several additional commonly used titles and formats of the principal financial statement or presentation. Preparers should consult the guidelines and regulations in their local jurisdiction to determine appropriate presentation titles and formats.)

f. Assets are reported in the "Summary of Account" at "fiduciary acquisition value," which represents market value on the date assets are transferred to the fiduciary (or cost for assets subsequently purchased). Current (market) values as of the date the "Summary of Account" is prepared are also disclosed. SFAS No. 157, *Fair Value Measurements*, provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and expands the disclosures about fair value measurements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. According to the text, which method of accounting is predominantly used for estates and trusts?

    a. Tax basis.

    b. Modified cash basis.

    c. GAAP basis.

    d. Agreed-upon basis.

24. To promote equitable treatment of all beneficiaries, fiduciary accounting must not differentiate among the interests of trust beneficiaries.

    a. True.

    b. False.

25. Which of the following is correct concerning the UFAP report issued by the Committee on National Fiduciary Accounting Standards?

    a. The report contains two fundamental objectives.

    b. The report contains five fiduciary accounting principles.

    c. UFAP gives specific guidance for recording and classifying individual transactions.

    d. UFAP has become codified law in many states.

26. Which of the following items is **not** included in the summary section of the fiduciary report, according to the text?

    a. The name of the fiduciary.

    b. The names of the beneficiaries.

    c. The reporting period.

    d. The name of the entity being reported.

27. According to the text, which of the following is correct concerning accounting conventions that could be categorized as generally accepted fiduciary accounting principles?

    a. Statements prepared by the fiduciary should include all assets of the estate, including those not under the control of the fiduciary.

    b. Estate liabilities must be reflected on a detailed debt schedule to be attached to the published fiduciary statement.

    c. The Summary of Account is the principal financial statement and resembles an income statement.

    d. The Summary of Account reports assets at fiduciary acquisition value and includes current market values as of report preparation date.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. According to the text, which method of accounting is predominantly used for estates and trusts? **(Page 65)**

    a. Tax basis. [This answer is incorrect. While used in certain cases, this is certainly not the predominant basis. Estates generally do not use this basis because of their short duration and common probate reporting requirements.]

    b. Modified cash basis. [This answer is correct. A pure cash basis is seldom used, but the modified cash basis is quite common—though it may be labeled as GAAP for reporting purposes.]

    c. GAAP basis. [This answer is incorrect. Although reports may indicate the GAAP basis was used, the use of GAAP in estates and trusts is not predominant and some accountants question the ability to use GAAP because of potential inconsistencies caused by governing documents and varying state laws.]

    d. Agreed-upon basis. [This answer is incorrect. An acceptable agreed-upon basis can result from governing document specifications, though the use of any such basis would not be predominant in fiduciary accounting.]

24. To promote equitable treatment of all beneficiaries, fiduciary accounting must not differentiate among the interests of trust beneficiaries. **(Page 69)**

    a. True. [This answer is incorrect. The fiduciary must account for the interests of each beneficiary individually.]

    b. False. [This answer is correct. Equitable treatment and equitable accounting are not synonymous. Different beneficiaries may be entitled to different rights under the governing documents, and the fiduciary must account for each beneficiary's interests separately. Fiduciaries must show that they have properly discharged their duties, which include safekeeping, management, and disposition of assets on behalf of others.]

25. Which of the following is correct concerning the UFAP report issued by the Committee on National Fiduciary Accounting Standards? **(Page 71)**

    a. The report contains two fundamental objectives. [This answer is incorrect. The report contains one basic objective that is composed of three parts. The first part is the fundamental objective—to provide essential and useful information in meaningful form to those interested in the accounting process.]

    b. The report contains five fiduciary accounting principles. [This answer is incorrect. The report contains six fiduciary accounting principles.]

    c. UFAP gives specific guidance for recording and classifying individual transactions. [This answer is incorrect. The report does not address this issue. Rather, it provides guidance for statement preparation and addresses certain accounting issues.]

    d. UFAP has become codified law in many states. [This answer is correct. Many states have now added the uniform principles to codified law.]

26. Which of the following items is **not** included in the summary section of the fiduciary report, according to the text? **(Page 73)**

    a. The name of the fiduciary. [This answer is incorrect. The name of the fiduciary is one of several elements to be included in the summary section of the fiduciary report.]

    b. The names of the beneficiaries. [This answer is correct. The text does not indicate the need to include beneficiary names in the summary section of the report. According to the text, it is likewise unnecessary to include the relationship of the reader to the entity.]

    c. The reporting period. [This answer is incorrect. Including the reporting period in the summary section helps the reader quickly identify and understand the timeframe under report.]

    d. The name of the entity being reported. [This answer is incorrect. This is one of the elements indicated for inclusion in the summary section by the text.]

27. According to the text, which of the following is correct concerning accounting conventions that could be categorized as generally accepted fiduciary accounting principles? **(Page 76)**

    a. Statements prepared by the fiduciary should include all assets of the estate, including those not under the control of the fiduciary. [This answer is incorrect. Estate assets not under the control of the fiduciary should be excluded from statements after the first accounting.]

    b. Estate liabilities must be reflected on a detailed debt schedule to be attached to the published fiduciary statement. [This answer is incorrect. Unlike trust liabilities, estate liabilities are not recognized until paid, although there is no prohibition against supplemental disclosure in the fiduciary statement.]

    c. The Summary of Account is the principal financial statement and resembles an income statement. [This answer is incorrect. The Summary Account most closely resembles a Statement of Cash Flows in a standard set of financial statements.]

    d. The Summary of Account reports assets at fiduciary acquisition value and includes current market values as of report preparation date. [This answer is correct. The acquisition value is market value at transfer date for assets transferred to the fiduciary, or cost in the case of assets subsequently purchased.]

ESTATE OR TRUST ACCOUNTING

Estate and Trust Accounting Systems

In order to demonstrate accountability for assets, the accounting records of the fiduciary should be designed to reflect a complete record of the assets controlled by the fiduciary and their subsequent disposition. Some considerations when establishing the accounting records are discussed in the following paragraphs.

The fiduciary accounting records should provide financial information that allows fiduciaries to administer the trust or estate. The records should be designed so that the fiduciary may:

- Obtain information about the assets on hand, income received, amounts available for distribution to beneficiaries, etc. at any point in time.

- Prepare accountings for the courts, beneficiaries, and other interested parties. This includes information about the original assets (inventory) of the trust or estate; activities of the trust or estate, including changes in assets due to sales, distributions, and purchases; payments made to administer the estate (i.e., funeral and administrative expenses); and distributions to beneficiaries.

- Prepare the estate and fiduciary tax returns.

Distinguishing between Principal and Income. The separation of principal from income is one of the primary differences from commercial accounting. In fiduciary accounting, there are typically two "owners"—a remainder beneficiary and an income beneficiary. In fiduciary accounting, the term "income" is used differently than it is used in the business world. Income includes the regular periodic earnings from assets of the estate or trust (e.g., dividends, interest, rents, and royalties) less associated expenses (e.g., custody fees, income taxes, real estate operating expenses, income commissions, etc.). On the other hand, increases and decreases resulting from sales of estate or trust assets (i.e., gains and losses) and charges against the entity such as estate taxes, legal fees, and the fiduciary's principal commissions are considered "principal." Principal and income commissions refer to the portion of the fiduciary's fees that that are charged to principal or income, respectively.

The existence of different classes of beneficiaries makes it necessary for the accounting records to differentiate between principal and income. Generally, this may be accomplished by maintaining separate general ledger accounts or separate worksheet or ledger columns for principal and income transactions. This allows for the proper allocation between income and principal on individual transactions. Such differentiation also facilitates the determination of income and principal components for reporting purposes.

Even if an estate is left entirely to one or more beneficiaries, it is necessary to distinguish between principal and income transactions for tax purposes (determination of fiduciary accounting income and preparation of the tax return). Fiduciaries must keep records that distinguish between principal and income when one or more beneficiaries and remaindermen are designated in a will, when a trust is created by the will (a testamentary trust), and for all other trusts.

Complexity of the Accounting Records

The complexity of the accounting records needed depends on the size, composition, and complexity of the estate or trust. Accounting records may vary from a simple checkbook and spreadsheet or worksheet for a small trust to a general ledger and subsidiary journals using double-entry accounting for larger or more complex entities. However, the size of the estate or trust is not the only factor influencing the complexity of the accounting system. Other factors that affect the complexity of the system include use of the cash or accrual method, incorporation into the fiduciary accounting system of the books of a business owned by the estate or trust, and the need to separate principal from income. An illustrative chart of accounts for a trust or estate is presented in Exhibit 2-4.

Exhibit 2-4

Illustrative Chart of Accounts for an Estate or Trust

ASSETS:

100	Petty Cash
101	Principal Cash
102	Income Cash
103	Stocks
104	Bonds
105	Proprietorship Business
106	Partnership Interests
107	Other Assets
108	Depreciation/Depletion Reserves

LIABILITIES:

200	
201	Reserve for Unusual Charges Against Income

NET WORTH (PRINCIPAL):

300	Estate Principal (or Trust Principal)
301	Assets Not Inventoried

EXPENSES AND DISTRIBUTIONS ALLOCABLE TO PRINCIPAL

400	Administrative Expenses
401	Estate and Inheritance Taxes
402	Gains on Realization
403	Losses on Realization
404	Legacies Paid
405	Distributions of Principal
406	Debts of the Decedent
407	Funeral Expenses
408	Depreciation/Depletion Principal

NET WORTH (INCOME):

500	Estate Income (or Trust Income)
600	Distributions of Income

INCOME:

700	Interest Income
701	Dividend Income
702	Rental Income
703	Proprietorship Income
704	Partnership Income
705	

EXPENSES:

800	Salaries
801	Office Expenses
802	Real Estate Taxes
803	Depreciation/Depletion Expense
804	Miscellaneous Expense
805	Income Taxes
806	Unusual Charges Against Income Reserve
807	Administrative Expenses

*   *   *

Accounting for an Estate

The books of an estate are generally not maintained until after the personal representative has completed the estate inventory. The inventory of assets is filed with the probate court in most jurisdictions.

Opening Entry. The opening entry to the estate books records the estate inventory. The fiduciary should establish a sufficient number of accounts to adequately classify the types of assets. The asset accounts are debited for the amounts indicated on the inventory list. The sum of the debits is offset by a single credit to an account titled Estate Principal (or Estate Corpus). This credit amount reflects the fiduciary's accountability at that date, and is sometimes referred to as the fiduciary accountability account.

The amount that should be debited for each asset is the inventory value at the date of the decedent's death. This value is based on the fair market value at that date. Jointly-owned property and community property should be recorded based on local jurisdiction laws or practices. Jointly-owned property that was acquired using the decedent's funds may be recorded by debiting an asset account and recording the subsequent distribution to the survivor-owner. Community property is generally recorded in one of two ways. Community property may be reflected at its gross value with a contra account for the surviving spouse's equity, or net (decedent's equity in community property). These methods are known as the gross method and net method of reporting community property. The gross method is recommended because it facilitates reconciling balances recorded to other documents (e.g., bank statements, loan agreements, etc.) and it provides more detailed information, without affecting the amount of the executor's accountability.

<u>Nonprobate Assets.</u> The assets typically included in the estate's inventory filed by the executor/personal representative with the probate court should not include nonprobate assets. The probate estate consists of only real and personal property titled in the name of the decedent on the date of death. The probate estate is often significantly different from what is referred to as the gross estate for estate tax purposes. Assets that are not a part of the probate estate include assets passing by operation of law in a joint tenancy with right of survivorship, or those passing by contract to individual beneficiaries of insurance policies or individual retirement accounts. Because the fiduciary has no management and control, either through contracted arrangement, operation of law, or lack of exercise of management and control by the fiduciary, these assets are generally excluded from the accounting records and any financial statements of the estate. However, this would not necessarily be true of records and financial statements prepared on the income tax basis of accounting. Because the executor has involvement with all assets in the estate, and is responsible for paying the tax on transfers of assets outside the probate estate, prudence suggests the executor maintain a listing of nonprobate assets.

<u>Liabilities of the Decedent.</u> Liabilities of the decedent existing at the date of death are generally not recorded on the books in the opening entry. Instead, the executor should record these items when they are paid (by transferring cash or another asset of the estate). The estate's liabilities are not recognized until they are paid for several reasons. First, because the records reflect the fiduciary's accountability for assets, the total assets for which the fiduciary is responsible is not reduced until assets are used to satisfy the liability. Second, many of the debts of the decedent are paid from estate assets within a relatively short time. A common question occurs when the assets of an estate include a home or other real estate with related mortgage debt. In such cases, the accounting records should disclose the current value of the home but not the related mortgage debt. Many accountants are uncomfortable with this accounting convention and encourage the executor to record such liabilities. In most cases, the accountant will disclose the debt in a note (or parenthetically on the face of the statement). In some local jurisdictions, this may be required.

Accounting Entries during Administration. The treatment of certain transactions during the period of estate administration are discussed in the following paragraphs. The treatment of transactions within the different accounting categories are also presented in Exhibit 2-5.

Exhibit 2-5

Activity in Series of Accounts

SERIES

100 ASSETS

- Accounts represent all property the fiduciary is initially charged with.
- Accounts needed for administration of trust/estate (e.g., allowance for depreciation).
- Number and level of detail determined by fiduciary/accountant.

200 LIABILITIES

- Liability accounts rarely used since liabilities at date of death are not recorded by fiduciary.
- Accounts needed if fiduciary enters into liability obligations during administration period.

300 NET WORTH (ESTATE OR TRUST PRINCIPAL)[a]

- Equity account, similar to investment or capital stock account of a business enterprise.
- Account is credited with initial inventory amount of the estate or trust property.
- Balance represents the amount the fiduciary is responsible or accountable for, as shown by the inventory.

400 EXPENSES AND DISTRIBUTIONS ALLOCABLE TO PRINCIPAL[a]

- Changes in principal (i.e., changes for which the fiduciary is responsible) are recorded in the 400 series.
- Accounts include:
  - All expenses that are chargeable to principal.
  - Corrections and adjustments to the original balance.
  - Distributions of principal.
- Periodically, accounts are closed into Estate (or Trust) Principal account.
  - Usually remains open until final settlement occurs.
  - After final distribution of assets, 400 series accounts are closed into Estate (or Trust) Principal [which should reduce Estate (or Trust) Principal to zero].

SERIES

500 NET WORTH (ESTATE OR TRUST INCOME)[b]

- Equity account for income beneficiaries.
- Account will never have a beginning balance (no activity until income is earned).
- Income (700 series) and expenses (800 series) applicable to income are closed into Estate (or Trust) Income at the end of the period.

600 DISTRIBUTIONS OF INCOME[b]

- Account is debited when there are distributions to income beneficiaries.
- Account remains open until final settlement occurs.

700 INCOME

800 EXPENSES

- Accounts are closed to the 500 series, Estate (or Trust) Income, at the end of the period.

Notes:

[a] Anytime prior to the final closing of the books, the sum of the 300 and 400 series of accounts equals the amount for which the fiduciary is responsible to the principal beneficiaries. This net credit amount should equal the net assets relating to principal.

[b] Anytime prior to the final closing of the books, the balance of Estate (or Trust) Income (500 series) less Distributions of Income (600 series) equals the undistributed income for which the fiduciary is responsible to the income beneficiaries.

* * *

Estate Principal. Changes in principal assets after the opening entry reflect increases or decreases in the executor's accountability and are recorded in accounts other than the "Estate Principal" account. Recording changes in principal assets in separate accounts makes it easier to prepare and reconcile the accounting records and reports filed by the executor.

Assets Not Inventoried. After the executor has prepared the original inventory of assets, it is common for additional assets to be discovered. This may include additional bank accounts or other property. For example, a note or mortgage debt may have been collected by the executor prior to filing the estate tax return and thus overlooked because it was not "on hand" at the time the inventory was prepared; or, an asset may have been discovered and liquidated after filing the return. An executor's review of the cash records may also reveal omitted assets that are brought to light by receipt of income or principal payments.

These assets should be reported in a supplementary inventory and recorded at fair value at the date of the decedent's death by debiting the appropriate asset account and crediting an account called "Assets Subsequently Discovered," "Assets Not Inventoried," or "Supplemental Inventory." The Estate Principal account previously should not be credited since that account should reflect the value of the original inventory. In summary, the executor should report the original inventory separate from assets subsequently discovered.

Depreciation/Depletion. Whether depreciation/depletion should be recorded is based on the requirements of the governing document and state law. The requirements of the 1931, 1962, and 1997 UPIAs vary relating to treatment of depreciation. In general, depreciation/depletion expense should only be recorded if the governing document or state law requires that assets be depreciated or depleted. Depreciation expense is usually recorded as a debit to depreciation/depletion expense [as a charge against (a) estate principal or (b) an expense account that is closed to estate income, depending on the governing document or state law] and a credit to an allowance or reserve account (contra-asset). Depreciation/depletion should be calculated based on the value of depreciable assets included in the estate inventory (fair market value at date of death) and not historical cost or tax basis. GAAP for commercial business enterprises is usually appropriate in terms of useful life, salvage value, and depreciation/depletion methods. As a result, the amount of accounting depreciation might be different from allowable tax depreciation.

Unusual Charges against Income. The 1931, 1962, and 1997 UPIA's permit a trustee to "regularize distributions" if charges against income are unusually large. However, the 1997 Act is more specific than the other Acts regarding the circumstances in which this authority may be used. The trustee may choose to use a "reserve approach" for accounting for these unusually large expenditures. Under the "reserve approach," the trustee must anticipate and estimate expected unusual charges before they are incurred. Charges are then made against income over a reasonable period of time prior to their incurrence, resulting in the buildup of a "reserve," or estimated liability. Or instead, the trustee may record the expenditure as a deferred charge, which is subsequently amortized against income.

Debts of the Estate. Liabilities of the decedent at the date of death are rarely recorded in the accounting records. However, if the estate itself borrows money during the administration period, the resulting liability should be recorded. The increase in assets (an increase in accountability) is offset by the recording of the corresponding liability. Payment of the debt would be treated similar to debt of a commercial enterprise, except payment would be made from Income Cash.

Payment of Debts of the Decedent. Payment of liabilities existing at the time of the decedent's death should be treated on a cash basis. The executor should debit Debt of the Decedent and credit Principal Cash. The Debt of the Decedent account debited is not an expense account. This account will be a charge to the Estate Principal account when it is closed into Estate Principal upon the termination of the estate.

Funeral and Administrative Expenses. The level of detail used to record funeral and administrative expenses may vary depending on the personal representative's desire for detail and the required level of reporting by the local jurisdiction. The funeral and administrative expenses may be grouped or recorded individually. In some instances multiple accounts are used to provide the personal representative with additional information about professional and other administrative fees. Debits to the funeral and administrative expense account(s) are charges against Estate Principal in most jurisdictions, and are not an expense.

Distributions to Beneficiaries. When distributions are made to beneficiaries, the personal representative credits the appropriate asset accounts (e.g., principal cash, income cash, personal property, etc.) and debits Distributions of Principal (charge against Estate Principal) for principal beneficiaries (remaindermen) or Distributions to Income Beneficiaries (charge against Estate Income) for income beneficiaries.

Other Transactions. The income and principal components of transactions should be recorded to the appropriate accounts. Expenses chargeable to principal should be recorded in the appropriate expenses/distributions of principal account (charges against Estate Principal). Income transactions should be reflected in the appropriate income accounts (closed to Estate Income).

Annual Closing Entry. At the end of the accounting period, all estate income accounts are closed to the Estate Income account by debiting all income accounts, crediting all expense accounts, and either debiting or crediting the Estate Income account.

Final Closing Entries. Several entries are necessary to close the estate, including entries to:

- Close the income and expense accounts to the Estate Income Account (same as annual closing entry).
- Debit the appropriate Distribution of Principal or Distribution of Income account to record all distributions of principal and income assets.
- Debit the Estate Principal and Estate Income accounts and credit the appropriate distribution accounts to close the estate.

Summary of Entries. Opening, closing, and other entries made during the estate administration are illustrated in Exhibit 2-6.

Accruals. The distinction between the cash and accrual basis of accounting is well defined in accounting for commercial enterprises. However, certain transactions relating to income and expenses that would be accrued for commercial business enterprises are treated differently for fiduciary accounting purposes. The dates that impact how transactions are recorded as either income or principal are:

- The date of death (DOD) of the testator.
- The date when the tenancy (rights of the income beneficiary) terminates and the remaindermen (principal beneficiaries) receive the corpus, or principal.

Exhibit 2-6

Summary of Entries for an Estate or Trust

Opening Entry	dr Assets (Fair Market Value)		XX,XXX	
		cr Estate (or Trust) Principal		XX,XXX
	Inventory of estate or trust assets turned over to fiduciary.			
Annual Entries During Administration	dr Assets (Specific Assets Discovered)		XX,XXX	
		cr Assets Not Inventoried		XX,XXX
	Assets discovered after initial inventory.			
	dr Expenses and Distributions Allocable to Principal		XX,XXX	
		cr Principal Cash		XX,XXX
	Expenses and principal transactions relating to administration.			
	dr Principal Cash		XX,XXX	
		cr Assets		XX,XXX
		cr Gains (Losses) on Realization		XX,XXX
	Principal transactions relating to realization of gains or losses.			
	dr Income Cash		XX,XXX	
	dr Expenses Attributable to Income		XX,XXX	
		cr Income Attributable to Income		XX,XXX
	Income transactions during the year.			
	dr Depreciation and Depletion Expense		XX,XXX	
		cr Depreciation and Depletion Reserves		XX,XXX
	Transactions relating to depreciable/depletable assets, when required.			
Annual Closing Entry	dr Income Attributable to Income		XX,XXX	
		cr Expenses Attributable to Income		XX,XXX
		cr Estate (or Trust) Income		XX,XXX
	To close income and expense accounts.			
Final Closing Entries	dr Income Attributable to Income		XX,XXX	
		cr Expenses Attributable to Income		XX,XXX
		cr Estate (or Trust) Income		XX,XXX
	To close income and expense accounts.			
	dr Distributions of Principal		XX,XXX	
	dr Distributions of Income		XX,XXX	
		cr Assets		XX,XXX
	To record distribution of assets.			
	dr Estate (or Trust) Principal		XX,XXX	
	dr Estate (or Trust) Income		XX,XXX	
		cr Distributions of Principal		XX,XXX
		cr Distributions of Income		XX,XXX
	To close out estate or trust.			

* * *

The following summarizes the treatment of accruals.

- *Income/Expenses Arising Prior to DOD.* Accrued income that relates to estate or trust assets or activity prior to the date of death belongs to the principal of the estate or trust, even though it is not collected until after death. Likewise, accrued expenses relating to transactions that occurred prior to death are also payable from principal cash.

- *Income/Expenses Arising after the DOD.* Unless contrary to the governing document or state law, income that accrues after the date of death and before the termination of tenancy belongs to the income beneficiary. Similarly, expenses for that period are payable from income cash. After termination of tenancy, any income and expenses accrue to the remaindermen, or principal beneficiaries.

Transfers to Trusts. Although a will may include the creation of a trust, this has no effect on how an estate is managed. Instead of making a distribution to a beneficiary, the distribution is made to the trust. The trust assets will then be managed by the trustee pursuant to the terms of the will and trust agreement.

After the personal representative or accountant has prepared the final accounting and it has been approved by the court or other jurisdiction, the personal representative may transfer the trust assets to the trustee. This terminates the personal representative's responsibilities relating to those assets. However, before the personal representative transfers any assets, they should ensure that the trust has obtained an Employer Identification Number (EIN). Most wills that "pour over" into a living trust created by the decedent will already have a EIN. The EIN generally needs to be obtained for testamentary trusts before they receive distributions.

In the accounting records of the estate, the assets being placed in trust are transferred to a separate assets account (of the estate) in the name of the trustee, as follows:

dr	Trust Assets—XYZ Trustee	XX,XXX	
	cr Estate Assets		XX,XXX

When preparing the final accounting, the personal representative reflects a principal distribution of the trust assets, as follows:

dr	Distribution of Principal	XX,XXX	
	cr Trust Assets		XX,XXX

Estate Accounting—Example Case Study

The following fiduciary accounting for an estate illustrates the following:

- Determination of probate and nonprobate assets.

- Entries made in the estate's accounting records, including:

  - Opening the estate's books.

  - Activity during the administration period.

  - Closing the estate's books (annual and final closing entries).

- The transfer of trust assets from the executor to a testamentary trustee.

Assumptions. Jerry Rivers died on February 1, 2002, leaving a will naming Mark Clark as executor, without bond. Mark agrees to serve as executor of Jerry's estate. Mark engages an accountant to establish and maintain the accounting system for his administration and to prepare the necessary reports to the court and to the beneficiaries.

At the date of Jerry's death, as the decedent, his estate consisted of the following assets, as appraised by the court-appointed appraisers:

Cash on hand	$ 806
Cash in bank	22,995
Principal residence, owned in joint survivorship with his wife (residence was paid for entirely by decedent)	102,000
Life insurance, payable to wife as named beneficiary	90,000
Life insurance, payable to estate as named beneficiary	30,000
Proprietorship business	100,000
Real estate mortgages receivable	625,421
Interest receivable on mortgages	2,345
Corporate stocks	145,000
Municipal bonds	110,300
Accrued interest on bonds	1,516
Rental building	109,000
Accrued rents receivable on building	1,175
Coin collection	6,800
Household furnishings	46,000
Automobiles	11,245
Wages receivable	475
Total	$ 1,405,078

Jerry's will provided as follows:

- His business should be left in trust to his son, John, age 23 for a period of three years, after which it will become the son's property. John and First National Bank are co-trustees.
- His coin collection should be given to his sister, Rose.
- The automobiles and household furnishings are to be given to Jerry's wife (Mrs. Rivers).
- A bequest of $10,000 should be given to State University to establish a scholarship in Jerry's name.
- The remainder of the estate, after the above bequests and after payment of taxes and expenses, is to given to his widow. Jerry also provided that his executor distribute $1,300 per month to his widow during the period of the estate's administration.

Upon reviewing Jerry's tax returns, Mark noted that Jerry had given $18,000 in cash to his son on May 10, 2001. A gift tax return was filed for this gift, but no gift tax was payable on it.

Inventory. Mark filed the following inventory with the court on March 28, 2002. This represents Jerry's known property interests for probate purposes.

Estate of Jerry Rivers
Inventory and Appraisal

Cash on hand	$ 806
Cash in bank	22,995
Life insurance receivable	30,000
Proprietorship business	100,000
Real estate mortgages receivable	625,421
Interest receivable on mortgages	2,345
Corporate stocks	145,000
Municipal bonds	110,300
Accrued interest on bonds	1,516
Rental building	109,000
Accrued rents receivable on building	1,175
Coin collection	6,800
Household furnishings	46,000
Automobiles	11,245
Wages receivable	475
Total	$ 1,213,078

The inventory does not include items that are not a part of the probate estate, such as:

- The principal residence (owned jointly with Mrs. Rivers with survivorship) that passed to Mrs. Rivers outside the will.
- Life insurance payable to Mrs. Rivers as named beneficiary.

While these assets must be considered when computing estate taxes, they do not represent assets for which the executor is accountable. The accountant may record memorandum entries or keep a separate record of these assets to ensure that information is available for the tax return and tax-basis financial statements, if prepared.

In addition, although the prior year gift to Jerry's son may have estate tax implications, the transaction has no effect on the probate estate or the executor's accountability for the estate. The U.S. Tax Code provides for a unified gift and estate tax system. Gifts made by the decedent prior to death that currently exceed $12,000 per year per person (in 2008) reduce the estate tax exclusion. The 2001 Tax Act provides for a gradual phase-out of the estate and generation-skipping transfer (GST) taxes resulting in total repeal in 2010. The estate tax exclusion increased to $2 million in 2007, with a final increase to $3.5 million scheduled in 2009 and full phase out in 2010. Reinstatement of the estate tax is automatic in 2011 (i.e., a rollback of the exclusion to 2002 level of $1,000,000).

Chart of Accounts. The accountant (and/or executor) established the chart of accounts at Exhibit 2-7 for use in posting transactions to the general ledger and subsidiary ledgers:

Exhibit 2-7

Chart of Accounts for the Estate of Jerry Rivers

ASSETS

100 Cash on Hand
101 Principal Cash
102 Income Cash
103
104 Corporate Stocks
105 Municipal Bonds
106 Government Bonds
107 Accrued Interest on Bonds
108 Proprietorship Business
109 Mortgages Receivable
110 Interest Receivable on Mortgages
111 Real Estate/Income Producing
112 Allowance for Depreciation/Real Estate
113 Rent Receivable
114 Coin Collection
115 Household Furnishings
116 Automobiles
117 Wages Receivable
118 Other Receivables
119 Other Assets
120

LIABILITIES

200
201

NET WORTH (PRINCIPAL)

300 Estate Principal
301 Assets Not Inventoried

EXPENSES AND DISTRIBUTIONS ALLOCABLE TO PRINCIPAL

400 Debts of Decedent
401 Funeral Expenses
402 Administrative Expenses
403 Capital Changes/Gains on Realization
404 Capital Changes/Losses on Realization
405 Distributions of Principal
406 Estate and Inheritance Taxes
407

NET WORTH (INCOME)

500 Estate Income

600 Distributions of Income

INCOME

700 Interest Income
701 Interest Income/Municipal Bonds
702 Dividends Received
703 Rental Income
704 Proprietorship Income
705 Interest on Mortgages
706

EXPENSES

800 Office Expenses
801 Repairs
802 Insurance
803 Utilities
804 Real Estate Taxes
805 Interest Expense
806 Depreciation Expense
807 Income Taxes Paid
808
809
810

* * *

The chart of accounts has been designed to facilitate the recording of activity in Jerry's estate and to allow the accountant to prepare the necessary reports to the court and to the beneficiaries, as well as the tax return.

Opening Entry. The opening entry to record the beginning of Mark's administration of Jerry's estate follows:

<u>Estate Books</u>

dr	100 Cash on Hand	806	
dr	101 Principal Cash	22,995	
dr	104 Corporate Stocks	145,000	
dr	105 Municipal Bonds	110,300	
dr	107 Accrued Interest on Bonds	1,516	
dr	108 Proprietorship Business	100,000	
dr	109 Mortgages Receivable	625,421	
dr	110 Interest Receivable on Mortgages	2,345	
dr	111 Real Estate/Income Producing	109,000	
dr	113 Rent Receivable	1,175	
dr	114 Coin Collection	6,800	
dr	115 Household Furnishings	46,000	
dr	116 Automobiles	11,245	
dr	117 Wages receivable	475	
dr	118 Other Receivables (Life insurance)	30,000	
	cr 300 Estate Principal		1,213,078

To record inventory of estate assets.

Note: Only probate assets are recorded in the estate's ledger. However, in some instances, accountants may wish to record nonprobate assets or liabilities relating to mortgages in memorandum accounts.

Entries to Record Estate Activity. Entries to record the transactions completed by the executor follow:

1.	dr	101 Principal Cash	806	
		cr 100 Cash on Hand		806

To record deposit of cash on hand in the bank account.

2.	dr	402 Administration Expense	300	
		cr 101 Principal Cash		300

To record payment of probate fees and costs to the judge and clerk of the probate court.

3.	dr	101 Principal Cash	475	
		cr 117 Wages Receivable		475

To record receipt of wages receivable.

Note: As indicated earlier receipt of wages earned before the date of death is considered income in respect of a decedent (IRD). When accrued IRD is collected, the assets are written off the books; however, no income is recorded. Since it will be necessary to know the amount of IRD for tax purposes and to separate principal and income transactions, these receivables were recorded in the opening entry on an accrual basis. This is one of the few instances where accrual accounting is used in fiduciary accounting.

4.	dr	401 Funeral Expenses	3,500	
	cr	101 Principal Cash		3,500

To record payment of funeral expenses, including costs of the burial plot and monument.

5.	dr	405 Distributions of Principal	6,800	
	cr	114 Coin Collection		6,800

To record the transfer of the coin collection bequest to Jerry's sister Rose.

6.	dr	101 Principal Cash	12,000	
	cr	301 Assets Not Inventoried		12,000

To record executor's discovery of an additional bank account that was not included in the initial inventory.

Note: It is generally preferable to credit a separate account for "assets not inventoried" or "assets subsequently discovered" rather than to credit the Estate Principal account directly. This allows the Estate Principal account to reflect the balance in the original inventory, while other accounts reflect any changes in principal.

7.	dr	400 Debts of Decedent	7,280	
	dr	805 Interest Expense	280	
	cr	101 Principal Cash		7,280
	cr	102 Income Cash		280

To record repayment of a $7,000 note payable to a bank. The $7,560 repaid represents the face amount of the note plus $560 in interest. Since one half of the interest accrued before Jerry's death, that portion in considered a deduction in respect of the decedent (see earlier discussion), and is a principal transaction.

8.	dr	400 Debts of Decedent	2,600	
	cr	101 Principal Cash		2,600

To record payment of Jerry's debts that existed at the time of his death. These debts include doctor and pharmacy bills, utilities, and other items.

Note: Since liabilities are not recorded in the estate's books, these items are accounted for on the cash basis and are recorded when paid.

9.	dr	400 Debts of Decedent	957	
	cr	101 Principal Cash		957

To record payment of Jerry's 1999 individual Form 1040 tax liability after preparation of the tax return.

Note: Since this liability existed at the date of death, the payment is charged against estate principal.

10.	dr	101 Principal Cash	147,945	
	dr	404 Capital Changes/Losses on Realization	7,415	
	cr	109 Mortgage Receivable		155,360

To record sale of $155,360 of mortgages for a loss of $7,415.

Note: For fiduciary accounting purposes, the loss from the sale represents an adjustment to the initial estate valuation, and not an income or expense transaction. The Capital Changes/Losses on Realization account reflects losses on principal and is a contra account to the Estate Principal account. For tax purposes, the loss on sale may be a deduction.

11.	dr	101 Principal Cash	32,552	
	cr	104 Corporate Stocks		28,224
	cr	403 Capital Changes/Gains on Realization		4,328

To record sale of $28,224 of corporate stocks for a gain of $4,328.

Note: As discussed in entry 10, for fiduciary accounting purposes, the gain from the sale affects estate principal. Although the gain does not relate to an adjustment of the date of death valuation, it is considered a principal transaction since the asset composition of principal may change in form or amount, but such assets continue to represent the principal of the estate.

12.	dr	405 Distributions of Principal	10,000	
	cr	101 Principal Cash		10,000

To record payment of the scholarship bequest in the amount of $10,000 to State University as directed by Jerry's will.

13.	dr	102 Income Cash	7,385	
	cr	702 Dividends Received		7,385

To record cash dividends received.

14.	dr	406 Estate and Inheritance Taxes	140,000	
	cr	101 Principal Cash		140,000

To record payment of federal estate taxes and state inheritance taxes upon filing the returns (Form 706 and state return).

Note: Estate, inheritance, and other transfer taxes are charged entirely against principal unless otherwise specified in the governing document.

15.	dr	106 Government Bonds		110,000	
		cr	101 Principal Cash		105,000
		cr	102 Income Cash		5,000

To record the purchase of government bonds purchased with uninvested principal cash of $105,000 and income cash of $5,000.

16.	dr	101 Principal Cash		47,345	
	dr	102 Income Cash		46,655	
		cr	110 Interest Receivable of Mortgages		2,345
		cr	109 Mortgages Receivable		45,000
		cr	705 Interest on Mortgages		46,655

To record $94,000 in collections on mortgages, of which $49,000 was interest and $45,000 was principal. The interest portion includes accrued interest of $2,345 at the date of death.

Note: The $2,345 included in the interest collection represents income in respect of a decedent and must be included in estate principal.

17.	dr	101 Principal Cash		1,516	
	dr	102 Income Cash		4,000	
		cr	107 Accrued Interest on Bonds		1,516
		cr	701 Interest Income/Municipal Bonds		4,000

To record $5,516 in interest collected on municipal bonds during the year, of which $1,516 was accrued at the date of death

Note: Although the $1,516 represents income in respect of a decedent, it will not be included in taxable income since it relates to municipal bonds.

18.	dr	101 Principal Cash		1,175	
	dr	102 Income Cash		10,000	
		cr	113 Rent Receivable		1,175
		cr	703 Rental Income		10,000

To record collection of building rentals, including $1,175 accrued at the date of death.

Note: The $1,175 represents income in respect of a decedent.

19.	dr	108 Proprietorship Business		24,000	
		cr	704 Proprietorship Income		24,000

To record the net profits of the proprietorship business during the year.

20.	dr	801 Repairs		825	
	dr	802 Insurance		975	
	dr	803 Utilities		3,400	
	dr	804 Real Estate Taxes		1,100	
		cr	102 Income Cash		6,300

To record expenses relating to the rental building.

21.	dr	600 Distributions of Income		14,300	
		cr	102 Income Cash		14,300

To record payments to Jerry's widow as partial discharge of amount due as an income beneficiary.

22.	dr	402 Administrative Expenses		12,000	
	dr	800 Office Expenses		4,200	
		cr	101 Principal Cash		12,000
		cr	102 Income Cash		4,200

To record the payment of office expenses (including wages) relating to the operation of the estate and partial payment of the estate attorney and accountant's fees.

23.	dr	806 Depreciation Expense		3,100	
		cr	112 Allowance for Depreciation		3,100

To record depreciation on the rental building, as specified in Jerry's will.

24.	dr	101 Principal Cash		30,000	
		cr	118 Other Receivables (Life insurance)		30,000

To record receipt of proceeds from Jerry's life insurance policy—the estate was named as beneficiary.

Trial Balance—December 31, 2002. In his role as the estate's executor, Mark had the accountant prepare the trial balance at Exhibit 2-8 from the estate's general ledger. The trial balance will be used to assist in preparation of the annual closing entry and any necessary adjusting entries.

Exhibit 2-8

Example Estate Trial Balance—Year 1

The Estate of Jerry Rivers
Trial Balance
December 31, 2002

		Debit	Credit
101	Principal Cash	$ 15,172	$
102	Income Cash	37,960	
104	Corporate Stocks	116,776	
105	Municipal Bonds	110,300	
106	Government Bonds	110,000	
108	Proprietorship Business	124,000	
109	Mortgages Receivable	425,061	
111	Real Estate/Income Producing	109,000	
112	Allowance for Depreciation/Real Estate		3,100
115	Household Furnishings	46,000	
116	Automobiles	11,245	
300	Estate Principal		1,213,078
301	Assets Not Inventoried		12,000
400	Debts of Decedent	10,837	
401	Funeral Expenses	3,500	
402	Administrative Expenses	12,300	
403	Capital Changes/Gains on Realization		4,328
404	Capital Changes/Losses on Realization	7,415	
405	Distributions of Principal	16,800	
406	Estate and Inheritance Taxes	140,000	
600	Distributions of Income	14,300	
701	Interest Income/Municipal Bonds		4,000
702	Dividends Received		7,385
703	Rental Income		10,000
704	Proprietorship Income		24,000
705	Interest on Mortgages		46,655
800	Office Expenses	4,200	
801	Repairs	825	
802	Insurance	975	
803	Utilities	3,400	
804	Real Estate Taxes	1,100	
805	Interest Income	280	
806	Depreciation Expense	3,100	
		$ 1,324,546	$ 1,324,546

*   *   *

Annual Closing Entry. The accountant has determined that no adjusting entries are necessary. The annual closing entry will close the balances of the income and expense accounts into the Estate Income account.

dr	701 Interest Income/Municipal Bonds	4,000	
dr	702 Dividends Received	7,385	
dr	703 Rental Income	10,000	
dr	704 Proprietorship Income	24,000	
dr	705 Interest on Mortgages	46,655	
cr	800 Office Expenses		4,200
cr	801 Repairs		825
cr	802 Insurance		975
cr	803 Utilities		3,400
cr	804 Real Estate Taxes		1,100
cr	805 Interest Expense		280
cr	806 Depreciation Expense		3,100
cr	500 Estate Income		78,160

To close accounts related to estate income.

Entries to Record Estate Activity—Year 2. Entries to record the transactions completed by the executor in the second year of administration (2003) follow:

1. dr 405 Distributions of Principal 124,000

   cr 108 Proprietorship Business 124,000

   To record the transfer of the operations of the proprietorship business to the co-trustees for Jerry's son.

2. dr 405 Distributions of Principal 57,245

   cr 115 Household Furnishings 46,000
   cr 116 Automobiles 11,245

   To record the transfer of household furnishings and automobiles to Jerry's widow as partial distribution of the principal of the estate.

3. dr 807 Income Taxes Paid 30,000

   cr 102 Income Cash 30,000

   To record the fiduciary income taxes paid for 2002 per Form 1041.

   Note: Unless otherwise specified in the governing document, income taxes should be allocated against the type of accounting income that caused the imposition of income taxes. In this case, the taxes paid per Form 1041 are charged entirely against income.

4. dr 101 Principal Cash 28,700
   dr 102 Income Cash 33,560

   cr 109 Mortgages Receivable 28,700
   cr 705 Interest on Mortgages 33,560

   To record $62,260 in collections on mortgages during the year, of which $33,560 was for interest and $28,700 was for principal.

5.	dr	102 Income Cash		6,825	
		cr	702 Dividends Received		6,825

To record cash dividends received.

6.	dr	102 Income Cash		5,516	
		cr	701 Interest Income/Municipal Bonds		5,516

To record $5,516 in interest collected on municipal bonds during the year.

7.	dr	102 Income Cash		11,175	
		cr	703 Rental Income		11,175

To record collection of building rentals during the year.

8.	dr	801 Repairs		750	
	dr	802 Insurance		975	
	dr	803 Utilities		3,300	
	dr	804 Real Estate Taxes		1,200	
		cr	102 Income Cash		6,225

To record expenses relating to the rental building.

9.	dr	102 Income Cash		4,000	
		cr	700 Interest Income (Government bonds)		4,000

To record $4,000 in interest collected on government bonds during the year.

10.	dr	402 Administrative Expenses		16,000	
	dr	800 Office Expenses		4,000	
		cr	101 Principal Cash		16,000
		cr	102 Income Cash		4,000

To record the payment of office expenses (including wages) relating to the operation of the estate and final payment of estate attorney, accountant, and executor's fees.

11.	dr	600 Distributions of Income		15,600	
		cr	102 Income Cash		15,600

To record the payments to the widow as partial discharge of amount due as an income beneficiary.

12.	dr	806 Depreciation Expense		3,100	
		cr	112 Allowance for Depreciation		3,100

To record depreciation on the rental building, as specified in the will.

13.	dr	402 Administrative Expenses		600	
	dr	807 Income Taxes Paid		13,000	
		cr	101 Principal Cash		600
		cr	102 Income Cash		13,000

To record the payment of fiduciary income taxes for the year 2003 per Form 1041 and fees and costs associated with closing the estate. The "Note" following entry 3 discusses allocation of income taxes to beneficiary classes.

Trial Balance—December 31, 2003. In his role as the estate's executor, Mark had the accountant prepare the trial balance at Exhibit 2-9 from the estate's general ledger. The trial balance will be used to assist in preparation of the annual closing entry and any necessary adjusting entries.

Exhibit 2-9

Example Estate Trial Balance—Year 2

The Estate of Jerry Rivers
Trial Balance
December 31, 2003

		Debit	Credit
101	Principal Cash	$ 27,272	$
102	Income Cash	30,211	
104	Corporate Stocks	116,776	
105	Municipal Bonds	110,300	
106	Government Bonds	110,000	
109	Mortgages Receivable	396,361	
111	Real Estate/Income Producing	109,000	
112	Allowance for Depreciation/Real Estate		6,200
300	Estate Principal		1,213,078
301	Assets Not Inventoried		12,000
400	Debts of Decedent	10,837	
401	Funeral Expenses	3,500	
402	Administrative Expenses	28,900	
403	Capital Changes/Gains on Realization		4,328
404	Capital Changes/Losses on Realization	7,415	
405	Distributions of Principal	198,045	
406	Estate and Inheritance Taxes	140,000	
500	Estate Income		78,160
600	Distributions of Income	29,900	
700	Interest Income		4,000
701	Interest Income/Municipal Bonds		5,516
702	Dividends Received		6,825
703	Rental Income		11,175
705	Interest on Mortgages		33,560
800	Office Expenses	4,000	
801	Repairs	750	
802	Insurance	975	
803	Utilities	3,300	
804	Real Estate Taxes	1,200	
806	Depreciation Expense	3,100	
807	Income Taxes Paid	43,000	
		$ 1,374,842	$ 1,374,842

* * *

Annual Closing Entry. The accountant has determined that no adjusting entries are necessary. The annual closing entry will close the balances in the income and expense accounts into the Estate Income account.

dr	700 Interest Income (Government bonds)	4,000	
dr	701 Interest Income/Municipal Bonds	5,516	
dr	702 Dividends Received	6,825	
dr	703 Rental Income	11,175	
dr	705 Interest on Mortgages	33,560	
cr	800 Office Expenses		4,000
cr	801 Repairs		750
cr	802 Insurance		975
cr	803 Utilities		3,300
cr	804 Real Estate Taxes		1,200
cr	806 Depreciation Expense		3,100
cr	807 Income Taxes Paid		43,000
cr	500 Estate Income		4,751

To close accounts related to estate income.

Final Closing Entries. After the approval of the final accounting by the probate court, the executor (Mark) was directed to distribute the remaining assets to the beneficiaries according to the provisions of Jerry's will. In this case, all the remaining assets will be distributed to the widow, as follows:

1.	dr	405 Distributions of Principal	840,709	
	dr	600 Distributions of Income	53,011	
	dr	112 Allowance for Depreciation	6,200	
	cr	101 Principal Cash		27,272
	cr	102 Income Cash		30,211
	cr	104 Corporate Stocks		116,776
	cr	105 Municipal Bonds		110,300
	cr	106 Government Bonds		110,000
	cr	109 Mortgages Receivable		396,361
	cr	111 Real Estate/Income Producing		109,000

To record the distribution of assets to the beneficiary.

Note: Final distribution of income includes $22,800 of previously undistributed income.

2.	dr	300 Estate Principal	1,213,078	
	dr	301 Assets Not Inventoried	12,000	
	dr	403 Capital Changes/Gains on Realization	4,328	
	dr	500 Estate Income	82,911	
	cr	400 Debts of Decedent		10,837
	cr	401 Funeral Expenses		3,500
	cr	402 Administrative Expenses		28,900
	cr	404 Capital Changes/Losses on Realization		7,415
	cr	406 Estate and Inheritance Taxes		140,000
	cr	405 Distributions of Principal		1,038,754
	cr	600 Distributions of Income		82,911

To close the remaining accounts in the estate.

Accounting for a Trust

The accounting principles used to account for a trust are similar to those discussed and illustrated previously for an estate. The principles are similar because the primary objectives of accounting for both estates and trusts are to (a) account for and report on the assets transferred to the trustee, and (b) report how the responsibility for the management and disposition of trust assets is discharged.

As in the accounting for an estate, distinguishing between transactions affecting principal and income beneficiaries is of primary importance when recording trust transactions. However, the manner in which the governing document addresses the separation of principal and income transactions is often different in a trust. For estates, the will generally does not contain specific guidance relating to the separation of principal and income that would override established legal requirements. However, a trust instrument will usually provide detailed guidance on transactions that should be considered principal and income. The provisions of the governing document override any contrary provision of state law.

Opening Entry. The books of a trust are generally not maintained until after the trustee receives the trust assets. For a testamentary trust, the trust is effective as of the date of death. However, the trustee does not have fiduciary responsibility for such assets until the trust property is received. However, even though the trust assets may not have been conveyed to the trustee, the income beneficiary is entitled to income earned after the decedent's death as part of trust income, unless otherwise specified by the trust agreement or state law. Any income accrued at the date of death becomes part of trust principal.

Similar to accounting for an estate, the trustee should establish a sufficient number of accounts to adequately classify the types of assets. The asset accounts are debited for the amounts transferred to the trust. The sum of the debits is offset by a single credit to an account titled Trust Principal (or Trust Corpus). This credit amount reflects the fiduciary's accountability at that date, and is sometimes referred to as the fiduciary accountability account. The amount that should be debited for each asset conveyed to the trust is the fair market value at the date of the transfer. The fair market value of trust assets will not necessarily coincide with the value of those assets for tax purposes.

Liabilities Conveyed to the Trust. Liabilities related to property transferred to the trust are generally recorded on the books in the opening entry. For example, property may be conveyed to the trustee that is subject to a mortgage (e.g., a home or other real estate with a related mortgage payable). These liabilities should be accounted for similar to the traditional accounting used for commercial business enterprises.

Accounting Entries during Administration. The treatment of certain transactions during the period of trust administration are discussed in the following paragraphs.

Trust Principal. Changes in principal assets after the opening entry reflect an increase or decrease in the trustee's accountability and are recorded in an account other than the "Trust Principal" account. By recording changes in principal assets in separate accounts, it makes it easier to prepare and reconcile the accounting records and reports filed by the trustee.

Debts of the Trust. If the trustee is authorized by the trust agreement to mortgage property or to otherwise borrow in the name of the trust, such liabilities of the trust should be recorded. This treatment is similar to the treatment of liabilities entered into by the executor or personal representative of an estate. The recording of the corresponding liability offsets the increase in assets (an increase in accountability). Payment of the debt would be treated similar to debt of a commercial enterprise, except payment would generally be made from Income Cash, unless otherwise specified in the trust agreement or state law.

Administrative Expenses. The level of detail used to record administrative expenses varies depending on the trustee's desire for detail and the required level of reporting by the local jurisdiction. In some instances multiple accounts are used to provide the trustee with additional information about professional and other administrative fees. In estates, debits to the funeral and administrative expense account(s) are charges against Estate Principal in most jurisdictions. However, there is more variability on where administrative expenses should be charged for a trust. Generally, the trust instrument will specify whether such expenses should be charged against principal, income, or divided between the two. If the agreement does not specify the treatment, state law should be followed.

In some states, the principal and income regulations indicate that administrative expenses should be equally divided between principal and income.

Distributions to Beneficiaries. When distributions are made to beneficiaries, the trustee credits the appropriate asset accounts (e.g., principal cash, income cash, personal property, etc.) and debits Distributions of Principal (charge against Trust Principal) for principal beneficiaries or Distributions to Income Beneficiaries (charge against Trust Income) for income beneficiaries.

Other Transactions. The income and principal components of transactions should be recorded to the appropriate accounts. Expenses chargeable to principal should be recorded in the appropriate expenses/distributions of principal account (charges against Trust Principal). Income transactions should be reflected in the appropriate income accounts (closed to Trust Income).

Annual Closing Entry. At the end of the accounting period, all trust income accounts are closed to the Trust Income account by debiting all income accounts, crediting all expense accounts, and either debiting or crediting the Trust Income account.

Final Closing Entries. Several entries are necessary to close the trust, including entries to:

- Close the income and expense accounts to the Trust Income Account (same as annual closing entry).
- Debit the appropriate Distribution of Principal or Distribution of Income account to record all distributions of principal and income assets.
- Debit the Trust Principal and Trust Income accounts and credit the appropriate distribution accounts to close the estate.

Trust Accounting—Example Case Study

The following fiduciary accounting for a trust illustrates the following entries made in the trust's accounting records, including:

- Opening the trust's books.
- Activity during the administration period.
- Closing the trust's books (annual and final closing entries).

Assumptions. In 2001, its first tax year, the Harold Hollis Family Trust had the following receipts and other transactions:

- Received $250,000 in cash from the grantor to fund the trust.
- Invested $40,000 in ABC Mutual Fund, $80,000 in DEF Corporate Bond Fund, and $105,000 in certificates of deposit.
- Received $4,800 in ordinary cash dividends from ABC Mutual Fund.
- Received $6,560 in interest on certificates of deposit.
- Received $4,000 of income from DEF Corporate Bond Fund.
- Paid $1,360 in trustee fees.

The trust instrument states that "All current income is to be distributed monthly to the income beneficiary, Bill Hollis, while he is alive."

According to the trust instrument, upon Bill's death, the entire corpus is to be distributed to Bill's daughter, Betty. The trust instrument does not permit the trustee to make charitable contributions of any kind and it requires the allocation of capital gains and losses to trust corpus. State law requires a trustee's fee to be charged against trust income. The trust instrument indicates that 50% of any other administrative expenses should be charged to principal and 50% to income.

Chart of Accounts. The accountant (and/or trustee) has elected to use the chart of accounts illustrated at Exhibit 2-4 for use in posting transactions to the general ledger and subsidiary ledgers. Entries to record the transactions in the trust's books follow.

Opening Entry. The opening entry to record the beginning of the fiduciary's administration of the trust follows:

dr	101 Principal Cash	250,000	
cr	300 Trust Principal		250,000

To record receipt of trust principal from estate.

Entries to Record Trust Activity. Entries to record the transactions completed by the trustee follow:

1.	dr	103 Stock Mutual Fund	40,000	
	dr	104 Bond Mutual Fund	80,000	
	dr	108 Certificates of Deposit	105,000	
	cr	101 Principal Cash		225,000

To record the purchase of ABC Mutual Fund, DEF Corporate Bond Fund, and certificates of deposit with uninvested principal.

2.	dr	102 Income Cash	4,800	
	cr	701 Dividend Income		4,800

To record cash dividends received (declared after the trust was created).

3.	dr	102 Income Cash	6,560	
	cr	700 Interest Income		6,560

To record interest received on certificates of deposit.

4.	dr	102 Income Cash	4,000	
	cr	700 Interest Income		4,000

To record interest received on DEF Corporate Bond Fund.

5.	dr	806 Trustee Fees	1,360	
	cr	102 Income Cash		1,360

To record payment of trustee fees.

Trial Balance—December 31, 2001. The accountant has prepared the trial balance at Exhibit 2-10 of the trust's general ledger to assist in preparation of the annual closing entry and any necessary adjusting entries.

Exhibit 2-10

Example Trust Trial Balance—Year 1

The Harold Hollis Family Trust
Trial Balance
December 31, 2001

		Debit	Credit
101	Principal Cash	$ 25,000	$
102	Income Cash	14,000	
103	Stock Mutual Fund	40,000	
104	Bond Mutual Fund	80,000	
108	Certificates of Deposit	105,000	
300	Trust Principal		250,000
700	Interest Income		10,560
701	Dividend Income		4,800
806	Trustee Fees	1,360	
		$ 265,360	$ 265,360

* * *

Annual Closing Entry. The accountant has determined that no adjusting entries are necessary. The annual closing entry will close the balances in the income and expense accounts into the Trust Income account.

			Debit	Credit
1.	dr	700 Interest Income	10,560	
	dr	701 Dividend Income	4,800	
	cr	500 Trust Income		14,000
	cr	806 Trustee Fees		1,360

To close accounts related to trust income.

			Debit	Credit
2.	dr	600 Distributions of Income	14,000	
	cr	102 Income Cash		14,000

To record payment of current income to income beneficiaries.

Note: For illustrative purposes, the monthly payment to the income beneficiary is shown in a single entry for the total amount distributed during the year.

Final Closing Entries. At the end of the trust administration, the trustee or accountant would close the trust by recording the annual closing entry followed by the final closing entries discussed previously and illustrated at Exhibit 2-6. In this case, the provisions of the trust agreement indicate that all the remaining assets will be distributed to Bill Hollis' daughter, Betty, upon his death. Assume that Bill dies at the end of 2008. After the year end entry to close the income and expense accounts into the Trust Income account, the accountant prepared the trial balance at Exhibit 2-11 of the trust's general ledger.

Exhibit 2-11

Example Trust Trial Balance

The Harold Hollis Family Trust
Trial Balance
December 31, 2008

		Debit	Credit
101	Principal Cash	$ 18,500	$
102	Income Cash	17,000	
103	Stock Mutual Fund	65,000	
104	Bond Mutual Fund	110,500	
108	Certificates of Deposit	115,275	
300	Trust Principal		250,000
400	Administrative Expenses	5,000	
402	Capital Changes/Gains on Realization		8,560
403	Capital Changes/Losses on Realization	4,850	
500	Trust Income		157,565
600	Distributions of Income	80,000	
		$ 416,125	$ 416,125

*   *   *

The entries to record final distributions and to close the trust are as follows:

1.	dr	405 Distributions of Principal	248,710	
	dr	600 Distributions of Income	77,565	
	cr	101 Principal Cash		18,500
	cr	102 Income Cash		17,000
	cr	103 Stock Mutual Fund		65,000
	cr	104 Bond Mutual Fund		110,500
	cr	108 Certificates of Deposit		115,275

To record the distribution of assets to the beneficiary.

2.	dr	300 Trust Principal	250,000	
	dr	402 Gains on Realization	8,560	
	dr	500 Trust Income	157,565	
	cr	400 Administrative Expenses (Allocable to Principal)		5,000
	cr	403 Losses on Realization		4,850
	cr	405 Distributions of Principal		248,710
	cr	600 Distributions of Income		157,565

To close the remaining accounts in the trust.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

28. Which method or approach is recommended for valuing community property for purposes of the opening entry to the estate books?

    a. The gross method.

    b. The net method.

    c. The asset-based approach.

    d. The market approach.

29. Which of the following would likely be considered a probate asset?

    a. A life insurance policy payable to the decedent's spouse.

    b. A joint bank account with right of survivorship.

    c. A collection of artwork to be liquidated and distributed.

30. Which of the following statements is correct concerning an estate's principal assets and assets subsequently discovered?

    a. Changes in principal assets reflect changes in fiduciary accountability.

    b. Changes in original principal assets should be offset in the Estate Principal account.

    c. Assets subsequently discovered should be valued at decedent's cost.

    d. Assets subsequently discovered should be recorded in the Estate Principal account.

31. Absent contrary provisions in governing documents or state law, how should accruals be handled on the estate books?

    a. Expenses accrued before DOD are payable from income cash.

    b. Income accrued after DOD is allocated equally to both principal and income.

    c. Income accrued before DOD but received after DOD is allocated to principal.

    d. Expenses accrued after DOD are paid from income cash.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

28. Which method or approach is recommended for valuing community property for purposes of the opening entry to the estate books? **(Page 84)**

    a. The gross method. [This answer is correct. The gross method better reconciles community property balances to other documents such as bank statements, mortgages, etc.]

    b. The net method. [This answer is incorrect. The net method reflects only the decedent's interest in community property.]

    c. The asset-based approach. [This answer is incorrect. This is a recognized approach to estate asset valuation, but this does not address the issue of community property on the estate books.]

    d. The market approach. [This answer is incorrect. This is one of three approaches under UFAP used for estate asset valuation, but does not answer the question of recording community property on the books of the estate.]

29. Which of the following would likely be considered a probate asset? **(Page 84)**

    a. A life insurance policy payable to the decedent's spouse. [This answer is incorrect. The beneficiary takes the asset by operation of contract.]

    b. A joint bank account with right of survivorship. [This answer is incorrect. The asset passes by operation of law.]

    c. A collection of artwork to be liquidated and distributed. [This answer is correct. The intent to liquidate and distribute indicates fiduciary action on behalf of the estate. This places the asset under the control and management of the fiduciary.]

30. Which of the following statements is correct concerning an estate's principal assets and assets subsequently discovered? **(Page 86)**

    a. Changes in principal assets reflect changes in fiduciary accountability. [This answer is correct. The fact that estate books reflect fiduciary accountability for assets is one of the reasons advanced to justify not reflecting estate liabilities until they are paid from estate assets.]

    b. Changes in original principal assets should be offset in the Estate Principal account. [This answer is incorrect. Such changes should be reflected separately from their original valuation.]

    c. Assets subsequently discovered should be valued at decedent's cost. [This answer is incorrect. Assets subsequently discovered should be valued at the date of the decedent's death.]

    d. Assets subsequently discovered should be recorded in the Estate Principal account. [This answer is incorrect. Assets subsequently discovered should be recorded separately from those reflected in the original entry.]

31. Absent contrary provisions in governing documents or state law, how should accruals be handled on the estate books? **(Page 89)**

    a. Expenses accrued before DOD are payable from income cash. [This answer is incorrect. Such expenses should be paid from principal cash.]

    b. Income accrued after DOD is allocated equally to both principal and income. [This answer is incorrect. The allocation depends on the date tenancy terminates.]

    c. Income accrued before DOD but received after DOD is allocated to principal. [This answer is correct. Such income belongs to the estate principal.]

    d. Expenses accrued after DOD are paid from income cash. [This answer is incorrect. Allocation depends on when tenancy terminates.]

SPECIFYING THE BASIS OF ACCOUNTING IN THE TERMS OF AN AGREEMENT

Applicability

Many accountants believe a uniform body of knowledge that could be described as GAAP for fiduciary accounting does not exist. They point to the inconsistent application of the Uniform Principal and Income Act and the wide assortment of financial presentations found in practice. They believe because of the ability of the governing document (i.e., the will or trust agreement) to establish unique accounting conventions for each estate or trust that fiduciary accounting records and the resulting financial statements are prepared in accordance with the terms of an agreement.

Authoritative Literature

While accountants who believe that GAAP does not exist for estates and trusts may view maintaining the accounting records on an "agreed-upon basis" as an acceptable basis of accounting, it is more likely that this is an acceptable *reporting* alternative only when the governing document *actually specifies a basis of accounting*. Financial presentations prepared in conformity with an agreement that specifies the basis of accounting do not meet the definition of an other comprehensive basis of accounting (OCBOA) in SAS No. 62 and SSARS No. 1, as amended by SSARS No. 15 (AR 100.04). Accountants should report on the conformity of such statements with the contractual agreement following the guidance in SAS No. 62, *Special Reports*, at AU 623.27–.30, for special-purpose financial statements. Interpretation 28 of SSARS No. 1, *Special-Purpose Financial Statements to Comply with Contractual Agreements or Regulatory Provisions*, at AR 9100.109–.119, contains guidance similar to SAS No. 62 for accountants engaged to compile or review special-purpose financial statements prepared on a basis of accounting specified in a contractual agreement that is not in conformity with GAAP or an OCBOA.

Agreement Specifies Basis of Accounting

Generally, the use of an "agreed-upon basis" is an acceptable *reporting* alternative only when the governing document actually specifies a basis of accounting. The "agreed-upon basis" of accounting used has little or no impact on the actual accounting that occurs for practical purposes. This is true whether (a) the accountant believes that the ability of the governing document to establish unique accounting conventions creates a situation where GAAP does not exist for fiduciary entities, or (b) labeling the basis of accounting according to what is specified in the governing document is more appropriate. Regardless of the actual label given to the basis of accounting (i.e., GAAP or agreed-upon basis), the governing document provides the first level of authority on how transactions are recorded.

OCBOA PRESENTATIONS

What Is an OCBOA?

The conventions, rules, and procedures that define GAAP constitute the comprehensive basis of accounting that is considered the norm. Both accountants and users of financial statements generally expect financial statements to be prepared in conformity with GAAP. However, determining what is GAAP for fiduciary accounting is difficult due to (a) the lack of specific standards addressing fiduciary accounting, (b) inconsistent application of the Uniform Principal and Income Act from state to state, and (c) the ability of the governing document (i.e., the will or trust agreement) to establish unique accounting conventions for each estate or trust. As a result, use of other comprehensive bases of accounting (OCBOA), for example, the income tax basis and the cash basis, are used as a basis of accounting for estates and trusts in certain circumstances.

Authoritative Literature. The FASB and its predecessors have not addressed measurement or disclosure for OCBOAs. Those standards-setting bodies have been primarily concerned with issues regarding financial statements intended for use in making investment decisions by the general public, and they have restricted their deliberations to the development of GAAP. As a result, the only references to OCBOAs in existing literature appear in Statements on Auditing Standards (SAS) and Statement on Standards for Accounting and Review Services (SSARS).

SAS No. 62, *Special Reports*, recognizes certain OCBOAs that may serve as the framework for an opinion on audited financial statements. SSARS No. 1, *Compilation and Review of Financial Statements*, also recognizes those OCBOAs for compiled and reviewed financial statements. Those OCBOAs are described as follows in SAS No. 62, Paragraph 4:

- Pure cash basis—the cash receipts and disbursements basis of accounting.
- Modified cash basis—modifications of the pure cash basis having substantial support.
- Tax basis—a basis of accounting that the reporting entity uses, or expects to use, to file its income tax return for the period covered by the financial statements.
- Regulatory basis—a basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a government regulatory agency to whose jurisdiction the entity is subject.
- Other basis—a definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

SSARS No. 1, as amended by SSARS No. 15, (AR 100.04), includes similar definitions for compiled or reviewed financial statements.

Can an OCBOA Be Used by an Estate or Trust?

The basis of accounting that an estate or trust uses to maintain its accounting records and/or to prepare its financial statements or other presentations generally is determined by:

- The basis, if any, specified in the governing document.
- State law.
- Accounting conventions that many accountants believe comprise GAAP for fiduciary entities.
- The needs of the users of the financial presentations.

Those factors, individually or in combination, can create instances where a fiduciary entity may choose to use an OCBOA for accounting and financial presentation purposes. In addition to the cash and tax basis of accounting, SAS No. 62 and SSARS No. 1, as amended by SSARS No. 15, describe two other OCBOAs: (a) regulatory basis and (b) other definite sets of criteria having substantial support. These two bases are *not* considered appropriate bases of accounting for fiduciary entities for the following reasons:

- *Regulatory Basis.* Both SAS No. 62 (AU 623.04) and SSARS No. 1 (AR 100.04) indicate that the regulatory basis is "a basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject." Examples of the regulatory basis include:
    - a uniform system of accounts that the Interstate Commerce Commission requires railroad companies to use.
    - the statutory accounting practices used by insurance companies pursuant to the rules of state insurance commissions.
    - the regulatory accounting practices used by credit unions.
    - the basis used by contractors in submitting state prequalification reports as a condition for bidding or working on government projects.

  Although fiduciary entities may be required to submit financial information to federal, state, or local agencies or jurisdictions (e.g., IRS, probate court or other jurisdiction), they are not considered to be regulated entities nor is their basis of accounting considered to be a regulatory basis. Fiduciary entities may maintain records and prepare financial presentations in conformity with an agreement. However, such presentations prepared on an "agreed-upon basis" or a contractual basis do not meet the definition of the regulatory basis of accounting in SAS No. 62 and SSARS No. 1 and should not be treated as regulatory basis records or financial presentations.

- *Other Basis.* Another type of OCBOA under SAS No. 62 (AU 623.04) is "a definite set of criteria having substantial support that is applied to all material items appearing in financial statements." The price-level basis of accounting is the only example of such an OCBOA explicitly mentioned in SAS No. 62. Some accountants have questioned whether the fiduciary accounting principles represent a basis of accounting that meets the SAS No. 62 requirements to be treated as an OCBOA. While some accountants view such accounting as GAAP or a basis specified in an agreement, others question whether such fiduciary accounting principles may be an OCBOA because they constitute a definite set of criteria having substantial support that is applied to all material items. Others believe that fiduciary accounting principles are not a definite set of criteria and lack substantial support because of the inconsistent application of the Uniform Principal and Income Acts and the ability of the governing document to establish unique accounting conventions. It is believed that classification of fiduciary accounting as an "other basis" under SAS No. 62 is inappropriate.

Cash Basis of Accounting

Authoritative Literature. SAS No. 62, *Special Reports*, at AU 623.04 states that acceptable other comprehensive bases of accounting include the "cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support." SSARS No. 1 (AR 100.04) includes a similar definition. One reason that the cash basis is a commonly used OCBOA for some entities is that entities often prepare cash basis financial statements more quickly and efficiently than GAAP or income tax basis financial statements. In addition, users of the financial statements may be able to understand cash basis financial statements more easily than financial statements prepared on another basis of accounting.

Entities that use the pure cash basis of accounting typically have the following characteristics:

- They are not profit oriented.
- Their operations are simplistic.
- Their accounting and finance functions are unsophisticated.
- There is only one major activity.
- Capital expenditures and long-term financing are not significant.

While some small estates or trusts may have many of these characteristics, use of the pure cash basis of accounting is usually not appropriate for fiduciary entities.

Considerations for Pure Cash Basis Fiduciary Entities. Under both SSARS No. 1 (AR 100.04) and SAS No. 62 (AU 623), the "cash basis of accounting" refers to the "pure" or "unmodified" cash basis. Under that basis of accounting, the financial statements reflect only transactions affecting cash or cash equivalents. The pure cash basis treats all receipts of cash as cash increases and all disbursements of cash as cash decreases. (For example, proceeds from maturing investments and interest are recorded when received and cash purchases of investments are reflected as expenditures, not assets, when paid.) In addition, noncash transactions such as charges against income (versus principal) for depreciation, as allowed by section 13(a)(2) of the Uniform Principal and Income Act, are not recorded since they do not affect cash or cash equivalents. Although fiduciary accounting uses cash basis recognition principles in many areas (for example, liabilities), generally the pure cash basis of accounting rarely results in fiduciary accounting in accordance with the governing document and/or state law. Accordingly, the pure cash basis of accounting usually is not considered appropriate for trusts and estates.

Considerations for Modified Cash Basis Fiduciary Entities. Both SSARS No. 1 (AR 100.04) and SAS No. 62 uses the term "cash basis" to describe the pure cash basis of accounting. Because the pure cash basis of accounting is used infrequently in practice, many accountants use the term "cash basis" to refer to modifications of the pure cash basis. The modified cash basis of accounting is described by SAS No. 62 (AU 623.04) and SSARS No. 1 (AR 100.04) as the pure cash basis incorporating "modifications of the cash basis having substantial support."

Issues Relating to Modified Cash Basis of Accounting for All Entities. The appropriate "modifications of the cash basis having substantial support" and the extent of those modifications are not clearly defined in the literature. SAS No. 62 does not elaborate on the definition of *substantial support* and SSARS No. 1 (AR 100.04) offers only limited guidance (as discussed in the next paragraph). Accordingly, some accountants choose not to prepare modified cash basis financial statements. Instead, they encourage entities wanting to use an OCBOA to use the pure cash basis of accounting, which is based solely on cash receipts and disbursements, or the income tax basis of accounting, which follows a specified set of regulations.

SSARS No. 1 (AR 100.04) and Technical Practice Aid (TPA) TIS 1500.05 offer some clarification of the term *substantial support*. According to both, a modification of the pure cash basis has substantial support if both of the following conditions are met:

a. *It Is Equivalent to the Accrual Basis of Accounting for the Particular Item.* Both AR 100.04 and the TPA seem to use the term "accrual basis of accounting" to mean GAAP. For example, both state that if the modifications are so extensive that the statements are in substance "on the accrual basis, the statements should be considered GAAP basis."

   This creates a quandary for fiduciary accounting since cash basis, not accrual basis, recognition principles are generally used. It is believed that fiduciary accounting records may be maintained on the modified cash basis and can present assets and liabilities based on cash (or modified cash) basis recognition principles. However, the modifications to the pure cash basis should not be so extensive that the accounting records (or financial statements) no longer reflect a cash orientation.

b. *It Is Not Illogical.* While neither AR 100.04 nor the TPA provide guidance on when modifications are illogical, the TPA gives as an example of an illogical modification "recording revenue on the accrual basis and recording purchases and other costs on the cash basis." (That assumes, of course, that items such as inventory, accounts payable, and accrued expenses are material.)

Issues Relating to Modified Cash Basis of Accounting for Estates and Trusts. Accountants may label the basis of accounting for trusts and estates as the modified cash basis of accounting. It is believed the language in governing documents and state statutes often contemplates the modified cash basis of accounting. For example, although a basis of accounting may not be formally specified, state statutes often use language such as "cash receipts" and "cash disbursements." Absent language to the contrary in the governing document, an informal poll indicated most fiduciary accountings are prepared using the modified cash basis of accounting in those states with statutes that have the type of language referred to in the preceding sentence. Such modified cash basis presentations are often considered to be GAAP in the relevant jurisdiction. It is believed state statutes often constitute substantial support for modifying the cash basis of accounting.

Under the modified cash basis of accounting, certain transactions are recorded on the accrual basis and other transactions on the cash basis. However, evaluation of such modifications is not clear for fiduciaries since GAAP is not well defined for trusts and estates. Thus, many accountants do not feel comfortable referring to estate or trust financial statements as modified cash basis financial statements. Other accountants present modified cash basis financial statements similarly to commercial entities. For example, they typically record assets at historical cost or fair value (depending on the type of asset), capitalize property and equipment, and record current and long-term liabilities. It is believed there is no single answer to the issue of which modifications to the cash basis are appropriate because of the varying interpretations of GAAP for fiduciaries, the diverse report requirements included in governing documents and/or state law, and the varying needs of financial statement users.

As a practical matter, financial statements prepared on the entity's tax basis may provide essentially the same information as cash basis statements modified for the types of transactions discussed in the preceding paragraph. That often occurs since trusts and estates generally use the cash basis of accounting for tax purposes. In those situations, some accountants choose to identify and report on the financial statements as income tax basis financial statements rather than modified cash basis financial statements. Identifying and reporting on the statements as income tax basis financial statements eliminates the need to evaluate the appropriateness of modifications to the pure cash basis. However, best practices indicate that accountants should not casually substitute the tax basis for the modified cash or other bases of accounting for fiduciary entities for the following reasons:

- Use of the tax basis would rarely be appropriate for court accountings, unless such basis was specified in the governing document.
- Tax basis presentations may include assets not recognized by the administrable estate.
- The tax basis of certain assets is different than fiduciary acquisition value, which is the basis of assets in fiduciary accountings.

The most common modifications for trusts and estates using the modified cash basis of accounting result from reporting liabilities on the accrual basis (e.g., debts of the estate) or capitalizing noncash assets such as property and equipment and mineral interests. However, there are other variations. Also, in many instances, the same accounting records may be identified as modified cash basis by some accountants and GAAP basis by others due to the lack of a clear definition of GAAP for estates and trusts. The following are some of the issues unique to trusts and estates that prepare modified cash basis financial statements:

- *Assets over Which the Fiduciary Has No Management and Control.* Best practices indicate trusts or estates that modify the pure cash basis to include assets over which the fiduciary has no management or control should record such assets at their "fiduciary acquisition value," which represents market value on the date assets are transferred to the fiduciary (or cost for assets purchased). Presumably, the intent behind presenting these assets in the financial statements is to provide a more complete accounting to financial statement users about the trust or estate's assets. Accounting conventions that are generally considered GAAP for fiduciaries exclude such assets from any statements prepared.
- *Property, Equipment, and Other Noncash Assets.* Property, equipment, and other noncash assets may be transferred to or purchased by the fiduciary. If the trust or estate decides to record transfers and acquisitions of such assets, best practices indicate they should capitalize all such acquisitions in accordance with the governing document and/or state law. Generally, this results in recording the assets at their fiduciary acquisition value. While recording such assets is a modification of the pure cash basis, it is not a modification from what is generally considered GAAP for trusts and estates.
- *Current and Long-term Liabilities.* If the pure cash basis is modified to recognize liabilities, accountants should consider whether the approach is consistent with the reporting objectives of the presentation. Such modifications should generally be evaluated in terms of whether they comply with the accrual basis of accounting [which SSARS No. 1 (AR 100.04) and Technical Practice Aid TIS 1500.05 seem to equate with GAAP] and are logical. However, accounting conventions that are generally considered GAAP for fiduciaries would result in liabilities being recognized on a cash basis (that is, when payment is made).

Income Tax Basis of Accounting

Authoritative Literature. SAS No. 62 (AU 623.04) and SSARS No. 1 (AR 100.04) state that the basis of accounting an entity "uses or expects to use to file its income tax return" is an other comprehensive basis of accounting. That basis, referred to as the income tax basis of accounting, typically is based on federal income tax laws found in the Internal Revenue Code and related revenue rulings, regulations, and procedures. Since income tax laws deal with the determination of taxable income, they focus primarily on the measurement of revenues and expenses and, in some cases, on the determination of the basis of assets and liabilities. However, income tax laws generally do not address financial statement presentation or disclosure considerations.

Considerations for Income Tax Basis Fiduciary Entities

The estate of a deceased person is a separate taxable entity from the individual. Likewise, a trust is generally a separate taxable entity from its grantor. Estates and trusts must file the following tax returns:

a. Form 706 [United States Estate (and Generation-Skipping Transfer) Tax Return] is used to determine and report a decedent's estate tax liability. Federal estate tax is imposed on the transfer of an individual's property at death and certain other transfers considered the equivalent of a transfer at death. The "gross estate" subject to tax can contain a variety of property interests, including life insurance, jointly owned property, and under certain circumstances, property the decedent gave away before death. Generally, a decedent's estate is required to file Form 706 if the value of the gross estate meets or exceeds $3.5 million in 2009. Form 706 summarizes the decedent's taxable estate, including the gross estate and allowable deductions (balance sheet only presentation). The 2001 Tax Act repeals the estate tax effective for decedents dying in 2010. Prior to repeal, the Act provides for a gradual increase in the applicable *credit* amount for estate tax purposes to a maximum of $1,455,800 by 2009.

b. Form 1041 (U.S. Income Tax Return for Estates and Trusts) is used by the fiduciary of a domestic estate, trust, or bankruptcy estate to report (a) the income received by the estate or trust, (b) whether that income is accumulated and held for future distribution or distributed currently to the beneficiaries, and (c) any applicable tax liability of the fiduciary. IRC Section 6012 prescribes the federal income tax return filing requirements for estates and trusts.

An arrangement referred to as a "trust" or an "estate" may not always be treated as such for tax purposes. Conversely, Reg. 1.6012-3(a) generally requires every fiduciary (or at least one of joint fiduciaries) to file Form 1041. Generally, when an organization (e.g., a bank) or individual is vested with broad discretionary powers of administration and management, a fiduciary relationship exists, and Form 1041 must be filed.

For estates and trusts electing to use the tax basis of accounting, it is believed such fiduciary entities should base their tax basis financial statements on the requirements of the form they expect to file. Following this logic, estates or trusts not required to file a return with the IRS may not prepare income tax basis financial statements since the fiduciary entities do not "use" or "expect to use" the basis of accounting to file a tax return. In that case, use of the tax basis for accounting purposes would not be appropriate. Best practices indicate income tax basis statements are rarely prepared for estates due to their relatively short duration. Subject to several exceptions, the IRS presumes that an estate's administration has been "unduly prolonged" if the estate remains open more than two years after the decedent's death. As with an estate, the winding up of a trust cannot be unduly prolonged. However, trusts may have a long-term existence before termination. Generally, the determination of whether a trust has terminated for income tax purposes depends upon whether the property held in trust has been distributed to the beneficiaries rather than on technicalities, such as whether the trustee has rendered a final accounting.

The guidance in the following paragraphs applies to situations in which the tax basis of accounting is used to record information that will be reported in Form 706 for estates or Form 1041 for estates or trusts. Note that the federal income tax return of an estate or trust may include assets not recognized by the administrable estate, and those not included in accounting records prepared in accordance with the previously mentioned basis of accounting alternatives.

Accounting Methods. The fiduciary of a trust or estate may choose the accounting methods to be used by the entity in Form 1041, regardless of the methods used by the grantor or decedent. That allows the fiduciary to terminate an undesirable method used by the decedent or grantor. However, the accounting methods selected must be used consistently and must clearly reflect income. Accounting methods include not only the overall method, such as cash or accrual, but also the special methods used to determine the tax treatment of specific items.

Similar to individuals, most fiduciary entities use the cash basis method of accounting. However, similar to commercial business entities, the accrual method is required when the production, purchase, or sale of merchandise is a material income-producing factor, regardless of whether inventory is physically on hand at year-end. The accrual method would be required, for example, when an estate continues to operate an accrual-basis manufacturing proprietorship owned by the decedent. That may result in using a hybrid overall accounting method if the accrual method is used for purchases and sales, and the cash method is used for other items of income and expense.

Form 1041 Considerations. Fiduciary accounting income, although not a tax concept, is nevertheless required to be disclosed by trusts (but not estates) within Form 1041. Estates are only required to show taxable income on Form 1041; however, the fiduciary must determine fiduciary accounting income for distribution purposes, and such distributions are reflected on the tax return. While fiduciary accounting income must be determined in accordance with the governing document and/or state law, the tax law must be complied with regardless of the provisions of the governing document or state law. Tax considerations for estates and trusts are essentially the same as that of an individual, with a few exceptions. Major exceptions include the following:

- *Personal Exemption.* The personal exemption deductible for estates, simple trusts, and complex trusts are $600, $300, and $100, respectively. In contrast, the personal exemption for individuals is $3,650 in 2009. Also, there is no phase-out of the exemption when income exceeds a threshold amount, as in the case for individuals.

- *Charitable Contributions.* Deductions for charitable contributions are unlimited at the trust and estate level.

The income of an estate or trust is taxed to either the estate or trust itself, to its beneficiaries, or in part to each. Generally, beneficiaries are taxed only on the distributions received or distributable. In addition, the estate or trust receives a special deduction for amounts taxable to but not actually distributed to the beneficiary.

Tax basis statements may be substantially identical to modified cash basis financial statements. This often occurs since trusts and estates generally use the cash method of accounting. However, it is believed that practitioners must carefully evaluate the reasons for using the tax basis of accounting instead of the modified cash basis for fiduciary entities.

Accounting Considerations for Estates. Assets included in an estate generally receive a step-up in basis. That is, they are valued at fair market value (FMV) on the decedent's date of death (or alternate valuation date) rather than at the decedent's tax basis. However, property representing income in respect of the decedent (IRD) is not "stepped up" to fair market value. See earlier discussion concerning IRD. After initial recording, the estate's assets, liabilities, income, and expenses generally are measured by following (a) fiduciary accounting principles for allocating receipts and disbursements to principal and income, and (b) tax conventions for individuals, with some exceptions. The following provides additional guidance for determining the value of an estate's assets and liabilities on the date the estate is created:

a. *Real Estate.* Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having knowledge of relevant facts. In the case of real estate, the FMV is determined based on the property's highest and best use, not its actual use. That means that if closely held business real property, including farm property, included in the decedent's estate has a greater value for residential or industrial purposes than it does as actually used, the value of the property for estate tax purposes will be based upon its higher and better use. However, if certain detailed requirements are met, the executor can elect to value qualified real property included in a decedent's gross estate that is used for farming or other trade or business purposes based on its current use, rather than its FMV based on its highest and best use. (The election is referred to as the *special use valuation election* and can serve to reduce the estate's tax liability.)

   If the real property is sold during the estate's administration and the date of sale is shortly after the valuation date, the realized sales price will ordinarily be considered more indicative of value than any of the appraised valuations. However, if the executor can document that there has been a major change in the market after the valuation date and before the date of sale, resulting in a higher sales price than the appraised valuation, the IRS may agree that the appraised valuation was correct.

   Generally, there are three recognized methods for valuing real property—the cost method, the income capitalization method, and the comparable sales method.

b. *Oil and Gas Properties.* When valuing mines, oil and gas wells, and other natural deposits, the IRS regulations consider all factors having a bearing on the market value such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, valuation for local and state taxation purposes, partnership accountings, litigation records, probate court appraisals, and disinterested party appraisals by an approved method. In addition, the fair market value (FMV) of mineral properties and improvements valued on a specific date (e.g., date of death), must be determined in light of the conditions and circumstances known on that date, regardless of later discoveries or developments or later improvements in methods of extraction and treatment of the mineral products. The courts also consider many other factors when determining the value of an oil and gas interest including reserves bypassed when drilling the hole, reserves that may be below the present producing sands, salvage rights to the equipment upon abandonment of the well, and whether or not the owner of the interest can be the operator of the working interest.

Common methods for determining the value of an oil and gas interest include computing the present value of the projected income stream or other analytical appraisal methods. The regulations state that the present value methods cannot be used, however, if mineral property and improvements can be valued on the basis of cost or comparative values and replacement value of equipment, or when the FMV can be determined by any method other than an analytical method.

c. *Investments.* When the value of stocks is listed on an exchange, the valuation process consists of locating the security's value in a financial publication. However, when securities are not traded on an open market (e.g., closely held stock), the services of a professional appraiser may be required to establish the security's value. In either event, a valuation discount or premium may be appropriate if the decedent held a minority interest or controlling interest, or the securities were subject to restrictions.

d. *Cash.* The FMV of cash in the decedent's possession (including cash found in a safety deposit box or deposited in a bank) is its face value. Collectible coins and currency with a value in excess of face value (e.g., gold or silver coins) are reported at their higher value. Foreign currency is valued in U.S. dollars, based on the official exchange rate on the valuation date.

e. *Certificates of Deposit.* Certificates of deposit (CDs) are included at the principal amount of the CD plus unpaid interest. No discount is allowed for early withdrawal penalties because they are not imposed for early withdrawals resulting from the death of the owner.

f. *Checking Accounts.* Checking accounts may be reported on the income tax basis using either the gross or the net method. Under the gross method, the balance in the checking account on the decedent's date of death is reported before any adjustments for outstanding checks. Outstanding checks that represent obligations of the decedent are recorded separately [and are deductible on Form 706 (see item h.)]. The net method reports the balance of the checking account adjusted for outstanding checks issued for bona fide obligations of the decedent.

g. *Life Insurance.* Proceeds of life insurance on the decedent's life are included in the gross estate if they are receivable by the estate (that is, the insured's estate is the named beneficiary of the policy) or by another for the benefit of the estate. Proceeds not receivable by or for the benefit of the estate may also be included if the decedent possessed incidents of ownership in the policy (that is, the insured or the insured's estate has a right to the economic benefits of the policy).

h. *Liabilities.* For purposes of preparing the Form 706, estates are permitted to record (deduct) claims representing personal obligations of the decedent that existed and were legally enforceable at the time of death, whether matured or unmatured. That includes unsecured notes, claims for services provided, and contracts for the purchase of property. In addition unpaid taxes and mortgages and other debts on property may be recorded (deducted).

Alternate Valuation Date. Under some circumstances, an executor can choose to value the decedent's assets on either the date of death, or the alternate valuation date, which is six months after the date of death [IRC Sec. 2032(a)]. However, if property is sold, exchanged, distributed, or disposed of between the date of death and six months after death, the date of disposal becomes the alternate valuation date.

The primary benefit of electing the alternate valuation date is the estate (and possibly generation-skipping transfer) tax savings that result from lowering the overall value of the property included in the estate when the total value of the estate assets has declined between the date of death and six months later. However, this election can only be made if it decreases both (a) the value of the decedent's gross estate and (b) the amount of federal estate tax after reductions for all allowable credits. While it is possible to elect to use the alternate valuation date when some assets have decreased in value and others have increased, there must be a net decrease in order to make the election.

Before the election is made, several issues should be considered to determine how they affect the benefits gained from making the election. An important consideration is the potential conflict among the estate's beneficiaries. Most property received from a decedent receives a basis equal to its fair market value (FMV) at the date of death. However, if the alternate valuation date is elected, the property's basis equals its value on this latter date. Typically, the election causes a net tax savings because the marginal estate tax bracket usually is greater than the estate's or beneficiary's income tax bracket. In some situations, however, the estate tax savings achieved for the lower estate tax basis might be offset by an increased income tax liability when the inherited property is sold by the beneficiary. This is particularly true if the beneficiary is contemplating selling the property relatively soon after receiving it.

Typically, if the overall value of the estate drops between the date of death and the alternate valuation date, some of the estate's assets will have increased in value while others will have decreased. In addition, some of the estate's assets will probably be sold quickly, while others may never be sold or are not likely to be sold until after passing through another estate (e.g., at the death of a surviving spouse) and receiving a step-up in basis. Thus, the decision to make the alternative valuation election normally requires more than just calculating the estate tax savings and the income tax costs for the estate and beneficiaries in aggregate. The election's effect on each major asset or group of assets generally should be considered separately.

Basis Considerations under the 2001 Tax Act. The 2001 Tax Act partially repeals the step-up in basis for most assets received from a decedent, along with the estate tax system, effective for decedents dying in 2010. The step-up in basis is replaced with modified carryover basis provisions. Under these provisions, property transferred at the decedent's death generally will receive a basis equal to the lesser of the decedent's adjusted basis or the property's fair market value (FMV) on the date of the decedent's death (i.e., no step-up). However, a decedent's estate generally will be permitted to increase the basis of appreciated assets transferred by up to a total of $1.3 million. The $1.3 million is increased by the amount of unused capital losses, net operating losses (NOLs), and various other losses of the decedent. In addition, the basis of appreciated property transferred to a surviving spouse can be increased by an additional $3 million. No step-up is allowed for property that is considered income in respect of a decedent (IRD).

Accounting Considerations for Trusts. In general, trusts only pay tax on income accumulated in the trust. When distributions of income are made to beneficiaries, the trust is treated as a conduit for income tax purposes. Instead of paying tax on distributed income, the income and deductions are taxed to the beneficiaries to the extent they receive income from the trust. Unlike estates, assets transferred to a trust do not always receive a step-up in basis. Instead, they generally are recorded at the donor's tax basis. Consequently, measurement issues for a trust's tax basis financial statements are similar to those for individuals. The determination of the tax basis of assets depends on:

- the type of trust.
- how the property was acquired (e.g., transfers during life, after death through a will, by gift, or other means).
- the nature of the asset.

The following provides additional guidance for determining the basis of trust assets for tax purposes:

- *Grantor Trusts*—for example, revocable inter vivos (living) trusts. A grantor trust is generally ignored for tax purposes and all income and deductions are reported on the grantor's individual tax return. For transfers during the grantor's lifetime, the basis of the assets is the same as the donor's basis at the time of transfer. In other words, the assets do not receive a step-up in basis. At the date of death, the trust becomes irrevocable and the assets would be valued at fair market value on the decedent's date of death or the alternate valuation date, if elected. Although the trust assets are not included in the probate estate at the decedent's death, they are a part of the taxable estate.
- *Nongrantor Trusts:*
  - *Assets Acquired by Gift.* For assets acquired by gift (whether by a transfer in trust or otherwise), the basis of such assets, for the purpose of recording and for determining gains is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. However, an adjustment is required if the donor incurred a gift tax when making the gift. In that case, the adjusted tax basis of the donated asset is increased by the amount of any gift tax paid that is attributable to

appreciation in the asset's value while held by the donor. The same rule applies in determining loss unless the basis is greater than the fair market value of the property at the time of the gift. In those cases, the basis for determining loss is the fair market value at the time of the gift.

- *Assets Received through a Will.* When assets are received by a trust from an estate, the tax basis to the trust is the same as its basis within the estate. This represents the estate's stepped-up basis, which means that the assets are valued at fair market value on the decedent's date of death or the alternate valuation date (see earlier discussion), if elected. This is sometimes referred to as the estate tax value. Similar to estates, assets representing income in respect of the decedent (IRD) is not "stepped up" to fair market value.

- *Assets Purchased by the Trust.* When assets are purchased by the trust, the tax basis to the trust is its historical cost.

Depreciation, Depletion, and Amortization. For purposes of Form 1041, fiduciaries are allowed a depreciation, depletion, or amortization deduction only to the extent the deduction is not allowed to the current income beneficiaries. If property is held in trust, the allowable deductions for depreciation and depletion are apportioned among the current income beneficiaries and the trust on the basis of the trust income allocable to each, unless the governing document (or state law) requires or permits the trustee to maintain a reserve and the reserve is, in fact, maintained. In that case, the tax deduction is first allocated to the trust to the extent income is set aside for the reserve, and any excess deduction is allocated among the income beneficiaries in the same manner as trust accounting income. For estates, the deduction is apportioned between the estate and its distributees on the basis of the estate's income allocable to each.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. What is the first level of authority governing the recording of estate transactions?

    a. Federal law.

    b. UPIA.

    c. Governing document.

    d. GAAP.

33. FASB has issued a fairly exhaustive amount of guidance concerning the use of OCBOAs.

    a. True.

    b. False.

34. Which of the following bases of accounting is **not** considered appropriate for estate accounting?

    a. Tax.

    b. Cash.

    c. Regulatory.

    d. Governing document.

35. Which fiduciary statement basis is usually easiest to prepare and easiest for users to understand?

    a. OCBOA.

    b. GAAP.

    c. Tax.

    d. Cash.

36. Which of the following statements is correct concerning the use of the cash basis in fiduciary accounting?

    a. Investments are reflected as expenditures under the modified cash basis.

    b. SAS 62 describes both the pure cash and the modified cash bases of accounting.

    c. Depreciation is not recorded, even when allowed by UPIA.

    d. The pure cash basis is preferred over the modified cash basis.

37. Which of the following was **not** mentioned in the text as a reason to exercise caution when substituting tax basis for a different OCBOA?

    a. Tax basis follows a specific set of regulations.

    b. Tax basis is generally not appropriate for court accountings.

    c. Tax basis presentations may include nonprobate assets.

    d. Tax basis asset value may differ from fiduciary acquisition value.

38. What is one of the reasons advanced by the text for excluding nonprobate assets from fiduciary statements?

    a. Excluding such assets presents a more complete picture of estate assets.

    b. Fiduciary statements indicate the level of estate accountability.

    c. Nonprobate assets are excluded from fiduciary-prepared income tax filings.

    d. Accounting conventions considered GAAP exclude nonprobate assets from statements.

39. Which of the following is correct concerning estate tax filings?

    a. All estates are required to file estate tax return Form 706.

    b. Estate income tax return Form 1041 is not required if income is distributed.

    c. Estate tax return Form 706 includes gifts given away before death.

    d. Estate tax is not due if the DOD occurs in 2009.

40. For federal tax purposes, which of the following is **not** considered a recognized method of valuing estate real property?

    a. The cost method.

    b. Highest and best use method.

    c. The income capitalization method.

    d. The comparable sales method.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

32. What is the first level of authority governing the recording of estate transactions? **(Page 112)**

    a. Federal law. [This answer is incorrect. Other than federal tax law, most governmental guidance concerning fiduciary accounting is found at the state level.]

    b. UPIA. [This answer is incorrect. The UPIA is secondary in the hierarchy.]

    c. Governing document. [This answer is correct. The governing documents, expressing the will of the creator, is primary authority governing the recording of fiduciary transactions.]

    d. GAAP. [This answer is incorrect. GAAP is important, but other authority takes precedence in fiduciary accounting.]

33. FASB has issued a fairly exhaustive amount of guidance concerning the use of OCBOAs. **(Page 112)**

    a. True. [This answer is incorrect. FASB has been more concerned with presentation of financial information in accordance with GAAP.]

    b. False. [This answer is correct. However, one can find authoritative literature concerning OCBOAs within certain Statements on Auditing Standards and Statements on Standards for Accounting and Review Services.]

34. Which of the following bases of accounting is not considered appropriate for estate accounting? **(Page 113)**

    a. Tax. [This answer is incorrect. Although not the predominant choice, the tax basis may be appropriate for estate accounting in some circumstances.]

    b. Cash. [This answer is incorrect. The cash, or modified cash, basis may be considered appropriate for estate accounting in certain situations.]

    c. Regulatory. [This answer is correct. This basis of accounting is used to comply with reporting requirements of certain governmental regulatory agencies such as the Interstate Commerce Commission, and have no relevance to fiduciary accounting.]

    d. Governing document. [This answer is incorrect. Under normal circumstances, the basis specified in the governing document is always controlling for estate accounting.]

35. Which fiduciary statement basis is usually easiest to prepare and easiest for users to understand? **(Page 114)**

    a. OCBOA. [This answer is incorrect. OCBOA, per se, is not a basis of accounting.]

    b. GAAP. [This answer is incorrect. Standard GAAP presentations may be affected by UPIA and other considerations.]

    c. Tax. [This answer is incorrect. Although there can be some advantages to preparation of fiduciary statement on the tax basis, ease of preparation and user comprehension are not necessarily among them.]

    d. Cash. [This answer is correct. Cash, or modified cash, basis preparations are usually easier for fiduciaries to prepare and for users to understand because noncash transactions, such as charges against income for depreciation, are not recorded.]

36. Which of the following statements is correct concerning the use of the cash basis in fiduciary accounting? **(Page 114)**

   a. Investments are reflected as expenditures under the modified cash basis. [This answer is incorrect. Investments are reflected as assets under the modified cash basis.]

   b. SAS 62 describes both the pure cash and the modified cash bases of accounting. [This answer is correct. SAS No. 62 describes both of these bases of accounting. Additional information is found in SSARS No. 1.]

   c. Depreciation is not recorded, even when allowed by UPIA. [This answer is incorrect. This would be the case under the pure cash basis, but depreciation may be recorded under the modified cash basis in certain circumstances, i.e. when required by governing documents or state law.]

   d. The pure cash basis is preferred over the modified cash basis. [This answer is incorrect. According to the text, the pure cash basis may result in fiduciary accounting that does not comply with the governing document or state law, and is usually not acceptable for fiduciary accounting.]

37. Which of the following was **not** mentioned in the text as a reason to exercise caution when substituting tax basis for a different OCBOA? **(Page 115)**

   a. Tax basis follows a specific set of regulations. [This answer is correct. Tax basis eliminates the need to determine the appropriateness of a modification from pure cash basis and may be viable in certain situations.]

   b. Tax basis is generally not appropriate for court accountings. [This answer is incorrect. The governing document may require otherwise, however.]

   c. Tax basis presentations may include nonprobate assets. [This answer is incorrect. Presentations prepared according to the tax basis may include assets outside the management and control of the fiduciary.]

   d. Tax basis asset value may differ from fiduciary acquisition value. [This answer is incorrect. Fiduciary acquisition value is the basis of assets in fiduciary accountings. Normally, this is the value at date of transfer, or acquisition cost if purchased.]

38. What is one of the reasons advanced by the text for excluding nonprobate assets from fiduciary statements? **(Page 116)**

   a. Excluding such assets presents a more complete picture of estate assets. [This statement is incorrect. Including both probate and nonprobate assets may present a more complete picture of estate assets.]

   b. Fiduciary statements indicate the level of estate accountability. [This answer is incorrect. Fiduciary statements indicate the level of fiduciary accountability.]

   c. Nonprobate assets are excluded from fiduciary-prepared income tax filings. [This answer is incorrect. Nonprobate and probate asset dispositions are included by the fiduciary for income tax filings.]

   d. Accounting conventions considered GAAP exclude nonprobate assets from statements. [This is correct. The body of support considered GAAP for fiduciary accounting excludes nonprobate assets from fiduciary statements since these assets are not under the control and management of the fiduciary.]

39. Which of the following is correct concerning estate tax filings? **(Page 116)**

    a. All estates are required to file estate tax return Form 706. [This answer is incorrect. Estates not meeting the gross valuation requirement are not required to file Form 706.]

    b. Estate income tax return Form 1041 is not required if income is distributed. [This answer is incorrect. All estate income is to be reported, whether or not distributed.]

    c. Estate tax return Form 706 includes gifts given away before death. [This answer is correct. The gross estate subject to tax may indeed include inter vivos gifts in certain circumstances.]

    d. Estate tax is not due if the DOD occurs in 2009. [This answer is incorrect. The 2001 Tax Act repealed estate tax beginning with those dying in 2010.]

40. For federal tax purposes, which of the following is **not** considered a recognized method of valuing estate real property? **(Page 118)**

    a. The cost method. [This answer is incorrect. The cost method is one of several recognized methods of valuing estate real property.]

    b. Highest and best use method. [This answer is correct. This is not a method, it is rather a philosophy used to apply a method. Basically stated, property is valued at the greater of its highest and best use, or its actual use.]

    c. The income capitalization method. [This answer is incorrect. This method is one of three recognized methods for valuing real property of the estate.]

    d. The comparable sales method. [This answer is incorrect. The comparable sales method is among the methods recognized for valuing estate real property.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (AETTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

23. If the governing documents are silent and GAAP does not otherwise appear to be specified or implied, which basis of accounting would a court of law most likely prefer concerning an estate or trust?

    a. Accrual basis.

    b. Modified cash basis.

    c. Tax basis.

    d. Agreed-upon basis.

24. While an executor is appointed by governing documents, an administrator is appointed by the court. As such, a court appointed fiduciary must be either a CPA or an attorney.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

25. Which of the following is correct concerning fiduciary accounting objectives?

    a. There are three main objectives of fiduciary accounting.

    b. Performance accounting requires uniformity for comparison to industry standards.

    c. Discharge accounting provides a review of fiduciary actions.

    d. Performance accounting is unnecessary in short duration situations.

26. Which of the following is **not** one of the valuation methods included in UFAP?

    a. Asset-based approach.

    b. Income approach.

    c. Lower of cost or market approach.

    d. Market approach.

27. The Summary of Account in a fiduciary report most closely resembles a corporate:

    a. Balance Sheet.

    b. Income Statement.

    c. Variable Costing Statement.

    d. Statement of Cash Flows.

28. Which statement is correct concerning methods used to reflect the decedent's community property holdings?

    a. The gross method is mandatory for tax purposes.

    b. The net method includes a contra-account for spouse ownership.

    c. The gross method facilitates reconciliation with other documents.

    d. The net method can affect fiduciary accountability.

29. Which statement is correct concerning estate assets?

    a. The fiduciary should account for all estate assets to the probate court.

    b. Estate assets passing by operation of law are included in probate assets.

    c. Estate assets passing by operation of contract are included in probate assets.

    d. The fiduciary must pay tax on nonprobate asset transfers.

30. When are decedent liabilities entered on the estate books?

    a. In the opening entry.

    b. Upon death of the decedent.

    c. Upon payment from estate assets.

    d. When associated with a noncash asset.

31. Even after the court has approved the final accounting, what must the executor ensure before transferring estate assets to a trust?

    a. That the trust has obtained a valid employer id number.

    b. That the trust has obtained a valid sales tax id number.

    c. That the trustee signs a receipt and release form for the assets transferred.

    d. That the court has received the notice of intent to transfer the subject assets.

32. Which of the following are listed in the text as examples of OCBOA used in fiduciary accounting?

    a. GAAP and income tax bases.

    b. UPIA and GAAP bases.

    c. UPIA and cash bases.

    d. Cash and income tax bases.

33. OCBOAs are not specifically addressed in which of the following authoritative resources?

    a. SAS No. 62.

    b. SSARS No. 1 as amended.

    c. SSARS No. 15.

    d. SFAS No. 162.

34. Which of the following is considered to be a regulatory basis of accounting?

    a. Requirements under the UPIA.

    b. Tax accounting requirements.

    c. Credit union accounting requirements.

    d. Requirements by the probate court.

35. Is the pure cash basis normally appropriate for estate recordkeeping and presentation?

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

36. When are purchased investments included as fiduciary expenditures?

    a. When the pure cash basis is used.

    b. When there are no associated liabilities.

    c. When the fiduciary entity is an estate.

    d. When the modified cash basis is used.

37. According to the text, fiduciary cash basis modifications occur most often from:

    a. Capitalizing noncash assets.

    b. Paying fiduciary liabilities.

    c. Allocating estate legal costs.

    d. Allocating cash receipts.

38. If not contrary to governing documents or state law, the text recommends that a pickup truck purchased by the estate should be:

    a. Charged to Expenses Allocable to Principal.

    b. Recorded to Estate Principal.

    c. Recorded as an asset.

    d. Charged to estate expenses to be closed to income.

39. According to the text, an estate or trust may use the income tax basis of accounting even when the fiduciary is not required to file an income tax return.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

40. The personal exemption for estates is:

    a. $100.

    b. $300.

    c. $600.

    d. $3,300.

GLOSSARY

ATI: Adjusted total income. ATI is the net taxable income to be taxed to the fiduciary entity or beneficiary.

DOD: Date of death of the testator.

DNI: Distributable net income. Taxable income recomputed with certain modifications to limit the size of the fiduciary distribution deduction and the amount included in beneficiary gross income.

FAI: Fiduciary accounting income. Accounting income as defined by the governing document and state law, FAI reflects the amount of income available for current distribution to income beneficiaries.

Fiduciary Accounting: The meaning of this term depends on the context in which it is used. As used in this course, the term refers to accounting within an estate or trust for different classes of beneficiaries, and includes both accounting systems and accounting principles for the fiduciary entity in question.

Governing Document: Also known as the governing instrument or trust instrument, this document expresses the will of the fiduciary entity's creator or, in the case of an intestate death, applicable state laws. The governing document contains the terms and conditions of the fiduciary entity, and is the resource of first resort for guidance related to classifying income and expense. The 1997 UPIA replaces the term "governing document" with the phrase "terms of the trust" in recognition of the fact that an estate is essentially a trust created by statute.

OCBOA: Other comprehensive basis of accounting, normally relevant when GAAP is not followed.

Remaindermen: Beneficiaries of the principal, or corpus, of the estate or trust.

Tenants: Beneficiaries of trust or estate income.

TI: Taxable income. This is a tax accounting concept defined in IRC Section 641. TI is the base amount for calculating the fiduciary entity's annual income tax liability.

Undistributed Income: The balance of fiduciary income less distributions of income.

UFAP: Uniform Fiduciary Accounting Principles and Model Account Formats. A report issued May 1980 by the Committee on National Fiduciary Accounting Standards to improve clarity and consistency in fiduciary accounting.

UPIA: Uniform Principal and Income Acts. Three different acts (1931, 1962, and 1997) designed to achieve fair allocation between fiduciary principal and income. Most states have adopted the 1997 Act.

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COMPANION TO PPC'S GUIDE TO ACCOUNTING AND REPORTING FOR ESTATES AND TRUSTS

COURSE 2

Fiduciary Reporting for Estates & Trusts (AETTG092)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to accounting and reporting for estates and trusts. This course provides an account of the types of financial presentations, an overview of format presentations and an outline of the various reporting requirements in relation to estates and trusts.

PUBLICATION/REVISION DATE: December 2009

RECOMMENDED FOR: Users of *PPC's Guide to Accounting and Reporting for Estates and Trusts*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of accounting.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

FIELD OF STUDY: Accounting

EXPIRATION DATE: Postmark by **December 31, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Financial Presentation and Disclosure

Completion of this lesson will enable you to:

- Describe the types of financial presentations and waivers submitted for a court of law and other third parties, and discuss issues related to reporting alternatives.
- Discuss formats and considerations concerning fiduciary presentations such as the Summary of Account.
- Identify the elements of the various statements involved in traditional format financial presentations and issues related to the basis used for reporting; describe form, content, and other considerations related to fiduciary statement disclosures; and identify authoritative literature and other topics related to fiduciary presentations.

Lesson 2—Reporting

Completion of this lesson will enable you to:

- Describe level of service issues related to the accountant and the fiduciary entity.
- Identify various requirements for a compilation.
- Describe issues and considerations involved in GAAP reporting; discuss, in general terms, issues related to OCBOA report engagements; and recognize considerations related to engagements involving incomplete statements or those not prepared in conformity with GAAP or OCBOA.
- Discuss issues related to tax return engagements; summarize issues related to compilations of management-use-only financial statements; discuss issues related to fiduciary statements involving an accountant acting in a fiduciary role; and describe forms of engagement reports related to fiduciary entities.
- Describe presentation of financial statement elements in various types of engagement reports; and identify considerations involved in restricting the use of engagement reports.

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Lesson 1: Financial Presentation and Disclosure

INTRODUCTION

One of the principal duties of fiduciaries of estates and trusts is to present an accountability of funds in the form of financial statements, which normally are intended to meet the requirements of a probate court or the beneficiaries of the estate or trust. One of the different meanings of the term *fiduciary accounting* is the actual reporting or accounting that fiduciaries prepare for courts and other interested parties. Therefore, the accounting records of, and accounting principles used by, an estate or trust, are focused toward providing information of such accounting. There are several forms of presentation that may be used for fiduciary accounting. Unfortunately, little authoritative guidance exists about presentation or disclosures. As used in this course, the terms "financial statements" and "financial presentation" are used interchangeably to describe the formal reporting of fiduciary accounting.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe the types of financial presentations and waivers submitted for a court of law and other third parties, and discuss issues related to reporting alternatives.
- Discuss formats and considerations concerning fiduciary presentations such as the Summary of Account.
- Identify the elements of the various statements involved in traditional format financial presentations and issues related to the basis used for reporting; describe form, content, and other considerations related to fiduciary statement disclosures; and identify authoritative literature and other topics related to fiduciary presentations.

Organization of This Lesson

This lesson discusses presentation and disclosure issues relating to preparation of fiduciary accountings. It addresses several presentation formats, provides guidance on when various formats should be used, and provides illustrative financial presentations. In addition, this lesson provides guidance on disclosure issues for fiduciary financial presentations.

This lesson is organized as follows:

a. Discussion of factors influencing the form and basis of accounting used in financial presentations.

b. Discussion of form and style considerations relating to "Summary of Account" and other similar financial presentations. In most cases, the summary of account format is the preferable format for reporting to courts, beneficiaries, and other interested parties.

c. Discussion of traditional format financial presentations. Although traditional financial statements (i.e., balance sheet and the operating statement format) appear less frequently in practice, they may be needed to comply with requirements in the governing document or to provide additional information to beneficiaries and interested parties in monitoring the fiduciary status and/or performance.

d. Discussion of the common disclosures found in fiduciary financial presentations.

DETERMINING THE FORM AND BASIS OF ACCOUNTING USED IN FINANCIAL PRESENTATIONS

General

The fundamental objective of fiduciary financial presentations is to:

- Provide essential and useful information in a meaningful form to the parties interested in the accounting process.

- Ensure that fiduciary presentations are sufficiently simple to enable their preparation without unreasonable expense to the fiduciary entity or undue distraction from the on-going administration of the entity.
- Assist interested parties in understanding—
  - the nature of the accounting process and the need to protect their interests.
  - the fiduciary relationship existing between the fiduciary and beneficiaries.
  - the need to present the accounting in a manner that demonstrates the fiduciary relationship.

In most states the probate court has jurisdiction over the administration of estates and trusts. In many states, the courts will provide regulations or guidelines relating to fiduciary accountings. However, for a variety of reasons, beneficiaries and other interested parties may also require or request accountings using different formats or bases of accounting.

Financial Presentations Prepared for a Court of Law

Reports of the progress of the administration of an estate or trust are generally required to be filed with the probate court, or other court with local jurisdiction. These reports, which generally are filed on a periodic basis, summarize the transactions completed during the period. Financial presentations filed with a court of law are commonly referred to as a Summary of Account or as a Charge and Discharge Statement. The format of the financial presentation is usually based on the requirements of the applicable jurisdiction. The Committee on National Fiduciary Accounting Standards has issued a model summary of account formats in its report titled *Uniform Fiduciary Accounting Principles and Model Account Formats* (UFAP). Although the format of the presentation may vary from state to state, most presentations submitted to courts include separate sections for principal and income transactions. Within the separate sections for principal and interest, the fiduciary presents an accounting of the assets for which he is responsible and reports how his accountability was discharged.

When preparing accountings for an estate or trust, there are two types of "account" or "accountings"—formal and informal accounts or accountings (hereafter referred to as accountings). Some jurisdictions do not refer to formal and informal accountings or administration in their laws and statutes. Instead, they may use terms such as *supervised administration* and *unsupervised administration*. In addition, a waiver of accounting or a waiver of formal court audit may be granted in certain instances.

Formal Accountings. A formal accounting is submitted to the probate or other local court with jurisdiction. The accounting may be voluntary or compulsory, depending on the circumstances. A fiduciary may prepare a voluntary accounting as part of performing his duties. In other cases, an accounting may be required by direction of the court.

Types of Formal Accountings. Regardless of whether an accounting is voluntary or compulsory, it will fall into one of several categories of accountings such as: periodic or interim accountings, final accountings, or small estate accountings. In all instances, it is imperative that the fiduciary and/or the accountant determine when accountings are due, and obtain the necessary forms or guidelines on format. This information is usually determined by contacting the clerk's office of the local court in the relevant jurisdiction.

Periodic or Interim Accountings. In some states, periodic or interim accountings are optional. Where periodic accountings are optional, the courts may only require that an initial inventory (for an estate) and a final accounting be filed. Periodic or interim accountings serve several purposes, including the following:

- They allow the court with jurisdiction to approve the year's transactions and disbursements.
- They may allow the court to provide permission for preliminary distributions of bequests.
- The interim report may facilitate the preparation of an income tax return.
- They may allow the fiduciary to learn of any objections to their performance from the court or other interested parties.

- Approval of the interim report may reduce the fiduciary's potential liability exposure for the period covered by the report. For example, the court has effectively signed off on the transactions that occurred during the interim reporting period, thus reducing the fiduciary's exposure to transactions or events already reported.

The inventory of assets filed with the probate court is not considered an "accounting." Instead, it serves as a record of the personal representative's (i.e., the fiduciary's) initial responsibility for assets to administer in the settlement of the estate.

Many jurisdictions require that the accounting be filed annually, however, the local court may order a fiduciary to render an accounting at any time. The interim accounting should include all transactions since the date of the last accounting or, if none, from the commencement of administration. Subsequent accountings reflect the status of the probate estate or trust at subsequent interim (and ultimately final) dates, usually at the end of the fiscal year of the fiduciary entity.

Final Accountings. In most jurisdictions that require formal accountings, a final accounting must be filed. In many instances, the court and/or beneficiaries will need to approve the fiduciary's final accounting before the fiduciary is discharged from responsibility for estate or trust transactions and before he can receive his final commission or fee. After the court and where appropriate, other interested parties approve the final accounting, the fiduciary entity is closed and the fiduciary is discharged.

If an interim accounting has not been filed, the fiduciary may file a "first and final accounting," which includes activity after the filing of the initial inventory. The content and form of accountings varies between jurisdictions. Therefore, preparers will need to determine whether the final accounting should include:

- A complete record of transactions of the estate or trust.
- A record of transactions since the most recent interim accounting.
- A schedule of proposed distributions, if final distributions have not been made.

Small Estate Accountings. In some jurisdictions, small estates may have simplified requirements for filings of accounts. Inquiry should be made at the clerk's office of the local court in the applicable jurisdiction to determine if this option is available. An example of a small estate provision follows:

> If the property of a decedent subject to administration in the District of Columbia has a value of $40,000 or less, the property may be administered as a small estate in accordance with the provisions of this subchapter.
>
> [SOURCE: District of Columbia Official Code, 2001 Edition, § 20-351]

Informal Accountings. Similar to formal accountings, the requirements relating to informal accountings vary by jurisdiction. Generally, informal accountings allow the fiduciary to file a more summarized report that omits the details behind certain types of transactions (e.g., receipts, disbursements, etc.). Informal accountings, sometimes referred to as *family settlement agreements*, can have several advantages, including:

- Informal accountings generally are more expedient than formal accountings.
- Informal accountings generally are less expensive, due to lower filing fees and faster preparation of the accounting by the fiduciary.
- Informal accountings may allow more (or all) information about the estate or trust to remain private.

However, informal accountings also have some disadvantages, including:

- Family settlement agreements are only binding for parties to the agreement.
- Such agreements generally do not bar future claims by creditors, beneficiaries, and other interested parties. However, future claims may already be barred for other reasons (e.g., a statute of limitations).

Waiver of Accounting. Many states allow the fiduciary to obtain a waiver of accounting. Written waivers signed by interested parties must be in writing and filed with the court. In many jurisdictions, a detailed accounting will not be waived if any of the beneficiaries are minors or are incompetent. Depending on the local court, the waiver may apply to the entire accounting process, just the final accounting, or merely allow the listing of detailed receipts and disbursements to be omitted, similar to an informal accounting.

Before obtaining a waiver, the fiduciary should consult with the estate or trust attorney about whether it will be prudent to obtain a waiver. This is especially important in situations where there are numerous beneficiaries, particularly if some are not family members, or there are complex issues within the estate or trust (e.g., businesses owned or operated by the decedent, special bequests or distributions of income, etc.). In such cases, the involvement of the court may be required. These situations might also increase the probability of potential objections by interested parties or warrant closer scrutiny by the court.

Waiver of Formal Court Audit. Some jurisdictions allow the fiduciary to obtain a waiver of formal court audit. Here, the term audit refers to the scrutiny and review performed by the court and not an audit under the AICPA's auditing standards or PCAOB standards. In this situation, an accounting is still prepared, but the supervision and review by the court may be more limited. Generally, a written waiver must be signed by each beneficiary and filed with the court. The waiver commonly addresses several concerns, including an acknowledgement by the beneficiaries that they are aware of their right to require a formal court audit of accounts and of their right to revoke the waiver under certain circumstances (e.g., written notice to the court within a specified number of days of the approval of the final accounting). As with waivers of accounting, many jurisdictions will not allow a waiver of formal court audit if any of the beneficiaries are minors or are incompetent. The extent of court scrutiny varies between jurisdictions. For example, the District of Columbia Official Code indicates that when waivers of formal court audit are granted, the court will "conduct a cursory review to determine if the accounts appear regular on their face and are supported by reasonable documentation" (§ 20-732).

Other Accounting and Reporting Formats Required by Third Parties (Including Beneficiaries)

Most presentations required by the courts, beneficiaries, or other interested parties are more concerned with showing how the fiduciary discharged his responsibility than (a) measuring financial position and operating results similar to a business enterprise or (b) reflecting fiduciary assets and transactions on a tax basis. However, as mentioned in the preceding paragraphs, beneficiaries and other interested parties may also require or request accountings using different formats or bases of accounting for a variety of reasons. These other forms generally are similar to the traditional format for preparing financial statements of business enterprises. That is, a balance sheet, statement of earnings, equity, and cash flows, as well as associated notes, are provided. Such financial statements may be prepared on a GAAP, terms of an agreement, or OCBOA basis.

Reporting Alternatives—Presentation Format

The reporting alternatives available to fiduciary entities include:

- Summary of account or similar style financial presentations.
- Traditional financial statements.

The following paragraphs should assist fiduciaries and accountants in selecting the presentation format that is most appropriate in their circumstances.

Why Are Summary of Account Format Presentations Prepared Most Frequently? Summary of account format statements usually are prepared to comply with the requirements of a court of law. Some reasons that traditional financial statements generally are not prepared include the following:

- *The Lack of Clear-cut Guidance on GAAP and Acceptable Reporting Alternatives.* The lack of authoritative guidance and the various viewpoints concerning GAAP often limit fiduciary reporting to compliance with court and tax filing requirements.
- *The Nature of Estates versus Trusts.* Estates usually are of short duration (generally two years). Thus, financial reporting generally is limited to compliance with court and tax filing requirements.

- *The Goals of Preservation of Corpus (Principal) and/or Maximizing Distributions to Beneficiaries.* As the "owners" of the trust or estate assets, the interests of the beneficiaries may be best served by minimizing expenses and maximizing income and principal. As a result, financial resources are not allocated to optional reporting formats.

- *Fiduciary Accountings Are Rarely Requested by or Submitted to Third Parties.* As a result, financial reporting may be limited to legal filings necessary to settle the estate or trust.

Why Would Traditional Financial Statement Presentations Be Needed? Although they appear less frequently in practice, best practices indicate that traditional financial statements (that is, balance sheet and operating statement formats) may be appropriate depending on the governing instrument and the requirements of state law. Such presentations are often presented in the form of more traditional financial statements for the following reasons:

a. *The Governing Document or State Law May Require Additional Accountings for Trusts or Estates.* The fiduciary is first required to comply with the governing trust or estate document, such as a trust instrument or will. If the governing document is silent concerning reporting requirements, the accountant must follow requirements established by state or local law.

b. *The Current and Remaindermen Beneficiaries May Require or Request Additional Information about the Management of the Estate or Trust.* Only in fiduciary accounting are there two classes of owners—remainder beneficiaries and income beneficiaries. In addition, their interests may be different (and perhaps opposing) since the income beneficiaries are primarily interested in maximizing income and the remainder beneficiaries are primarily interested in safety and growth of the principal (corpus).

c. *An Accounting for Estate or Trust Assets in a Format More Similar to GAAP Presentations for Commercial Entities May Be More Useful.* The summary of account format, which is sometimes called a "Charge and Discharge Statement", reflects the transactions relating to the estate or trust assets for which the fiduciary is responsible. In essence, fiduciary accounting can be viewed as "responsibility" accounting. The summary of account format does not purport to present financial position and results of operations in a manner that resembles traditional GAAP or OCBOA presentations for other entities. Its focus is on the assets received by the trust or estate, the income transactions related to those assets, expenses and disbursements to beneficiaries, and the remaining assets at the end of the reporting period. A point of confusion for many users is that the balance sheet (statement of assets) of an estate does not include liabilities, including liabilities secured by estate assets. In addition, the normal valuation basis for the assets of an estate or trust is current value as of the date of death (i.e., basis is stepped up at the date of death), which differs from the historical cost measurement of most assets of commercial entities.

d. *The Nature of the Trust.* Since a trust may have a long-term existence, the trust agreement and/or the trustee may wish to present a more complete financial presentation of the trust's financial position and results.

e. *Nature of Assets and Activities.* If the trust or estate owns a proprietorship business, the individual assets and liabilities of the business are not reflected in the trust's or estate's financial statements. Instead, the trust or estate's interest in the business is recorded as a single line item and any profits distributed to the fiduciary are reflected as income, and distributions of profit to income beneficiaries are considered distributions of income. Similarly, only the fiduciary's stock in a business and associated dividends are reported in the financial statements.

Blending of Formats. When presenting traditional format financial statements, the statements may appear to be a blending of the statement of account and traditional formats. For example, tax basis financial statements may be prepared on a traditional basis, but separate statements of revenue and disbursements—federal income tax basis are prepared for trust principal and income transactions. In addition, such statements are presented in a style that reflects some of the summary of account/charge and discharge statement formats.

Reporting Alternatives—Basis of Accounting Issues

If the fiduciary has determined that the GAAP, or other basis specified in the governing document, or the basis specified/implied by state statute such as the cash or modified cash basis should be used for accounting purposes, that same basis generally will be used to prepare the fiduciary financial presentation, regardless of the format chosen. However, in situations where the fiduciary has determined that the accounting records should be maintained on the tax basis of accounting, the fiduciary should consider whether the tax basis of accounting is consistent with the financial reporting needs of the entity.

Cash Basis. Some accountants argue that while an adequate body of accounting conventions does exist for accountings of estates and trusts, it is incorrect to label them as GAAP. They believe the term GAAP implies the use of accrual accounting. But financial statements of most estates and trusts do not recognize liabilities. Accordingly, they prefer to label the basis of accounting as the cash basis. In addition, state statutes, and not the will or trust instrument, are primarily used to define the accounting and reporting requirements. Although a basis of accounting may not be formally specified, state statutes often use language such as "cash receipts" and "cash disbursements," etc. On the other hand, many practitioners argue that such language indicates that the cash or modified cash basis of accounting *is* GAAP for fiduciary entities. An informal survey of practitioners specializing in the area of fiduciary accounting has found support for this argument. The majority of practitioners surveyed, absent requirements in the governing document to the contrary, prepared fiduciary accountings using the modified cash basis, which in most instances was considered to be GAAP in the relevant jurisdiction. If such basis is the predominant practice used in a given state, there may be a strong argument that the cash or modified cash basis of accounting constitutes the prevalent practice and may be considered GAAP for fiduciary entities. If the practitioner believes, based on appropriate circumstances, that the modified cash basis of accounting is GAAP, such financial presentations should be reported as such using the guidance found in lesson 2.

Some trusts and estates, the fiduciaries, beneficiaries, or other parties also may require an accounting of the trust or estate based on the cash basis of accounting using a more traditional financial statement presentation (instead of the summary of account format).

Tax Basis. Financial statements prepared in accordance with the federal income tax basis of accounting are prepared on an OCBOA. Entities filing returns with the IRS (including estates and trusts) may prepare their financial statements on the income tax basis of accounting, and accountants may report on those financial statements as income tax basis statements. However, these accountants should be aware that the federal income tax return of an estate or trust might include assets not recognized by the administrable estate and thus are not included in financial statements prepared in accordance with the previously mentioned reporting alternatives.

Basis of Accounting for Reporting Purposes. Since authoritative literature does not directly address fiduciary accounting, it appears that accountants have latitude when selecting the basis of accounting to use for fiduciary accounting. It may be possible to justify each alternative (GAAP, basis specified in the governing document, cash, and tax), at the present stage of development of authoritative literature, under the appropriate circumstances. However, due to the nature and purpose of fiduciary accounting, accountants should carefully consider the selection of a basis of accounting since some choices of basis of accounting are more appropriate than others.

The version of the Uniform Principal and Income Act adopted by the state, other laws relating to allocation of principal and income, and state statutes relating to fiduciary entities, play a large part in determining what is "generally accepted" in a particular state. When the governing document is silent about a required basis of accounting, state statutes define the accounting and reporting requirements. Practitioners should be cautious when considering any accounting basis or format that does not comply with the governing document or state law. They should be prepared to justify to the courts, beneficiaries, and other interested parties, why their accounting is not in compliance with either the applicable requirements of the governing document or the state.

If no reporting requirements are included (or implied) in the governing document or state law, that increases the options available to practitioners in choosing a basis of accounting for reporting purposes. While the modified cash basis, whether labeled as GAAP or an OCBOA, may frequently be used in practice, if the governing document or state law does not preclude accrual or tax basis, the accrual or tax basis of accounting may still be used. However, as a practical matter, use of the tax basis should be rare in accountings for the court since the court is generally not interested in tax basis information. Likewise, accrual-based statements are considered to be of limited usefulness to a court of law.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What are the two types of accountings prepared for an estate or trust?

    a. Summary of Account and Charge and Discharge Statement.

    b. UFAP and non-UFAP.

    c. Formal and Informal.

    d. Periodic and Interim.

2. Which of the following is correct concerning waivers that affect fiduciary?

    a. The waiver of formal court audit includes a waiver of accounting.

    b. A minor beneficiary may sign a waiver of formal court audit in some jurisdictions.

    c. A waiver of formal accounting results in the equivalent of an informal accounting.

    d. A waiver of formal court audit must be signed by a simple majority of beneficiaries.

3. Which of the following statements is correct concerning basis of accounting issues and reporting alternatives?

    a. Tax basis statements may exclude assets reflected on a modified cash basis.

    b. The basis of fiduciary financial presentation follows the basis of accounting used.

    c. Accrual basis is used most frequently when governing documents and local law are silent.

    d. What is considered "generally accepted" varies between jurisdictions.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. What are the two types of accountings prepared for an estate or trust? **(Page 142)**

   a. Summary of Account and Charge and Discharge Statement. [This answer is incorrect. These are two of the financial presentations which report the progress of the administration of an estate or trust and are filed with the court of law.]

   b. UFAP and non-UFAP. [This answer is incorrect. UFAP is a report issued by the Committee on National Fiduciary Accounting Standards and includes model summary of account formats. UFAP is not a type of accounting.]

   c. Formal and Informal. [This answer is correct. A formal accounting is submitted to the probate. The accounting may be voluntary or compulsory, depending on the circumstances. Informal accountings allow the fiduciary to file a more summarized report that omits certain details.]

   d. Periodic and Interim. [This answer is incorrect. These are sub-types of one of the types of accountings indicated in the text.]

2. Which of the following is correct concerning waivers that affect the fiduciary? **(Page 144)**

   a. The waiver of formal court audit includes a waiver of accounting. [This answer is incorrect. Obtaining a waiver of formal court audit does not automatically affect the requirement that an accounting be prepared. Depending on the local court, the waiver may apply to the entire accounting process, just the final accounting, or merely the listing of detailed transactions.]

   b. A minor beneficiary may sign a waiver of formal court audit in some jurisdictions. [This answer is correct. In jurisdictions that allow a waiver in these circumstances, it generally must be signed by each beneficiary and filed with the court.]

   c. A waiver of formal accounting results in the equivalent of an informal accounting. [This answer is incorrect. While the waiver *may* achieve this result, it can take many forms including a waiver of the entire accounting process.]

   d. A waiver of formal court audit must be signed by a simple majority of beneficiaries. [This answer is incorrect. The waiver generally must be signed by each beneficiary and filed with the court. Those beneficiaries who are minors or are incompetent may receive special consideration by the court when reviewing the waiver for approval.]

3. Which of the following statements is correct concerning basis of accounting issues and reporting alternatives? **(Page 146)**

   a. Tax basis statements may exclude assets reflected on a modified cash basis. [This answer is incorrect. Tax basis statements may include assets not included in the administrable estate and therefore not reflected on statements prepared on a modified cash basis.]

   b. The basis of fiduciary financial presentation follows the basis of accounting used. [This answer is incorrect. Tax basis may or may not be appropriate for fiduciary financial presentations even though it has been chosen for accounting purposes.]

   c. Accrual basis is used most frequently when governing documents and local law are silent. [This answer is incorrect. According to the text, an OCBOA method appears to be the predominant method chosen for fiduciary accounting and reporting absent guidance from governing documents and local law.]

   d. What is considered "generally accepted" varies between jurisdictions. [This answer is correct. When governing documents are silent, local law prevails. The version of the Uniform Principal and Income Act adopted, as well as other laws passed in a particular state concerning estates and trusts, can play a big role in what is considered "generally accepted" for fiduciary accounting and reporting.]

SUMMARY OF ACCOUNT AND OTHER SIMILAR FINANCIAL PRESENTATIONS

The Committee on National Fiduciary Accounting Standards issued a report titled *Uniform Fiduciary Accounting Principles and Model Account Formats* (UFAP) that includes six principles for application in discharge-type accountings, as well as model presentation formats. The purpose of these fiduciary accounting principles is to provide reports that protect the appropriate parties while permitting the fiduciary flexibility based on the circumstances.

I. *Accounts should be stated in a manner that is understandable by persons who are not familiar with practices and terminology peculiar to the administration of estates and trusts.*

II. *A fiduciary account shall begin with a concise summary of its purpose and content.*

III. *A fiduciary account shall contain sufficient information to put the interested parties on notice as to all significant transactions affecting administration during the accounting period.*

IV. *A fiduciary account shall include both carrying values—representing the value of the asset at acquisition by the fiduciary—and current values at the beginning and end of the accounting period.*

V. *Gains and losses incurred during the accounting period shall be shown separately in the same schedule.*

VI. *The account shall show significant transactions that do not affect the amount for which the fiduciary is accountable.*

As a practical matter, the label given to the basis of accounting used often has little or no impact on the actual accounting that occurs because the governing document provides the first level of authority on how transactions should be recorded. Of particular note for financial reporting purposes:

- There is one principal financial statement, called the "Summary of Account," that is supported by subsidiary schedules and notes explaining items on the statement. That statement most closely resembles the "Statement of Cash Flows" as included in the financial statements of most commercial entities. It begins with assets on hand at the beginning of the period, shows receipts and disbursements during the period, and ends with assets on hand at the end of the period.

- Assets are reported in the Summary of Account at *fiduciary acquisition value*, which represents market value on the date assets are transferred to the fiduciary (or cost for assets subsequently purchased). Current (market) value as of the date the Summary of Account is prepared is also disclosed.

Exhibit 1-1 lists some of the characteristics of fiduciary accounting for GAAP purposes.

Summary of Account Format Presentations

In most cases, the summary of account format is the preferable format for preparation of the fiduciary's reports to the court, beneficiaries, and other interested parties. As mentioned previously, the requirements of state and local jurisdictions often dictate the format of the report.

Exhibit 1-1

Characteristics of GAAP Financial Presentations Used for Fiduciary Entities[a]

Characteristics	Unique Attributes
Basis of valuing assets.	The normal valuation basis for the assets of an estate or trust is *fiduciary acquisition value*, which generally is market value on the date assets are transferred to the fiduciary (date of death or date of transfer to trust).[b] Current (market) values as of the date of the financial presentation are also disclosed.
Separate accounting for principal and income.	In fiduciary accounting, there are two classes of owners—*remainder* beneficiaries and *income* beneficiaries. Their interests may be different (and perhaps opposing) since the income beneficiaries are primarily interested in a maximizing income and the remainder beneficiaries are primarily interested in safety and growth.
Lack of internal consistency in accounting for principal or income.	The determination of how to account for principal[c] or income[d] of an estate or trust normally depends on the terms of each unique governing document (will or trust instrument) or on the requirements of state law. Consequently, there can be a lack of consistency between individual estates or trusts in accounting for transactions that affect principal or income. This is in contrast to the relative consistency of accounting for most transactions of commercial entities.
The financial presentations of an estate do not include liabilities.	The executor of an estate is not responsible for recording liabilities; he is only responsible for assets. Creditors are responsible for filing claims against the estate, but such claims are not reflected as liabilities on the financial statements. Likewise, notes payable secured by a deed of trust on assets of an estate are not reflected as liabilities. Only actual cash payments on creditor claims or debt are reflected in the financial statements under the disbursement or other appropriate caption.
The financial presentations of an estate or trust are normally intended for only a limited number of users.	Although some fiduciary accountings are a matter of public record, they are rarely requested by or submitted to third parties. Instead, such accountings are merely a part of the legal papers in an accounting proceeding, served on the specific parties interested in the particular estate or trust being settled.

Notes:

[a] While this table represents characteristics and unique attributes of GAAP financial statements presented in a Summary of Account style of presentation, there is a considerable amount of debate in practice about the appropriate characteristics that comprise GAAP basis traditional financial statement presentations.

[b] In other words, *carrying value* is the value of the asset at the time the fiduciary acquired the asset.

[c] Principal, or corpus, is the property set aside by the owner for eventual delivery to one or more remaindermen (for example, proceeds from the sale of assets, dividends, insurance proceeds, royalties from depletable resources, allowances for depreciation, and other receipts that will be distributed to the remaindermen).

[d] Income is the earnings from the use or investment of principal (for example, dividends, rents, royalties, and other receipts from principal).

* * *

Fiduciary Considerations. Use of the summary of account format allows the fiduciary to most effectively reflect his accountability for assets by presenting:

- The disposition of all property for which the fiduciary has been accountable. This generally includes presentation in the form of:

  Beginning inventory of assets
  \+ Gains on sale or disposition
  − Losses on sale or disposition
  \+ Income
  − Expenses
  − Distributions
  = Ending inventory of assets

- Separate reporting of income and principal transactions (i.e., income and expenses associated with income transactions are shown separately from receipts and disbursements relating to principal transactions). The existence of different classes of beneficiaries makes it necessary for the accounting records to differentiate between principal and income transactions. This segregation within the accounting records allows the fiduciary to report information about the status of the estate or trust in a manner that is useful to both income and principal beneficiaries.

The following paragraphs illustrate several of the more commonly used formats. These formats show the nature of the information that generally must be submitted in fiduciary accountings. How the information is presented is a style issue.

Getting Started. Because the fiduciary's actions start when the entity is created, and end when the entity is dissolved, a complete financial picture of how a fiduciary has discharged his duty must be reflected in the report. This is accomplished by starting with the beginning balance for each asset, showing the changes during the period and stating the ending balance. The ending balance then becomes the beginning balance for the next period. A first and final accounting incorporates every transaction since the entity's beginning.

Summary Section. The second UFAP fiduciary accounting principal indicates that fiduciary financial presentations should begin with a concise summary of their purpose and content. The summary section of the fiduciary report should state the following:

- *The Time Period Involved.* This is generally presented as a range such as "For the Period (date) to (date)."
- *The Entity Being Accounted For.* The name of the estate or trust should be presented exactly as listed in the governing document. For estates, the legal name of the testator (the person making the will) is specified in the will. For purposes of titling the financial presentation, the legal name of the decedent (i.e., the testator) should either be (a) preceded by "(The) Estate of," or (b) followed by "Estate." In some cases, the name of the decedent is followed by ", deceased." For trusts, the will provision creating the trust or the trust agreement itself will include the exact name of the trust. Examples of how to present the name of the fiduciary entity are as follows:

  THE ESTATE OF JOHN DOE
  ESTATE OF JERRY RIVERS
  ESTATE OF JOE HERBERT SMITH, DECEASED
  JANE DOE TESTAMENTARY TRUST
  JOHN H. DOE IRREVOCABLE LIVING TRUST

- *The Name of the Fiduciary.* The legal name of the fiduciary should be listed in the summary section, typically with other general information about the entity.

Normally the summary takes the form of a cover letter. Included with the cover letter is a statement that the information should be reviewed and where to obtain additional information. Finally, a table of contents should be included to help the reader find specific information that might be of interest.

Content and Format Considerations. There are several commonly used titles and formats of the principal financial presentation using the summary of account format. Preparers should consult the guidelines and regulations in their local jurisdiction to determine appropriate presentation titles and formats. Such jurisdictions may require certain presentation formats, or merely recommend formats that are considered suitable for reporting purposes. In the absence of specific guidelines, preparers may refer to the model formats issued by the UFAP or other commonly used formats. Preparers should ensure that the format used is acceptable to the courts, fiduciaries, beneficiaries, attorneys, and other interested parties. In general, fiduciary accountings are presented similar to a statement of cash receipts and disbursements (including any distributions) from the date of the most recent accounting or, if none, from the filing of the initial inventory.

General Format. The Summary of Account begins with assets on hand at the beginning of the period, shows receipts and disbursements during the period, and ends with assets on hand at the end of the period. Regardless of the format used, most accountings contain a summary format similar to the following:

	Beginning inventory of assets	Inventory on hand at the beginning of the period covered by the account, which is the value of property initially received by the fiduciary if this is the first accounting. If it is a subsequent accounting, present the ending balance on hand as of the previous accounting.
+	Assets subsequently discovered	Depending on the jurisdiction, (a) any new assets discovered after the initial inventory or (b) any new assets discovered and not previously accounted for in the opening inventory or in supplemental inventories previously reported.
+	Income received during the accounting period	Amount of receipts of income during the period.
+	Capital gains during the accounting period	Gains on sales or other disposition of assets (i.e., amounts received in excess of inventory value).
−	Disbursements during the accounting period	Amount of disbursements during the period.
−	Capital losses during the accounting period	Losses on sales or other disposition of assets (i.e., amounts received are less than inventory value).
−	Distributions to beneficiaries	Distributions of cash or property to beneficiaries.
=	Ending inventory	Inventory on hand at the end of the period, stated at its carrying value.

Supporting schedules accompany the Summary of Account to provide detailed information about balances and transactions.

<u>Illustrative Formats.</u> It is impossible to describe and illustrate all possible formats used in various jurisdictions. However, two of the more common general formats are discussed in the following paragraphs. The charge and discharge statement format is also discussed.

Illustrative Formats—UFAP Model Account Format. Accountants may use the model account format developed by the National Fiduciary Accounting Standards Project Committee that is included in its May 1980 report titled *Uniform Fiduciary Accounting Principles and Model Account Formats* (UFAP).

Exhibit 1-2

Summary of Account—UFAP Model Account Format

Summary of Account

	Schedule	Current Value	Fiduciary Acquisition Value
Proposed Distribution to Beneficiaries[a]	I	$ 846,225	$ 824,700
PRINCIPAL			
Receipts	A		$ 1,025,000
Net Gain (or Loss) on Sales or Other Dispositions	B		3,700
Less Disbursements:[b]			$ 1,028,700
Debts of Decedent	C	$ 10,000	
Funeral Expenses	C	8,000	
Administrative Expenses	C	115,000	
Fees	C	5,000	138,000
Balance before Distributions			$ 890,700
Distributions to Beneficiaries	D		75,000
Principal Balance on Hand	E		$ 815,700
For Information:[c]			
Investments Made	F		
Changes in Investment Holdings	F		
INCOME			
Receipts	G		$ 70,000
Less Disbursements	H		16,000
Balance before Distributions			$ 54,000
Distributions to Beneficiaries	H		45,000
Income Balance on Hand			$ 9,000
Combined Balance on Hand (Principal and Income)			$ 824,700

Notes:

[a] For optional use when applicable.

[b] For a trust, disbursements may be included under the captions "General Disbursements" and "Fees."

[c] Information concerning investments made and changes in investment holdings is reported in supporting schedules.

* * *

In most instances, the supporting schedules for the summary of account format developed for UFAP should show the nature or purpose of each item or transaction and date thereof. Such schedules include the following:

- Receipts of Principal.

- Gains and Losses on Sales or Other Dispositions.
- Disbursements of Principal.
- Distributions of Principal to Beneficiaries.
- Principal Balance on Hand.
- Information Schedules—Principal: investments made, changes in investment holdings (e.g., stock splits).
- Receipts of Income.
- Disbursement of Income.
- Distributions of Income to Beneficiaries.
- Proposed Distributions to Beneficiaries (optional—for use if necessary).

If a fiduciary accounting contemplates a proposed distribution, the preparer should include a schedule presenting the proposed distribution, including the allocations between principal and income beneficiaries. In addition, any allocations between trusts should also be included in the schedule, unless the allocation is to be made by a trustee after receipt of the assets. In cases where the proposed distribution is based on the value of assets at the date of distribution, the schedule should include the market value of such assets.

Some jurisdictions require the fiduciary (or a fiduciary may elect) to include a schedule of liabilities of the estate or trust. The schedule of liabilities should include:

- All liabilities that are a lien on estate or trust assets.
- Taxes due but unpaid, as reflected on filed returns or assessments received subsequent to filing of returns.
- All notes payable.
- Any judgments for which the estate or trust is liable.
- Any other material liability.

In most instances, routine liabilities such as the monthly amount due for rent, utilities, salaries, or other recurring expenses, need not be included in the schedule.

Additional requirements for supporting schedules may be obtained by reference to the rules of the particular jurisdiction. For example, a jurisdiction might include the following requirements for additional information:

> The petition for approval of the account or a report accompanying the petition shall contain all of the following:
>
> a. A description of all sales, purchases, changes, in the form of assets, or other transactions, occurring during the period of the account that are not otherwise readily understandable from the schedule.
>
> b. An explanation of any unusual items appearing in the account.
>
> c. A statement of all compensation paid to the fiduciary or to the attorneys for the fiduciary other than pursuant to a prior court order.
>
> d. A statement disclosing any relationship between the fiduciary or the attorneys for the fiduciary and any agent hired by the fiduciary during the accounting period.
>
> e. An allegation disclosing whether all of the cash has been invested and maintained in interest bearing accounts or in investments authorized by law or the governing instrument, except for an amount of cash that is reasonably necessary for the orderly administration of the estate.

While this information may need to be included in the court filing, accountants and fiduciaries/attorneys should coordinate to determine where and how such information should be presented, including responsibility for developing the required disclosures and schedules.

Illustrative Formats—Alternative Format. Another commonly used format presents more summarized information (than is included in the UFAP model account format) on the summary of account. Instead of detailed information on the summary of account, the details are included in schedules that accompany the summary. Common variations of this format are as follows:

- Principal and income transactions are reported in separate columns of the summary of account. (When this format is used, principal and income transactions are also reported separately in supporting schedules.)
- Principal and income transactions are reported separately only in supporting schedules.
- Single-column format for amounts in the summary of account.
- Multi-column format for amounts in the summary of account—captions for column headings might be as follows:
    - "Principal," "Income," "Total."
    - "Receipts," "Disbursements."
    - "Debits (Receipts)," "Credits (Disbursements)."

The illustrative summary of account at Exhibit 1-3 reflects a multi-column format with columns for principal and income transactions, and a total.

Exhibit 1-3

Summary of Account—Alternative Format

Summary of Account[a]

		Income	Principal	Totals
I.	Starting Balance			
	Assets per Inventory or on Hand at Close of Last Accounting Period	$ —	$ 1,000,000	$ 1,000,000
II.	Receipts			
	Schedule A:	$ 70,000	$ 25,000	$ 95,000
III.	Disbursements			
	Schedule B:	$ 16,000	$ 138,000	$ 154,000
IV.	Distributions			
	Schedule C:	$ 45,000	$ 75,000	$ 120,000
V.	Capital Transactions and Adjustments			
	Schedule D: Net Gain or (Loss)	$ —	$ 3,700	$ 3,700
VI.	Assets on Hand at Close of Accounting Period			
	Schedule E: Cash and Other Assets	$ 9,000	$ 815,700	$ 824,700

Note:

[a] This illustration is based on the model account format developed by The Florida Bar.

* * *

Supporting schedules for the summary of account format illustrated at Exhibit 1-3 would include schedules similar to the following:

- Schedule A—Receipts during period, includes receipts during the administration period that are not included in the opening inventory. The schedule should note the nature and purpose of each item, the source of the receipt, and the date thereof. Receipts from sale or other dispositions of principal assets and other adjustments to the carrying value of assets are not included in receipts during the period. Those transactions are included in Schedule D.

- Schedule B—Disbursements, includes disbursements made during the accounting period. Disbursements are classified as income or principal transactions under the terms of the governing document, or state law, if the governing document is silent. The schedule should note the nature and purpose of each item, the name of the payee, and the date thereof. Disbursements to purchase assets or make distributions to beneficiaries are not included in this schedule. These transactions are included in Schedules D and C, respectively.

- Schedule C—Distributions, includes items distributed to beneficiaries during the accounting period. Amounts are shown at their fiduciary acquisition value or adjusted carrying value, if appropriate. Disbursements are classified as income or principal transactions under the terms of the governing document, or state law, if the governing document is silent.

- Schedule D—Capital Transactions and Adjustments, includes all purchases and sales of assets and adjustments to the carrying values of assets. Sales or other dispositions should include the fiduciary acquisition value or adjusted carrying value, the costs and expenses relating to the sale or disposition, the net proceeds received, and the gain or loss (in separate columns) on sale or disposition. For purchases, the purchase price, expenses or other adjustments, and the total amount paid should be included. Any adjustments to capital assets (e.g., a stock split) should be included and explained with any net gain or loss reflected in the appropriate column. Distributions to beneficiaries are not included in this schedule. Those transactions are included in Schedule C.

- Schedule E—Assets on Hand at Close of Accounting Period, includes all inventory on hand at the end of the accounting period, stated as the fiduciary accounting value or adjusted carrying value. Current value amounts are also disclosed.

Additional disclosures and supporting schedules may be required.

Illustrative Presentations. The UFAP model account formats for estates and trusts represent only a few of the possible summary of account formats used in practice. Other formats may also be acceptable depending on the jurisdiction receiving the financial presentation. Charge and discharge statement formats are discussed in the following paragraphs.

Charge and Discharge Statement Presentations

There are several variations of what is commonly referred to as a "Charge and Discharge Statement." The nature of such statements provides flexibility and ease of presentation.

Titles, Formats and Captions. The name "Charge and Discharge Statement" is used because such statements usually present charges (increases in the fiduciary's accountability) separately from credits [decreases (discharges) in the fiduciary's responsibility]. Titles that may be used for charge and discharge statements include:

- Charge and Discharge Statement.

- Charge and Discharge Statement as to Principal. (Principal transactions are presented in a separate statement.)

- Charge and Discharge Statement as to Income. (Income transactions are presented in a separate statement.)

- Summary of Account.

Some fiduciaries view the title "Charge and Discharge Statement" as outdated and prefer to call this presentation a "Summary of Account."

Charge and discharge statements are usually presented in one of the following formats:

- *Charges Equal Credits Format.* In this format, the total charges and credits in each section (i.e., principal and income) of the statement are equal in amount. When using this format, the statement communicates that all assets and transactions the fiduciary is responsible for or is charged with, must equal all of the responsibility from which the fiduciary has been relieved, or credited with. Exhibit 1-4 presents an example of this statement format.
- *Charges Exceed Credits Format.* In this format, the total charges exceed credits in each section (i.e., principal and income) of the statement by the amount of inventory on hand. This statement format communicates that after crediting the fiduciary for responsibilities from which the fiduciary has been relieved, the fiduciary retains a net charge of the amount of ending inventory. This represents the amount of the fiduciary's remaining accountability. Exhibit 1-5 presents an example of this statement format.

Captions within the Charge and Discharge Statement will vary based on (a) the nature of a fiduciary entity (e.g., estate versus trust), (b) state or local jurisdiction requirements regarding captions, (c) the nature of activity within the fiduciary entity (e.g., entities may need to disclose business activities separately), (d) the detail presented, and (e) the format of the statement. The following paragraphs discuss some practical guidelines when the Charge and Discharge Statement includes both principal and income sections.

The sections can be labeled "Principal" and "Income" (usually centered over statement captions), as follows:

Principal

(detail the charge and credit captions relating to principal)

Income

(detail the charge and credit captions relating to income)

The sections are labeled "First as to Principal" and "Second as to Income" at the margin as the initial entry in each section. Generally, these captions are either presented in capital letters, underlined, or bolded. This is generally followed by a caption indicating that the fiduciary charges himself with the items in the statement, as illustrated at Exhibit 1-6.

Exhibit 1-4

Charge and Discharge Statement (Charges Equal Credits Format)

Charge and Discharge Statement
For the Period (Date) to (Date)

FIRST AS TO PRINCIPAL:		
The Executor Charges Himself With:		
Assets Per Inventory (Schedule A[a])	$ 1,000,000	
Assets Not Inventoried (Schedule B)	25,000	
Gains on Sale of Assets (Schedule F)	9,500	
Total Charges—Principal		$ 1,034,500
The Executor Credits Himself With:		
Funeral Expenses (Schedule C)	$ 8,000	
Debts of Decedent (Schedule D)	10,000	
Administration Expenses (Schedule E)	20,000	
Losses on Sale of Assets (Schedule F)	5,800	

Bequests Paid (Schedule G)	75,000	
Estate and Inheritance Taxes	100,000	218,800
Principal Balance on Hand (Schedule H)		$ 815,700 [b]
Total Credits—Principal		$ 1,034,500
SECOND AS TO INCOME:		
The Executor Charges Himself With:		
Dividends Received[c]	$ 10,000	
Interest on Municipal Bonds[c]	10,000	
Rental Income[c]	50,000	
Total Charges—Income		$ 70,000
The Executor Credits Himself With:		
Building Repairs[d]	$ 1,000	
Insurance[d]	2,000	
Utilities[d]	3,000	
Real Estate Taxes[d]	5,000	
Depreciation[d]	4,000	
Interest Expense[d]	1,000	
Distributions of Income	45,000	61,000
Balance of Income on Hand (Schedule I)		9,000 [b]
Total Credits—Income		$ 70,000

Notes:

[a] The schedules that accompany the statement have been omitted.

[b] Principal and income balances on hand may be listed in the second column or included in the first column. Listing the balances on hand in the first column generally results in a cleaner presentation of total charges and credits. However, presenting end of year principal and income balances in the second (from right) column clearly reflects remaining asset balances and the fact that the balance on hand captions are fundamentally different from the other captions (i.e., they represent amounts for which the fiduciary remains accountable).

[c] These captions may be combined into a single caption "Receipts of Income," with the detail transactions and classifications included in a supporting schedule.

[d] These captions may be combined into a single caption "Disbursements of Income," with the detail transactions and classifications included in a supporting schedule.

* * *

Exhibit 1-5

Charge and Discharge Statement (Charges Exceed Credits Format)

Charge and Discharge Statement For the Period (Date) to (Date)

FIRST AS TO PRINCIPAL:			
The Executor Charges Himself With:			
Assets Per Inventory (Schedule A[a])		$ 1,000,000	
Assets Not Inventoried (Schedule B)		25,000	
Gains on Sale of Assets (Schedule F)		9,500	$ 1,034,500
The Executor Credits Himself With:			
Funeral Expenses (Schedule C)		$ 8,000	
Debts of Decedent (Schedule D)		10,000	
Administration Expenses (Schedule E)		20,000	
Losses on Sale of Assets (Schedule F)		5,800	
Bequests Paid (Schedule G)		75,000	
Estate and Inheritance Taxes		100,000	218,800
Leaving a Principal Balance of:			$ 815,700
Consisting of:			
Cash	$ 50,000		
Corporate Stocks	100,000		
Government Bonds	100,000		
Rental Buildings (net of accumulated depreciation)	485,700		
Household Furnishings	50,000		
Automobiles	30,000		
	$ 815,700		
SECOND AS TO INCOME:			
The Executor Charges Himself With:			
Dividends Received		$ 10,000	
Interest on Municipal Bonds		10,000	
Rental Income		50,000	$ 70,000
The Executor Credits Himself With:			
Building Repairs		$ 1,000	
Insurance		2,000	
Utilities		3,000	
Real Estate Taxes		5,000	
Depreciation		4,000	
Interest Expense		1,000	
Distributions of Income		45,000	61,000
Leaving an Income Balance of:			$ 9,000
Consisting of:			
Cash	$ 6,000		
Government Bonds	3,000		
	$ 9,000		

Note:

[a] The schedules that accompany the statement have been omitted.

* * *

Exhibit 1-6

Charge and Discharge Statement Captions

Third Person	First Person
FIRST AS TO PRINCIPAL:	FIRST AS TO PRINCIPAL:
The Executor (or Trustee) charges himself with:	I charge myself with:
(detail captions relating to principal)	(detail captions relating to principal)
The Executor (or Trustee) credits himself with:	I credit myself with:
(detail captions relating to principal)	(detail captions relating to principal)
SECOND AS TO INCOME:	SECOND AS TO INCOME:
The Executor (or Trustee) charges himself with:	I charge myself with:
(detail captions relating to income)	(detail captions relating to income)
The Executor (or Trustee) credits himself with:	I credit myself with:
(detail captions relating to income)	(detail captions relating to income)

* * *

In some instances, the information just discussed is combined by labeling sections as follows:

First as to Principal, the Executor (Trustee) charges Himself as follows:

Second as to Income, the Executor (Trustee) charges Himself as follows:

Generally, these captions are either presented in capital letters, underlined, or bolded.

The Charge and Discharge Statement may be presented in a single or multi-column format. In addition, similar to the summary of account format the supporting schedules should be included to provide additional detail.

If it is not necessary to report principal and income separately, the Charge and Discharge Statement may be presented without separate principal and income sections.

Choosing between Charge and Discharge Statement and Summary of Account Titles. Use of the first and third person captions generally lend themselves to the presentation being referred to as a Charge and Discharge Statement. However, that format of statement may also be titled a Summary of Account or Statement of Account. Using that format, regardless of whether separate principal and income sections are included, the title "Summary of Account" reflects more up-to-date terminology.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Which of the following correctly states a fiduciary accounting principle included in the *Uniform Fiduciary Accounting Principles and Model Account Formats* report?

    a. Use of fiduciary accounting jargon in accounts is expected, but the fiduciary must be available to answer questions.

    b. Fiduciary accounts should be stated at current value and at decedent's acquisition cost.

    c. Gains and losses should be separated and should be shown in separate supporting schedules.

    d. Accountings should show significant transactions occurring during the period.

5. Which of the characteristics listed below best reflects the GAAP financial presentation used for a fiduciary entity?

    a. Assets of an estate or trust are generally valued at lower of cost or market.

    b. The interests of remainder beneficiaries and income beneficiaries are always similar.

    c. Liabilities are unlikely to appear on a fiduciary financial statement.

    d. Estate or trust's financial presentations are prepared for many parties other than the legal system.

6. Ben Gray prepares fiduciary statements for the estate of Lynn James and includes a Summary of Account based on the following information: ending asset balance from previous report $243,000; capital gains from asset liquidations during the period $27,000; capital losses from asset liquidations during the period $4,000; distributions to Carl James, Lynn's son and the sole beneficiary, during the period $75,000; disbursements to creditors during the period $54,000. During the period, a $10,000 life insurance policy payable to the decedent's sister was found. Also found during the period were additional assets worth $7,000. How much inventory should Gray report at the end of the period?

    a. $137,000.

    b. $144,000.

    c. $154,000.

7. There is a requirement in some jurisdictions for a fiduciary to include a schedule of liabilities of the estate or trust. When preparing the schedule which of the following generally does not need to be included?

    a. Notes payable.

    b. Liens on estate or trust assets.

    c. Judgments

    d. Rent.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. Which of the following correctly states a fiduciary accounting principle included in the *Uniform Fiduciary Accounting Principles and Model Account Formats* report? **(Page 149)**

   a. Use of fiduciary accounting jargon in accounts is expected, but the fiduciary must be available to answer questions. [This answer is incorrect. Accountings should be prepared to be understandable by those not familiar with estate and trust practices and terminology.]

   b. Fiduciary accounts should be stated at current value and at decedent's acquisition cost. [This answer is incorrect. A fiduciary account shall include both carrying values which represent the value of the asset at acquisition by the fiduciary not that of the decedent.]

   c. Gains and losses should be separated and should be shown in separate supporting schedules. [This answer is incorrect. Although gains and losses incurred in the same period shall be shown separately, they should be shown in the same schedule.]

   d. Accountings should show significant transactions occurring during the period. [This answer is correct. Significant transactions should be reflected in the accounting, even though they do not affect the amount for which the fiduciary is accountable.]

5. Which of the characteristics listed below best reflects the GAAP financial presentation used for a fiduciary entity? **(Exhibit Page 150)**

   a. Assets of an estate or trust are generally valued at lower of cost or market. [This answer is incorrect. The normal valuation basis for the assets of an estate or trust is fiduciary acquisition value which is generally market value on the date assets are transferred to the fiduciary which is normally date of death or date of transfer to the trust.]

   b. The interests of remainder beneficiaries and income beneficiaries are always similar. [This answer is incorrect. Their interests may be different, even opposing, since the income beneficiaries are primarily interested in maximizing income and the remainder beneficiaries are primarily interested in safety and growth.]

   c. Liabilities are unlikely to appear on a fiduciary financial statement. [This answer is correct. The executor of an estate is responsible only for assets and is not responsible for recording liabilities. They record only the cash payments made to creditors, not the debts themselves.]

   d. Estate or trust's financial presentations are prepared for many parties other than the legal system. [This answer is incorrect. Although some fiduciary accountings are a matter of public recorded, they are rarely requested by or submitted to third parties. They are normally intended for only a limited number of users. They are merely a part of the legal papers in an accounting proceeding, served on the specific parties interested in the particular estate or trust being settled.]

6. Ben Gray prepares fiduciary statements for the estate of Lynn James and includes a Summary of Account based on the following information: ending asset balance from previous report $243,000; capital gains from asset liquidations during the period $27,000; capital losses from asset liquidations during the period $4,000; distributions to Carl James, Lynn's son and the sole beneficiary, during the period $75,000; disbursements to creditors during the period $54,000. During the period, a $10,000 life insurance policy payable to the decedent's sister was found. Also found during the period were additional assets worth $7,000. How much inventory should Gray report at the end of the period? **(Page 152)**

   a. $137,000. [This answer is incorrect. Additional assets found during the period must be considered.]

   b. $144,000. [This answer is correct. Gray should exclude life insurance because it is a non-administrable asset found during the period. $243,000 + $27,000 − $4,000 − $75,000 − $54,000 + $7,000.]

   c. $154,000. [This answer is incorrect. Life insurance payable to the decedent's sister should not be considered because life insurance proceeds payable to an entity other than the decedent's estate are not part of the estate.]

7. There is a requirement in some jurisdictions for a fiduciary to include a schedule of liabilities of the estate or trust. When preparing the schedule which of the following generally does **not** need to be included? **(Page 154)**

   a. Notes payable. [This answer is incorrect. The jurisdiction would expect to see any notes payable on the schedule because a creditor has asked the trust or estate for payment on the note.]

   b. Liens on estate or trust assets. [This answer is incorrect. A creditor who has a lien on the estate or trust assets would be filing a claim to the trust or estate for this amount, so it should be included on the liability schedule.]

   c. Judgments. [This answer is incorrect. If there are judgments for which the estate or trust is liable, then these are considered liabilities that would need to be on the schedule.]

   d. Rent. [This answer is correct. In most instances, routine liabilities such as monthly amount due for rent, utilities, salaries, or other recurring expenses, are not considered liabilities and, as such, should not be included on the schedule.]

TRADITIONAL FORMAT FINANCIAL PRESENTATIONS

This section discusses matters of form and style as they relate to preparing traditional format financial presentations for estates and trusts. While authoritative literature provides some guidance relating to certain form and style considerations, there are a wide variety of approaches used in practice in areas where little authoritative guidance is available. This section summarizes key issues addressed in the authoritative literature and provides guidance relating to the application of reporting principles to GAAP and OCBOA financial statement presentations of fiduciary entities.

General Considerations

The concept of *basic financial statements* is important because the basic financial statements represent what is generally accepted as the end product of an entity's financial accounting process. As discussed earlier, the financial statements of a trust or estate are issued primarily to meet the needs of beneficiaries and other third party users of the financial statements. Applying the logic of SAS No. 29 (AU 551), *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, to the basic financial statements of an estate or trust prepared in accordance with generally accepted accounting principles, such basic financial statements should include the following:

a. Balance Sheet.

b. Statement of Earnings.

c. Statement of Estate or Trust Equity or Changes in Estate or Trust Equity.

d. Statement of Cash Flows.

e. Description of accounting policies.

f. Notes to financial statements.

FASB ASC 220-10 (formerly SFAS No. 130, *Reporting Comprehensive Income*) requires comprehensive income and its components to be reported when a company presents a full set of financial statements that report financial position, results of operations, and cash flows. Comprehensive income may be reported in the income statement, in a separate statement of comprehensive income, or in a statement of changes in equity. Entities that have no items of comprehensive income are not required to report comprehensive income. Most estates and trusts will not have comprehensive income.

The basic financial statements listed in the preceding paragraph provide information about the fiduciary entity from an overall perspective and are provided to beneficiaries and other interested parties when the governing document requires or the fiduciary determines that preparation of a traditional financial statement presentation is necessary. Many fiduciary entities prepare complete basic financial presentations with full disclosure only on an annual basis. Other entities only prepare statements and omit full disclosure. After determining that a traditional financial presentation should be prepared, there are several decisions the fiduciary must make in choosing the nature of the financial presentation. These decisions include:

- What basis of accounting will be used in the financial statements?
- Will the financial statements provide full disclosure or will they omit substantially all disclosures?
- What level of assurance will the fiduciary entity's CPA provide—compilation, review, or audit?

Name of Fiduciary Entity—Financial Statement Titles. The name of the estate or trust should be presented exactly as listed in the governing document. For estates, the legal name of the testator (the person making the will) is specified in the will. For purposes of titling the financial statements, the legal name of the decedent (i.e., the testator) should either be (a) preceded by "(The) Estate of," or (b) followed by "Estate." In some cases, the name of the decedent is followed by ", deceased." For trusts, the will provision creating the trust or the trust agreement itself will include the exact name of the trust. This should be the same name as that entered on the IRS Form SS-4, Application for Employer Identification Number (EIN). In all cases, the name of the fiduciary entity must indicate what type of legal entity it is (i.e., estate or trust). Some accountants disclose the type of entity on the title page or parenthetically in the accountants' or auditors' report. While that policy is acceptable, the critical disclosure is in the accounting policies note. Additional disclosure on the title page or in the accountants' or auditors' report is optional. Examples of how to present the name of the fiduciary entity are as follows:

THE ESTATE OF JOHN DOE
ESTATE OF JERRY RIVERS
ESTATE OF JOE HERBERT SMITH, DECEASED
JOSEPH ANDREW SMITH ESTATE
JANE DOE TESTAMENTARY TRUST
JOHN H. DOE IRREVOCABLE LIVING TRUST
WILSON FAMILY TRUST

Financial Statement Headings. Each financial statement should use a heading that includes (a) the legal name of the fiduciary entity, as listed in the governing document, (b) the title of the specific statement, and (c) the date or period covered.

- THE ESTATE OF JOHN DOE
  BALANCE SHEET
  December 31, 20X1

- JANE DOE TESTAMENTARY TRUST
  STATEMENT OF EARNINGS
  Year Ended December 31, 20X1

Format considerations such as the placement of the heading and capitalization should be consistent with the style used for other parts of the financial presentation.

The spacing between the last line of the financial statement heading and the first line of the column headings, e.g., 20X2, or the first caption in single-period financial statements, e.g., ASSETS, will vary with the length of the statement.

Different Levels of Services. When comparative financial statements are issued, the level of service provided for the periods presented may differ. Unaudited financial statements presented in comparative form with audited financial statements must be clearly marked to indicate their status. That may be done parenthetically either in the statement headings or column headings. Some accountants follow a similar policy when the financial statements for all periods are unaudited but the level of service differs. The following illustrates disclosing the level of service in the financial statement headings when one period has been compiled and another has been reviewed.

- THE ESTATE OF JOHN DOE
  BALANCE SHEETS
  December 31, 20X2 (Reviewed)
  and 20X1 (Compiled)

If one of the periods is audited and the other unaudited, disclosure in the heading is as follows:

- THE ESTATE OF JOHN DOE
  BALANCE SHEETS
  December 31, 20X2 (Audited)
  and 20X1 (Unaudited)

  or

- December 31, 20X2 (Unaudited)
  and 20X1 (Audited)

Referencing Notes. Generally accepted accounting principles do not require the financial statements be referenced to the notes. However, it is common practice to do so either by reference to specific items in the financial statements (a practice followed by many firms in the interest of clarity) or by a general reference (usually shown at the bottom of the page). A general reference is usually included because it reduces both professional time and clerical time in production and the likelihood of referencing errors also is eliminated. Examples of general references to the notes follow:

- See accompanying notes.
- See notes to financial statements.
- The accompanying notes are an integral part of these financial statements.

If only one financial statement is presented, the reference might refer to the statement by name rather than use of a general reference to the "financial statement." For example, when only a balance sheet is presented (e.g., a balance sheet only presentation for an estate, presented as of the date of death), the reference could appear as follows:

See notes to balance sheet.

Also, if an individual financial statement extends beyond a single page, only the last page should include a reference to the notes.

While any of the preceding references are acceptable, "See accompanying notes" may be used unmodified for almost any combination of financial statements.

When a note that is presented directly on the face of a financial statement also applies to other financial statements, a reference such as "See Note A on the balance sheet" should be made on those statements.

Balance Sheet (Statement of Assets, Liabilities, and Trust or Estate Equity)

Title. In practice, the most widely used title is "Balance Sheet" and that is the term used throughout this lesson. However, "Statement of Financial Position" also is acceptable. When the presentation includes more than one period, the title should be plural, for example, "Balance Sheets." Similar to the separate reporting of principal and income transactions when using the summary of account format, it may also be appropriate to present separate balance sheets for principal and income accounts.

Heading. In addition to the statement title, the heading of the balance sheet should include the legal name of the fiduciary entity and the date or dates as of which the statement is presented. For example, a comparative presentation might be headed as follows:

JANE DOE TESTAMENTARY TRUST
BALANCE SHEETS
December 31, 20X2 and 20X1

Alternative Formats. There are two basic ways that balance sheets are arranged.

- *Account Form (Side-by-side Format).* Assets are listed on the left-hand side and totaled to equal the sum of liabilities and equity on the right-hand side.
- *Report Form [Layered (or Running) Format].* Assets are listed at the top of the page followed by liabilities.

Recommended Format. Layered (or running) format, presented on a single, normal width page ($8\frac{1}{2} \times 11$) with a balanced presentation of assets equal to liabilities and equity, allows the reader to see the entire balance sheet at a glance.

Captions. Captions are headings within the statement that designate major groups of accounts to be totaled or subtotaled. Captions are also used to identify major totals or subtotals. The balance sheet for most estates and trusts includes three primary captions—Assets, Liabilities, and Trust or Estate Equity.

If a classified balance sheet is presented, secondary captions would be Current Assets and Current Liabilities, with the remaining assets and liabilities combined into two or three other secondary captions, based on their materiality. In most cases, fiduciary financial statements are not classified. Some of the more frequently used secondary captions are:

a. Assets
   - Property and Equipment
   - Receivables
   - Investments
   - Other Assets
   - Intangible Assets

b. Liabilities and Equity
   - Payables
   - Short-term Debt
   - Federal Income Taxes Payable
   - Long-term Debt
   - Obligations Under Capital Leases (or Long-term Capital Lease Obligations)
   - Other Liabilities
   - Trust (or Estate) Equity

The amount of detail included in secondary captions on the face of the balance sheet varies. The condensed presentation shown below may be preferable. (Additional disclosures necessary to conform with GAAP may be presented in the notes to the financial statements.)

ASSETS

Cash
Investments
Investment in Partnership
Receivables
Property
Other Assets

Accounting Policies in Captions. Some accounting policies for balance sheet accounts may be disclosed through expanded captions. For example, the method of valuing investments may be disclosed using a balance sheet caption such as:

Investments, at fiduciary acquisition value

The accounting policies for trusts and estates should generally be disclosed in the notes instead of on the face of the balance sheet.

Order of Presentation of Captions. The following guidelines for the order of assets are recommended:

a. Start with items held primarily for conversion into cash and rank them in the order of their expected conversion.

b. Follow with items held primarily for use in liquidating outstanding creditor claims and payment of bequests but that could be converted into cash, and rank them in the order of liquidity.

Following the guidelines just discussed, the order might be as follows:

a. *Assets.* The major assets normally would be presented in the following order:

   (1) Cash.

   (2) Marketable securities.

(3) Accounts and notes receivable.

(4) Inventories.

(5) Long-term investments (primarily business interests).

(6) Property and equipment.

(7) Intangible assets.

(8) Deferred charges.

b. *Liabilities.* Liabilities ordinarily are presented in the order of maturity as follows:

(1) Notes payable.

(2) Accounts payable.

(3) Accrued expenses.

(4) Long-term debt.

(5) Other liabilities.

(6) Deferred income taxes.

c. *Equity.* Prevalent practice is to present a single caption, Trust (or Estate) Equity, and include a separate statement of trust (or estate) equity. However, if several components are shown on the balance sheet, they may be presented in the following order:

(1) Trust (or Estate) Principal.

(2) Accumulated Trust (or Estate) Income (Undistributed Net Earnings).

Statement of Earnings

Title. Authoritative literature does not prescribe a title for the income statement. The following titles are found most frequently in practice for commercial business enterprises:

- Statement of Income.
- Statement of Operations.
- Income Statement.
- Statement of Earnings.

While "Statement of Income" is probably the most frequently used title by nonpublic companies, the title "Statement of Earnings" is probably more appropriate for an estate or trust. That title is consistent with the nature of a trust or estate since their purpose is generally not to measure the results of operations or determine income. In addition, referring to the statement as a "Statement of Earnings" avoids any confusion concerning whether the term "income" refers to overall income, or only transactions relating to the income beneficiaries. Cash and tax basis statements should not use one of the preceding titles without modification.

Heading. In addition to the statement title, the heading of the statement of earnings should include the legal name of the fiduciary entity and the period or periods for which the statement is presented. For example, a comparative presentation might be headed as follows:

JANE DOE TESTAMENTARY TRUST
STATEMENTS OF EARNINGS
Years Ended December 31, 20X2 and 20X1

Alternative Formats. The statement of earnings for business enterprises is usually presented in one of the following formats:

- *Single-step Format.* The single-step format groups the components of net earnings into two categories: (a) revenues and gains and (b) expenses and losses. The difference between the two subtotals is net earnings or loss for the period. In practice, the strict single-step format is often modified to show distributions to beneficiaries, income taxes, or equity in net earnings or losses of investees as a separate caption preceding net income, rather than including those amounts among operating items.

- *Multiple-step Format.* The multiple-step format shows intermediate components of net earnings. Generally, expenses are deducted from revenues, gains, expenses, and losses, and expenses are grouped by type or function. Intermediate components of net earnings that are frequently presented in multiple-step statements are gross profit, earnings from operations, and other income and expenses. The discussion of gross profit and income from operations assumes that the trust or estate holds an operating entity.

Recommended Format. The single-step format is consistent with the nature and reporting needs of an estate or trust. This contrasts with the common use of the multiple-step format by business enterprises, since the multiple-step format highlights gross margins and operations—areas that have little or no relevancy to many trusts and estates. Grantor trusts or trusts with extensive business activities may prefer to use the multiple-step format.

Captions. Captions within the statement of earnings will vary based on the nature of a fiduciary entity. For example, the way revenues and expenses are recognized, the detail presented, and the format of the statement of earnings will depend on the complexity of the fiduciary entity. Many of the captions discussed apply only to trusts or estates that hold an operating entity. The following are some practical guidelines:

Single-step Format:

- If the statement of earnings includes more than one revenue account, they are ordinarily listed under a heading such as "Earnings," "Revenues," or "Income." [Note: For cash or tax basis (cash basis taxpaying entity) presentations, these captions may be "Revenues Collected" or "Receipts."]

- Expenses are ordinarily listed under a heading such as "Costs and expenses" or "Expenses." [Note: For cash or tax basis (cash basis taxpaying entity) presentations, these captions may be "Expenses Paid" or "Disbursements."]

Multiple-step Format:

- If the statement of earnings includes more than one revenue account, they are ordinarily listed under a heading such as "Operating revenues."

- Amounts deducted in arriving at revenue presented on the statement of earnings should be disclosed on the face of the statement of earnings or in the notes to the financial statements, if material.

- Multiple-step formats usually present "Operating expenses" either as (a) a separate line item or (b) a heading below which are listed elements of costs.

- Other income and expenses should be identified, if material, either on the face of the statement of earnings or in the notes to the financial statements. Material income and expense items should not be obscured by classifying them under captions such as "Other income—net" or "Other expense—net."

Statement of Trust or Estate Equity

Title. In practice, the most widely used title is "Statement of Trust (or estate) Equity" and that is the term used throughout this lesson. However, "Statement of Changes in Trust Equity" also is acceptable. When the presentation includes more than one period, the title should be plural, for example, "Statements of Trust Equity."

Heading. In addition to the statement title, the heading of the statement of trust equity should include the legal name of the fiduciary entity and the period or periods for which the statement is presented. For example, a comparative presentation might be headed as follows:

JANE DOE TESTAMENTARY TRUST
STATEMENTS OF TRUST EQUITY
Years Ended December 31, 20X2 and 20X1

Alternative Formats. As discussed in Exhibit 1-1, only in fiduciary accounting are there "two classes of owners"—remainder beneficiaries and income beneficiaries. As a result, even if trust or estate equity is reflected in only one or a few captions on the balance sheet, the income and principal beneficiaries have an interest in determining the effect of the period's activities on their respective equity balances. Changes in trust or estate equity can be presented as follows:

a. Combined with the statement of earnings. (This approach is generally only appropriate when there is a single class of beneficiary.)

b. Presented as a separate statement or statements.

c. Presented on the face of the balance sheet. (This approach is rarely used in practice.)

In practice, the statement of trust (or estate) equity is generally presented in the following formats:

a. *Total Equity Format.* The change in trust equity is presented in a single column form and explained by captions to the left of the column. This format is primarily used when there is only one class of beneficiary. This format is illustrated in Exhibit 1-7.

b. *Component or Component/Beneficiary Format.* The components that comprise trust or estate equity are listed across the top of the statement and changes in each component are presented in columnar form and explained by captions to the left of the columns. In some cases, the changes in equity components are shown by beneficiary with a total column at the far right. The Component/Beneficiary format is illustrated in Exhibit 1-8.

Exhibit 1-7

Statement of Trust Equity—Total Equity Format

JOE JOHNSON TRUST
STATEMENT OF TRUST EQUITY
For the year ended December 31, 20X1

Balance at January 1, 20X1	$ 1,000,000
Net income	
Distributions to income beneficiaries	(150,000)
Balance at December 31, 20X1	$ 950,000

* * *

Exhibit 1-8

Statement of Trust Equity—Component/Beneficiary Format

JOE JOHNSON TRUST
STATEMENT OF TRUST EQUITY
For the year ended December 31, 20X1

	BENEFICIARY A		BENEFICIARY B		TOTAL	
	Principal	**Accumulated Trust Income**	**Principal**	**Accumulated Trust Income**	**Principal**	**Accumulated Trust Income**
Balance at January 1, 20X1	$ 450,000	$ 50,000	$ 450,000	$ 50,000	$ 900,000	$ 100,000
Net income		50,000		50,000		100,000
Distributions to beneficiaries		(75,000)		(75,000)		(150,000)
Balance at December 31, 20X1	$ 450,000	$ 25,000	$ 450,000	$ 25,000	$ 900,000	$ 50,000

* * *

In addition, separate statements may also be presented for each component within trust equity. This method may be appropriate only when (a) separate captions of each component are listed on the balance sheet or (b) separate balance sheets are presented for principal and income accounts.

Statement of Cash Flows

FASB ASC 230-10 (formerly SFAS No. 95, *Statement of Cash Flows*) requires that a statement of cash flows be included when financial statements purport to present both financial position and results of operations in accordance with GAAP. (A statement of cash flows is not required for OCBOA financial statements.) A statement of cash flows has five basic elements:

a. Cash flows from operating activities.

b. Cash flows from investing activities.

c. Cash flows from financing activities.

d. Net change in cash during the period.

e. Supplemental disclosure of noncash investing and financing activities.

Title. The guidance does not specify a title for the statement of cash flows. The predominant title found in practice is "Statement of Cash Flows."

Heading. As with the statement of earnings, the heading of the statement should include the legal name of the fiduciary entity, and the period or periods covered by the statement. For example, a comparative presentation might be headed as follows:

JANE DOE TESTAMENTARY TRUST
STATEMENTS OF CASH FLOWS
Years Ended December 31, 20X2 and 20X1

Alternative Formats. Cash flows from operations can be presented in either of two basic formats: the direct method or the indirect method. Most preparers of financial statements for commercial business enterprises use the indirect method. The direct method, which begins with cash receipts and deducts cash payments for operating costs and expenses, is probably best suited for fiduciary entities since it shows the actual sources and uses of cash. While the direct method may take more time to prepare than the indirect method for business enterprises, the nature of fiduciary accounting should simplify its preparation for trusts and estates.

Captions. Because cash flow statements are classified according to cash flows from operating, investing, and financing activities, captions are used to identify each section. Some typical examples are as follows:

a. Cash Flows from Operating Activities, Cash Flows from Investing Activities, Cash Flows from Financing Activities

b. Cash Provided by (Used by) Operations, Cash Provided by (Used by) Investments, Cash Provided by (Used by) Financing

c. Operations, Investments (or Investment Activities), Financing (or Financing Activities)

Because cash flows from operating activities applies only to an operating entity, a caption such as "cash flows from trust (or estate) activity" may be appropriate when the fiduciary entity does not hold an operating entity. The captions "Cash Flows from Trust (or Estate) Activities," "Cash Flows from Investing Activities," and "Cash Flows from Financing Activities" may be preferable for fiduciary statements, along with "Net Cash Provided (Used) by . . ." as captioned subtotals for each classification. Finally, the caption "Net Increase (Decrease) in Cash" can be used to identify the change in cash during the period.

Basic Financial Statements for an OCBOA

In an OCBOA presentation, the basic financial statements of a fiduciary entity will essentially be the same as a GAAP basis of accounting entity except that a statement of cash flows is not required. The financial presentation will include statements presenting financial position and results of operations measured under the OCBOA, descriptions of accounting policies, and notes to the financial statements. However, an exception exists for entities using the pure cash basis of accounting. Under the pure cash basis of accounting, a statement of assets, liabilities, and equity would be superfluous because the cash balance would be the only item that would appear, and a statement of changes in equity would be unnecessary because the cash basis does not recognize equity. Consequently, entities using the pure cash basis of accounting present a single statement titled "Statement of Cash Receipts and Disbursements."

Statement Titles. SAS No. 62, *Special Reports* (AU 623), indicates that titles of OCBOA financial statements should differ from those for similar statements prepared in accordance with GAAP so that there is no implication that the statements are presented in conformity with GAAP (AU 623.07). This is also inferred by SSARS No. 1, as amended, at AR 100.4 by the suggested use of appropriate OCBOA financial statement titles. While neither SAS No. 62 nor SSARS No. 1 specifies *required* titles for OCBOA financial statements, they present examples as follows:

- *Modified Cash Basis:*
  - Statement of Assets and Liabilities Arising from Cash Transactions
  - Statement of Revenue Collected and Expenses Paid
- *Tax Basis:*
  - Statement of Assets, Liabilities, and (Trust or Estate) Equity—Income Tax Basis
  - Statement of Revenue and Expenses—Income Tax Basis

AICPA Technical Practice Aids TIS Section 1500, *Financial Statements Prepared Under an Other Comprehensive Basis of Accounting (OCBOA),* Paragraph .04, echoes SAS No. 62 and SSARS No. 1 in stating that *the use of unmodified GAAP titles in and OCBOA presentation is not acceptable.* The TIS notes that any modified title would meet the SAS No. 62 requirements provided it is clear that the financial statements are not prepared in accordance with GAAP. Best practices indicate that OCBOA statements are made more understandable by the consistent use of uniform statement titles, including:

- using the title "Cash Basis" to refer to "Modified Cash Basis" financial statements (since the "modified cash basis" is frequently referred to as "cash basis" in practice), and
- using consistent titles [e.g., "Statement of Assets, Liabilities, and (Trust or Estate) Equity" in referring to the balance sheet] for cash basis and tax basis financial statements, except for the addition of "cash basis" or "tax basis" to the end of each title.

This approach should facilitate review and promotes consistency. Exhibit 1-9 summarizes recommended OCBOA financial statement titles. Those titles, which are acceptable under SAS No. 62 and SSARS No. 1, as amended by SSARS No. 15 (AR 100.04), are used uniformly throughout this course for all OCBOA financial statements.

Exhibit 1-9

Recommended OCBOA Statement Titles

GAAP	Cash	Tax
1. Balance Sheet	1. Statement of Assets, Liabilities, and (Trust or Estate) Equity—Cash Basis	1. Statement of Assets, Liabilities, and (Trust or Estate) Equity—Income Tax Basis
2. Statement of Earnings	2. Statement of Revenues and Expenses—Cash Basis	2. Statement of Revenues and Expenses—Income Tax Basis (or Statement of Income and Expenses—Income Tax Basis)
3. Statement of (Trust or Estate) Equity	3. Statement of (Trust or Estate) Equity—Cash Basis	3. Statement of (Trust or Estate) Equity—Income Tax Basis
4. Statement of Changes in (Trust or Estate) Equity	4. Statement of Changes in (Trust or Estate) Equity—Cash Basis	4. Statement of Changes in (Trust or Estate) Equity—Income Tax Basis
5. Statement of Cash Flows	6. Statement of Cash Flows—Cash Basis	7. Statement of Cash Flows—Income Tax Basis

Notes:

1. These statement titles are acceptable under SAS No. 62, *Special Reports*, and SSARS No. 1, as amended (AR 100.04). Other equally suitable titles may be derived from the suggested titles in the authoritative literature.
2. The pure cash basis has a single asset and no liabilities. Accordingly, there is no need to present a "Statement of Assets, Liabilities, and Equity." Instead, a single statement titled "Statement of Cash Receipts and Disbursements" is customarily presented.
3. Although FASB ASC 230-10 (formerly SFAS No. 95) does not require a statement of cash flows for OCBOA financial statements, if it is presented, it can be titled "Statement of Cash Flows—Cash (or Income Tax) Basis."

* * *

Statement of Assets, Liabilities, and Trust or Estate Equity. With the exception of measurement and statement titles (see previous discussion), the presentation of the statement of assets, liabilities, and trust (or estate) under an OCBOA would be the same as those discussed earlier concerning the balance sheet.

Statement of Revenues and Expenses—OCBOA Basis. With the exception of measurement and statement titles, the presentation of the statement of revenues and expenses under an OCBOA would be the same as those discussed regarding the statement of earnings. Issues relating to presentation of nontaxable revenues and nondeductible expenses in tax basis financial presentations are discussed shortly.

Statement of Trust or Estate Equity. As discussed previously, financial presentations should present a statement of trust or estate equity or statement of changes in trust or estate equity, as appropriate. The fact that the basis of accounting used is an OCBOA does not change this basic financial statement requirement.

Statement of Cash Flows. As discussed earlier, FASB ASC 230-10 (formerly SFAS No. 95, *Statement of Cash Flows*) requires presenting a statement of cash flows whenever financial statements purport to present both financial position and results of operations in conformity with GAAP. Accordingly, a statement of cash flows is not required if the financial statements are prepared on a basis of accounting other than GAAP. That conclusion is consistent with Interpretation No. 14 of SAS No. 62 (AU 9623.90–.95), "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity with an Other Comprehensive Basis of Accounting (OCBOA)," which notes that a statement of cash flows is not required in OCBOA presentations. In practice, some entities present statements of cash flows in OCBOA presentations anyway. However, it is believed that a statement of cash flows in an OCBOA presentation of a fiduciary entity is rare. Nonetheless, if presented, the statement of cash flows should be treated and reported on as a basic financial statement—not as supplemental information.

Special Considerations for Income Tax Basis Financial Presentations. Entities should report taxable revenues and deductible expenses at the amounts reflected in the income tax return. However, in computing taxable income, income tax rules provide for the exclusion of certain tax-exempt revenues and nondeductible expenses. Those nontaxable revenues and nondeductible expenses are normally referred to as *permanent differences*, but some accountants refer to them as *excludable items*. Unlike many other income tax returns, the fiduciary tax return (Form 1041) does not include a schedule that reconciles *net income* with *taxable income*. Instead, information about tax-exempt income (e.g., receipts of tax-exempt interest income) is included as "Other Information" on Form 1041. Nondeductible expenses (e.g., itemized deductions falling within the 2% floor, disallowed passive losses, certain personal expenses, etc.) are not included in the return. However, nondeductible items are often reported in supporting schedules to the return.

As is the case with individuals, miscellaneous itemized deductions of estates and trusts are deductible only to the extent they exceed 2% of adjusted gross income. In addition, personal expenses not associated with the management, conservation, or maintenance of property are not deductible. For example, utilities, repairs and maintenance expenses incurred for a house that is used as the personal residence of a beneficiary would not be deductible.

The following are two common questions accountants have related to nontaxable revenues and nondeductible expenses and their effect on income tax basis financial statements:

a. How should nontaxable revenues and nondeductible expenses be presented in tax basis financial statements?

b. Does the statement of revenues and expenses need to reflect taxable income?

<u>Presenting Nontaxable Revenues and Nondeductible Expenses in Tax Basis Financial Statements.</u> If tax basis financial statements are intended to measure results (including nontaxable revenues and nondeductible expenses) on a comprehensive basis of accounting rather than to simply mirror the tax return, then measuring permanent differences and reflecting them in some way in tax basis financial statements is also necessary for the financial statements to balance. For example, the cash receipt of exempt interest income results in a debit to cash in the fiduciary accounting records. Therefore, a corresponding credit is necessary for the entry to balance. Accordingly, tax-exempt revenues and nondeductible expenses should be included in earnings in the period they are measured. That is, cash basis entities should recognize nontaxable revenues when received and nondeductible expenses

when paid, and accrual basis entities should recognize nontaxable revenues when earned and nondeductible expenses when incurred.

Taxable Income and the Financial Statements. Reporting permanent differences on the statement of revenues and expenses can result in reporting net income that differs from taxable income on the tax return. As just mentioned, that raises the question of whether the statement of revenues and expenses should reflect taxable income. Initially, it seems desirable for net income on the financial statements to agree with taxable income on the tax return (or for taxable income to at least be captioned on the statement of revenues and expenses). For fiduciary entities, "taxable income" is a caption in Form 1041, (U.S. Income Tax Return for Estates and Trusts).

The bottom line of the statement of revenues and expenses should be viewed as net income determined on the income tax basis, regardless of the specific caption used. Therefore, there is no attempt to show taxable income on the statement. (A copy of the tax return can often be obtained if users are interested in information about taxable income.) Also, it is believed that disclosure of the amounts of items that are not ultimately included in taxable income has relevance only in assessing the relationship of income taxes to pretax income. Therefore, it would seldom provide users with useful information in the financial statements of nontaxable fiduciary entities (e.g., grantor trusts in which income and losses are passed through to the grantor). Accordingly, it is believed disclosure of nontaxable revenues or nondeductible expenses is not required in the tax basis financial statements of nontaxable entities. However, the authors believe the significant reasons for the difference between the tax provision in an entity's financial statements and the amount that would result from applying statutory rates to pretax income should be disclosed in the notes to the financial statements.

Reporting Taxable Income or Disclosing Nondeductible and Nontaxable Amounts. Circumstances may arise in which it is useful to provide information to users about taxable income or the amounts of nontaxable revenues and nondeductible expenses. In such cases, that information can be provided either in the notes to the financial statements or in the statement of revenues and expenses, in one of the following ways:

- Present the nontaxable revenues and nondeductible expenses as separate line items on a statement of revenues and expenses that does not reconcile to taxable net income (e.g., a separate financial statement line item might be captioned "tax-exempt interest income on state and local government obligations").

- Include the nontaxable revenues and nondeductible expenses in line items with taxable revenues and deductible expenses (such as interest income and other expenses), but then provide a reconciliation on the statement of revenues and expenses or in the notes that starts with pretax income and lists permanent differences and deductions subject to limitations to arrive at taxable income.

If a reconciliation to taxable income is presented in the statement of revenues and expenses, the disclosure of the change in trust or estate equity can reflect either (a) the net income amount that would have been shown on the statement of revenues and expenses had the reconciliation not been provided or (b) the two components of that amount, consisting of net income and amounts that were nontaxable or nondeductible. In practice, a reconciliation to taxable income is rarely presented in the statement of revenues and expenses. If the change in trust or estate equity reflects an amount for nontaxable revenues and nondeductible expenses, the summary of significant accounting policies might include a disclosure similar to the example provided later in the lesson.

Exhibit 1-10 illustrates an example statement of revenues and expenses that presents nontaxable revenues and nondeductible expenses as separately captioned line items. It also illustrates an example statement of trust equity that would be appropriate for that type of presentation.

Exhibit 1-10

Jane Doe Testamentary Trust
Statement of Revenues and Expenses—Income Tax Basis
Year Ended December 31, 20X8

REVENUE	
Dividend income	$ 50,025
Tax-exempt interest income on state and local government obligations	25,000
Other interest income	35,520
Gains on sale of investments	8,000
	118,545
EXPENSES	
General and administrative expenses	20,127
Interest expense	8,500
Property taxes	10,800
Depreciation	5,000
Nondeductible expenses	5,000
	49,427
EXCESS OF REVENUES OVER EXPENSES BEFORE INCOME TAXES	69,118
FEDERAL INCOME TAX EXPENSE	19,000
EXCESS OF REVENUES OVER EXPENSES	$ 50,118

Jane Doe Testamentary Trust
Statement of Trust Equity—Income Tax Basis
Year Ended December 31, 20X8

BALANCE, January 1, 20X8	$ 550,205
Excess of revenues over expenses	50,118
BALANCE, December 31, 20X8	$ 600,323

* * *

DISCLOSURE CONSIDERATIONS

The next few paragraphs discuss the most common disclosures found in trust and estate financial statements. Generally, financial statement disclosures include those made on the face of the statements and those included in notes to the financial statements. This discussion is not intended to be all-inclusive, but is intended to discuss and illustrate the more common, and unique disclosures relating to trusts and estates.

General Considerations

Because the notes are an integral part of financial statements, they should be used to present material disclosures that are not otherwise presented in the statements, i.e., generally, on the face of the statements. Notes for comparative financial statements should cover all periods presented to the extent they remain relevant.

Responsibility for Notes. As an integral part of the financial statements, the notes are the responsibility of the client even though the practitioner may assist with, or totally prepare, the statements and notes. The wording of the notes should follow that principle, and, to avoid any implication of reference to the practitioner, words such as "we," "us," "client," and "our" should not be used. Terms such as "the Trust," "the Estate," or "the Trustee," are more appropriate ways of referring to the client.

Title and Heading. The predominant title found in practice is "Notes to Financial Statements." The heading of the notes should include the legal name of the entity and the title. In practice, some practitioners include the balance sheet date in the heading while others do not. A date is not included because notes relate to the accompanying statements, each of which is dated. An example of a heading for the notes is as follows:

JANE DOE TESTAMENTARY TRUST
NOTES TO FINANCIAL STATEMENTS

When a single statement is presented and notes are presented on separate pages, the title should include the name of the statement rather than the general term "financial statements."

JANE DOE TESTAMENTARY TRUST
NOTES TO STATEMENT OF ASSETS, LIABILITIES AND TRUST EQUITY

When compiled financial statements exclude substantially all disclosures but do include selected notes, the separate pages of the notes should be labeled as follows:

JANE DOE TESTAMENTARY TRUST
SELECTED INFORMATION—Substantially All Disclosures Required by Generally Accepted Accounting Principles are Not Included

Format and Captions. Generally, the notes should be arranged in the same order as the amounts in the statements to which they relate, and each note should bear a descriptive caption that corresponds to the related financial statement caption, using letters of the alphabet to identify notes rather than numbers. For example, a note discussing property and equipment might be captioned as follows:

NOTE C—PROPERTY AND EQUIPMENT

Overview of GAAP Disclosure Requirements

SSARS No. 1 (AR 100) allows the client to omit substantially all disclosures only in a compilation engagement. However, as a practical matter, this reporting alternative is not encouraged because the accounting conventions for estates or trusts are not widely known by the public. Also, certain GAAP accounting conventions can be peculiar to each entity, depending on the requirements of the governing document. Whenever possible, the accountant should recommend that the financial statements include the following note disclosures:

a. A summary of significant accounting principles that explains the GAAP accounting conventions used and any peculiar accounting required by the governing document (or state law).

b. A disclosure of significant transactions that do not affect the amount (or assets) for which the fiduciary is accountable. For example, disclosure in a note (or parenthetically on the face of the statement) of any debt that is secured by a deed of trust on assets of the estate or trust is encouraged.

c. A description of the methods used to determine the current values.

d. A disclosure of major subsequent events. For example, a major decline in the current values of an asset (like common stock) that occurred between the financial statement date and the date that the report is issued should be disclosed.

Departures from GAAP. In most engagements, the accountant should not encounter GAAP departures. However, in certain interim engagements, the fiduciary may not desire to present an asset (or principal and income) strictly in accordance with GAAP. An example might be the failure to reflect both the current values determined at the date an estate was originally created and the current values at the interim statement date. (For example, the fiduciary may believe it is not prudent for the estate to incur the cost of obtaining new appraisals on real estate assets at an interim date.) Another departure at an interim date might be the fiduciary's wish not to distinguish between principal/income receipts and disbursements. Whenever there is a *material* GAAP departure, the SSARS report should be modified accordingly. As a word of caution, the materiality guidelines for commercial entities may not be appropriate for an estate or trust because a court or beneficiaries may view every adjustment as being material.

Summary of Significant Accounting Policies

FASB ASC 235-10-50 (formerly APB Opinion No. 22) states that disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, results of operations, or cash flows. In general, the disclosure should include important principles related to recognition of revenue and allocations of asset costs to current and future periods. In particular, the disclosure of significant accounting policies should include accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives.

b. Industry peculiarities (such as fiduciary accounting principles for trusts and estates) in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry.

c. Unusual or innovative application of GAAP.

Caption and Format. The format, including the location of the summary of significant accounting policies, is flexible. However, it is preferable to present a separate summary or to include it in the first note (or second note if basic information about the entity is addressed in the first note). Presentation as the first note is recommended. Although not required, if the form of fiduciary entity (estate, trust, type of trust, etc.) is not apparent, it should be described in the summary.

The caption recommended is:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

That caption appears to be the most commonly used in practice.

Generally, the summary of significant accounting policies note is divided into subsections for each specific policy or financial statement caption discussed. The format used in this course includes first letter capitalization and underlining of subcaptions as follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

<u>Nature of Operations</u>

<u>Use of Estimates</u>

<u>Investment Securities</u>

<u>Depreciation</u>

Numbers in the Policy Notes. Normally, the summary of significant accounting policies should deal only with policies, and numbers should be excluded. However, exceptions may be justified when an additional note would have to be presented just to disclose the numbers.

Nature of Operations. FASB ASC 275-10-50 (formerly AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*) requires that entities disclose the following:

a. A description of the major products or services the reporting entity sells or provides and its principal markets, including the location of those markets.

b. If the entity operates in more than one business, disclosures must indicate the relative importance of each business and the basis for determining relative importance.

The guidance does not specify where the disclosure should be located, suggested the disclosure be either (a) the first paragraph in the Summary of Significant Accounting Policies or (b) included in a note that precedes the summary of significant accounting policies that addresses basic information about the fiduciary entity. The disclosure might be as follows:

> The principal business of the John Smith Trust (the Trust) is oil and gas exploration and production in several states within the United States, and investing activities, which include investments in equity securities of foreign and domestic corporations, affiliates, partnerships, and debt securities.

For fiduciary financial statements, the nature of operations disclosure relates to businesses, other activities, and revenue sources. This information may be readily apparent from (or combined with) other basic disclosures about the fiduciary entity, as discussed in the following paragraphs.

Basic Information about the Fiduciary Entity. For traditional business enterprises, the nature of operations disclosure combined with other information (e.g., name of entity, operations presented in the income statement, etc.) usually provides the financial statement users with basic information about the entity. However, in fiduciary financial statements, often only the name of the entity is necessary to clue the reader that the financial statements relate to a trust or estate. In order to provide full disclosure of information that is important to the interested parties of the fiduciary entity, the following information should either be included (a) in the first note, or (b) in the summary of significant accounting policies:

- Date created (trust); date of death (estate).
- Type of trust.
- General information about—
  - the purpose of the trust.
  - termination of the estate or trust (e.g., date, terms, etc.).
  - beneficiaries and distribution of estate or trust assets.
- Identification of trustee or executor (optional).

In determining the nature and extent of such disclosures, preparers must balance the need to provide sufficient information to make the statement useful and the desire on the part of most fiduciary entities to keep certain details private.

The disclosures might be as follows:

- The trust was created on March 15, 20X4, for the benefit of the lineal descendants of William and Nancy Wonka. Distributions are made for the support and education of the beneficiaries from income, in equal or unequal amounts for any one or more of the beneficiaries at the discretion of the Trustee, subject to certain limitations. When a beneficiary attains the age of 18 years, the Trustee shall distribute one half of the principal of the trust as constituted to the beneficiary and the balance of the principal of such share shall be distributed to that beneficiary when the age of 25 is attained.

- The Joe Johnson Trust is a generation skipping trust created in the state of Texas in 20X6. The lifetime income beneficiary is Mary Johnson. The trustee is Ellen Johnson Smith.

- The Thomas Rich Trust (the Trust), with Joe Smith, Betty Jones, and Richard Evans, as trustees, was created by declaration of trust executed in 20X8. The Trust is a grantor trust established by Thomas Rich (the Grantor) for his sole benefit.

The captions recommended include:

Trust (Estate) Organization

Creation of the Trust (Estate)

Terms of the Trust (Estate)

Regardless of placement of the summary of significant accounting policies, the information may be combined with the nature of operations disclosure discussed earlier.

Use of Estimates. FASB ASC 275-20-50 requires that financial statements include an explanation that preparing financial statements requires the use of management's estimates. The guidance acknowledges that the disclosure will usually be standardized (that is, boilerplate) but does not specify where the disclosure should be located. One option is to place the disclosure near the beginning (i.e., second or third paragraph) of the Summary of Significant Accounting Policies. Other locations may be equally acceptable. The following examples illustrate how the disclosure might be made:

- The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities (assuming liabilities are presented in the financial statements) and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

- Management uses estimates and assumptions in preparing financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities (assuming liabilities are presented in the financial statements), the disclosure of contingent assets and liabilities, and the reported revenues and expenses. Actual results could differ from those estimates.

- Management uses estimates and assumptions in preparing financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities (assuming liabilities are presented in the financial statements), the disclosure of contingent assets and liabilities, and the reported revenues and expenses.

Disclosure of significant risks and uncertainties, including two additional disclosure requirements that appear less often in the financial statement of trusts and estates (i.e., certain significant estimates and current vulnerability due to concentrations), are not discussed in detail in this course.

Basis of Accounting. Financial statements should include a note that discusses the basis of accounting (i.e., basis of presentation), preferably as the first item following the use of estimates disclosure in the Summary of Significant Accounting Policies, but other locations may be equally acceptable. Because (a) readers may not be familiar with GAAP for fiduciary entities and (b) certain GAAP accounting conventions can be peculiar to each entity, depending on the requirements of the governing document, best practices indicate that all GAAP accounting conventions used and any peculiar accounting required by the governing document (or state law) should be disclosed. Because of the issues surrounding GAAP for fiduciary entities, this disclosure will vary based on the basis of presentation and the particular governing document. As a result, the disclosure may appear similar to an OCBOA basis of accounting disclosure where differences from traditional GAAP principles are described.

Format of Financial Statements. Because financial presentations for estates and trusts may be presented in several formats (e.g., summary of account, charge and discharge statement, and traditional financial statements), the following disclosure may be included in the summary of significant accounting policies when a traditional financial statement presentation is used:

> The format for presenting the financial condition of the Trust is a format similar to a general business financial statement presentation because the Trustee believes this format more clearly presents the financial operations and position of the Trust.

This statement will generally be included with (or near) the basis of accounting or basis of presentation disclosure.

Cash. When a statement of cash flows is presented, disclosure of items considered to be cash equivalents is required. Examples of such disclosures follows:

> Cash Equivalents
>
> For purposes of the statement of cash flows, the Trust considers all short-term securities purchased with a maturity of three months or less to be cash equivalents.
>
> Cash Equivalents
>
> The Trust considers all investments with original maturities of less than three months to be cash equivalents. Cash equivalents at December 31, 20X8, consist of time deposits and deposits with brokers.

Income Taxes. Although not required by the criteria discussed earlier, some practitioners include an income tax accounting policy note. In instances where the disclosure is made, the following note is often used:

> Income Taxes
>
> Distributions to beneficiaries are allowed as a deduction from taxable income in arriving at taxable income for the Trust. These distributions to the beneficiaries flow through to the individual returns of the beneficiaries.
>
> Income Taxes
>
> The liability for federal income taxes is based on net earnings for the year less distributions to the Trust's current income beneficiaries and certain other allowable deductions.

Other Accounting Policies Disclosures. Several authoritative pronouncements specifically require disclosure of accounting policies. Disclosures that are common for trusts and estates are as follows:

- *Property and Equipment/Depreciation.* Basis for stating property and equipment and general description of the methods used in computing depreciation for major classes of depreciable assets.

  > Property and Equipment
  >
  > Property and equipment are stated at cost and used solely for income producing purposes. Depreciation is computed over prescribed periods using the straight-line method.

- *Marketable Securities.* The basis on which cost (or fiduciary accounting value) is determined in computing realized gain or loss.

  > Marketable Investment Securities
  >
  > The majority of the Trust's investments in marketable investment securities is held in portfolios managed under arrangements with certain third party investment managers, while the remaining investments in marketable securities are managed by the Trust. Marketable securities are recorded at cost. The cost of securities sold is determined on an average cost basis.

- *Intangibles Amortization.* The method and period of amortization.

In addition, disclosing relatively complex accounting methods prescribed by authoritative literature is advised. For instance:

- *Investments in Debt and Equity Securities.* The basis on which cost (or fiduciary accounting value) is determined in computing realized gain or loss, and the accounting treatment of unrealized gains and losses.

Accounting for Investments

Investments in debt securities are stated at cost. In accordance with the trust agreement, gains and losses associated with the investments are recorded in the accompanying financial statements when realized.

- *Investments in Businesses, Joint Ventures, or Partnerships.* Basis on which cost (or fiduciary accounting value) is determined in computing realized gain or loss, method of accounting (e.g., cost, equity), and any differences between the investee's and fiduciary investor's year end. Additional guidance follows.

Investments in Partnerships

Investments in partnerships consist of capital contributions and advances plus the Trust's share of partnership operating results, less capital withdrawals and distributions.

Other Common Disclosures

Some of the common disclosures for trusts and estates are discussed in the following paragraphs.

Investments in Corporations, Joint Ventures, and Partnerships. Accounting for investments in partnerships is not directly addressed in authoritative literature. However, FASB ASC 323-10-15-3 (formerly AICPA Accounting Interpretation No. 2 of APB Opinion No. 18), while specifically stating that FASB 323-10 applies only to investments in common stock of corporations and investments in partnerships, does state that many of its provisions are appropriate in accounting for such investments. Based on FASB ASC 323-10 and 323-30-15-3 (formerly APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and AICPA Accounting Interpretation No. 2 of APB No. 18), fiduciary entities ordinarily should use the equity method of accounting for investments of 20% or more but less than 50% of a partnership, corporation, or unincorporated joint venture. The Interpretation notes, however, that for partnerships in certain industries (e.g., oil and gas ventures), it may be appropriate for the investor to record in its financial statements its pro rata share of the assets, liabilities, revenues, and expenses of the venture. For investments of less than 20%, the cost method generally should be used. However, as with other transactions, the provisions of the governing document and state law should be considered relating to accounting treatment.

Accounting for business operations is generally performed in a separate set of books and is not combined or consolidated with those of the trust or estate. While the operations are generally not "consolidated" with the fiduciary entity, the trust or estate must meet certain disclosure requirements. The equity method is used to account for an investment if the investor has the ability to significantly influence the investee's financial and operating policies. Like other investors, FASB ASC 323-10-50 (formerly APB Opinion No. 18) requires the fiduciary entity to include the following disclosures about an investment accounted for under the equity method:

a. Name of the investee.

b. Percentage ownership of the investee's common stock.

c. Investor's accounting policies with respect to investments in common stock. (If an investee is 20% or more owned but not accounted for under the equity method, the disclosure should include the name of the investee and the reasons why the equity method is not appropriate. Conversely, if an investee is less than 20% owned but accounted for under the equity method, the disclosure should include the name of the investee and the reasons why the equity method is being used.)

d. Difference, if any, between the carrying amount of the investment and the underlying equity in net assets, and the accounting treatment of the difference.

e. If a quoted market price for the investment is available, the aggregate value of the investment based on the quoted price.

f. If equity method investments are, in the aggregate, material to the investor's financial position or results of operations, summarized information about the investees' assets, liabilities, and results of operations.

g. Material effects on the investor of possible conversions of the investee's outstanding convertible securities.

Like other entities, when determining the extent of the disclosures, the investment's significance to the fiduciary entity's financial position and results of operations should be considered. However, as a word of caution, the materiality guidelines for commercial entities may not be appropriate for an estate or trust because a court or beneficiaries may view *every* transaction or balance with heightened interest.

Notes Payable and Long-term Debt. If a classified balance sheet is presented, current portions of notes payable and long-term debt should be presented as current liabilities. Long-term debt should be identified in the balance sheet or related notes by significant categories (e.g., notes to banks, mortgage notes, or related party notes). If liabilities are not presented on the face of the financial statements due to the fiduciary principles applied, best practices indicate that such liabilities should be disclosed in the notes. This is consistent with the guidance provided by the Committee on National Fiduciary Accounting Standards in its report titled *Uniform Fiduciary Accounting Principles and Model Account Formats* (UFAP), which encourages such disclosures. Common disclosures for notes payable and long-term debt include:

a. Assets pledged or otherwise subject to lien.

b. Maturities of long-term debt for each of the five years following the date of the latest balance sheet presented.

c. Financial arrangement and terms for short-term obligations classified as noncurrent because of expected refinancing.

d. Interest rates, maturity dates, restrictive covenants, and subordinate features.

Related Party Transactions. FASB ASC 850-10-50 (formerly SFAS No. 57, *Related Party Disclosures*) requires the following disclosures for related party transactions:

a. The nature of the relationship involved.

b. A description of the transactions, including those to which no amounts or nominal amounts were ascribed, for each of the statement of earnings periods presented, and such other information deemed necessary to understand the effects of the transactions on the financial statements.

c. The dollar amounts of transactions for each of the periods for which statements of earnings 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 balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

In addition, the related party disclosures may also be affected by the SFAS No. 13, *Accounting for Leases*, requirement to recognize the economic substance of leasing arrangements with related parties rather than the legal form.

The FASB currently has a project to evaluate existing accounting for leases. Further discussion is included later in this lesson.

Common related party disclosures of fiduciary entities include:

a. Receivables from beneficiaries.

b. Payment of management, fiduciary, or other fees to the trustee or personal representative, a beneficiary, or a related entity.

c. Leases between related entities and the fiduciary entity.

d. Other transactions with beneficiaries or related trusts.

Notes and Accounts Receivable. FASB ASC 310-10-50 [formerly SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*] provides disclosure guidance for loans, notes, and trade receivables, and other financing activities. The guidance generally applies to entities that lend to or finance the activities of others and, therefore, is applicable to a wide variety of small and midsize entities. An example would be a business whose only receivables are balances outstanding under customary short-term trade arrangements with customers. As discussed previously, assets of an estate or trust generally are not recognized until there is a passage of legal title, other indications of ownership, or the asset has been converted to cash. Thus, receivables generally are not recognized unless there is written evidence of their existence.

For an estate, receivables that are commonly recorded include:

- Receivables for life insurance.
- Receivables from beneficiaries.
- Notes receivable.

Receivables for life insurance proceeds rarely would meet the criteria contained in FASB ASC 310-10-50. Depending on the nature of the receivables from beneficiaries or notes receivable, such receivables could be subject to its provisions.

Receivables occur more frequently in trusts due to the ongoing nature of many trusts and the types of assets included in the trust. One way that the requirements of SOP 01-6 could be applicable to estates or trusts is when the fiduciary entity's assets include a business or other assets that generate trade or other receivables. For example, this could include receivables relating to:

- Property rentals.
- Oil and gas activities.
- Financing activities of a trade or business.

The required disclosures generally fall into the following categories:

- Accounting policies for trade receivables, such as the basis of accounting for them and the method of recognizing interest assessed on balances outstanding.
- Accounting policies for credit losses and doubtful accounts.
- Accounting policies for nonaccrual and past-due receivables, such as policies for placing receivables on nonaccrual status, recording payments received on nonaccrual loans, charging off uncollectible amounts, and determining past-due or delinquency status.
- Gains and losses from sales of trade receivables.
- Foreclosed and repossessed assets.
- The carrying amount of trade receivables on nonaccrual status and receivables that are past-due 90 days or more and still accruing interest.
- The carrying amount of trade receivables that serve as collateral for borrowings.

Subsequent Events. The authoritative literature on accounting for subsequent events that is in FASB ASC 855-10 (formerly SFAS No. 165, *Subsequent Events*) provides guidance on two types of subsequent events.

a. The first type, referred to as *recognized subsequent events*, provides additional information about whether an asset was impaired or a liability was incurred at the end of the reporting period. This information should be considered in determining the carrying amount of the asset or liability at the end of the reporting period.

b. The second type, referred to as *nonrecognized subsequent events*, provides information that does not indicate that an asset was impaired or a liability was incurred at the end of the reporting period but may require disclosure so the financial statements will not be misleading.

To illustrate how to apply the guidance in financial statements prepared using generally accepted accounting principles, assume that at year-end an estate that includes a sole proprietorship business has a significant amount due under a trade account with a major customer that is having financial difficulties. Subsequent to year-end, the customer incurs a substantial uninsured loss. That information should be considered in determining whether a loss should be recognized for impairment of the principal outstanding under the account at year-end.

Now change the illustration so that the customer was not having financial difficulties at year-end. Although the principal outstanding under the trade account was not impaired at year-end, it may be necessary to disclose the subsequent uninsured loss in order to keep the financial statements from being misleading.

FASB ASC 855-10-50 requires disclosure of the following:

a. The date through which subsequent events have been evaluated by the reporting entity's management and whether that date is the date the financial statements were issued or the date the financial statements were available to be issued. Note that this disclosure is required regardless of whether an actual subsequent event occurred.

b. The nature of, an estimate of the financial statement effect of, or a statement that such an estimate cannot be made for subsequent events that are of such a nature that they must be disclosed to keep the financial statements from being misleading (nonrecognized subsequent events).

TIS 1500.07, *Disclosure Concerning Subsequent Events in Financial Statements Prepared on an Other Comprehensive Basis of Accounting*, clarifies that these disclosures should be made in financial statements prepared on the pure cash, modified cash, or income tax basis of accounting.

FASB ASC 855-10-50-3 also notes that an entity should consider supplementing the historical financial statements with pro forma data or presenting pro forma financial statements if a nonrecognized subsequent event is so significant that disclosure is best made by means of such pro forma financial data.

When financial statements are reissued, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. FASB ASC 855-10-25-4 states that events occurring between the time of original issuance and reissuance of the financial statements should not result in adjustment to the financial statements unless required by GAAP or regulatory requirements.

FASB ASC 855-10-50-4 requires an entity to disclose the date through which subsequent events have been evaluated in both the originally issued financial statements and the reissued financial statements. Generally this disclosure should also be made in financial statements prepared on the pure cash, modified cash, or income tax basis of accounting in OCBOA financial statements.

Other subsequent events guidance for compilation and reviews can be found at AR 100.73–.76 and Exhibit C in the SSARS Codification.

Illustrative Disclosure. An example subsequent events disclosure follows.

NOTE X—SUBSEQUENT EVENT

Events subsequent to December 31, 20X7 have been evaluated through March 18, 20X8, the date these financial statements were available to be issued, to determine whether they should be disclosed to keep the financial statements from being misleading. Under an agreement effective February 16, 20X8, a partnership in which the Trust has an interest was relieved of future obligations in a real estate joint venture. Substantially all of the Trust's investment in the partnership, totaling approximately $76,000 at December 31, 20X7, will be deemed worthless for federal income tax purposes during 20X8. Management found no other subsequent events that should be disclosed.

Disclosure Considerations—Terms of an Agreement Basis

The disclosure requirements for fiduciary financial statements prepared in accordance with the terms of an agreement are the same as those for GAAP financial statements, with added emphasis given to the disclosure of the basis of accounting. The accounting policy note should state that the financial statements are prepared in accordance with the governing document and should list the significant accounting policies required by the governing instrument.

Disclosure Considerations—OCBOA Financial Statements

Financial statements prepared on an OCBOA also require notes and other disclosures. (If the statements are compiled, management may elect to omit substantially all disclosures. However, that option is not available if the statements are reviewed or audited.) The disclosure requirements under OCBOAs are not defined in the accounting literature as they are under GAAP. Guidance is found in Paragraphs 9 and 10 of SAS No. 62 (AU 623.09–.10) under the section titled "Evaluating the Adequacy of Disclosure in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting." Interpretation No. 14 of AU 623 (AU 9623.90–.95) clarifies the requirement further. The guidance in SAS No. 62 and Interpretation No. 14 are discussed in the following paragraphs.

General Considerations. SAS No. 62 provides the following guidance on disclosures to be provided in audited financial statements prepared on an OCBOA:

- A note should state the basis of presentation and describe how the basis differs from GAAP.
- The authoritative accounting literature has established disclosure requirements for various items. When OCBOA financial statements reflect the same or similar items as statements prepared using generally accepted accounting principles, similar disclosures should be made. Interpretation No. 14 of SAS No. 62 further clarifies the SAS No. 62 disclosure requirements by stating that OCBOA financial statements should provide relevant disclosures that would be required under GAAP provided that information communicates the substance of the disclosure. (Thus, in some cases, qualitative information could replace the quantitative information requited by GAAP). Some of the more common disclosures under GAAP and OCBOA financial statements include property and equipment, depreciation, equity, contingencies and uncertainties, related party transactions, restrictions on assets and equity, and subsequent events.

Interpretation No. 14 of SAS No. 62 provides the following additional guidance on disclosures to OCBOA financial statements:

- The discussion of the basis of presentation required by SAS No. 62 may be brief and only needs to describe the primary differences from GAAP. Quantifying those differences is not required.
- If the financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for the quantitative information required by GAAP. For example, rather than present a schedule of long-term debt maturities over the next five years, an entity with only one or two significant borrowings may communicate the requirement's substance merely by disclosing the repayment terms of the borrowings.
- If GAAP sets forth requirements that apply to the presentation of financial statements, cash, modified cash, and income tax basis statements should either comply with those requirements or provide information that

communicates the substance of those requirements. For example, the effects of extraordinary items, accounting changes, and discontinued operations could either be shown on the statements of revenues and expenses following GAAP presentation requirements or disclosed (net of tax) in the notes to the financial statements.

- A statement of cash flows is not required in OCBOA presentations. However, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present a cash flows statement, the statement either should conform to the requirements for a GAAP presentation or communicate the substance of the GAAP requirements.

- If GAAP would require disclosure of other matters, the need for that same disclosure or disclosure that communicates the substance of those requirements should be considered to the extent the disclosure is relevant to the basis of accounting. For example, litigation and contingencies are relevant to cash, modified cash, and tax basis presentations and should be disclosed if necessary. However, information about the use of estimates is not relevant in a presentation of cash receipts and disbursements with no estimates.

- Nonrelevant GAAP disclosure requirements need not be considered.

As just discussed, SAS No. 62 requires disclosure of the OCBOA that is used and a description of how it differs from GAAP in the financial statements. This same disclosure ordinarily should be included in compiled or reviewed financial statements that are prepared on an OCBOA. The disclosure should be made as the first note in the summary of significant accounting policies and should be captioned "Basis of Accounting." The disclosure has two main objectives:

a. To put the readers on notice that the basis may be different from what they are used to seeing.

b. To disclose the primary differences between the basis of accounting used and GAAP.

Generally, the primary differences are those that individually have a material effect on the financial statements. Immaterial differences need not be mentioned. Note that although the primary differences between the OCBOA and GAAP are discussed, they need not be quantified. The intent of the disclosure is to warn the readers, not to reconcile the basis to GAAP.

Other matters should be disclosed if they would be required under GAAP and are relevant to the OCBOA used. Following the guidance in Interpretation No. 14, of SAS No. 62, if OCBOA statements contain amounts for which GAAP would require disclosure, the statements either should provide the relevant disclosure that would be required for those amounts in a GAAP presentation or provide information that communicates the substance of that disclosure. For example, FASB ASC 360-10-50-1 (formerly APB Opinion No. 12) establishes a GAAP requirement to disclose depreciation expense for the period. A fiduciary entity using an OCBOA in which property and equipment are depreciated would disclose depreciation expense as described in the Opinion; a fiduciary entity using an OCBOA that does not depreciate such items, however, would deem the disclosure irrelevant and unnecessary.

GAAP requires entities to disclose a variety of information that does not relate directly to items reported in GAAP financial statements, such as going concern considerations and related party transactions for which amounts are not recorded. Practitioners should evaluate the need for similar disclosures in OCBOA financial statements by (a) identifying the other information that GAAP would require disclosing, (b) deciding whether the GAAP disclosure requirement is relevant to the basis of accounting, and (c) if the requirement is relevant, deciding whether to follow that requirement or to meet the objective of that requirement through other means.

Applicability of Audit Literature to Compilation and Review Engagements. Footnote 6 of SSARS No. 1, *Compilation and Review of Financial Statements*, previously made the disclosure guidance in the auditing literature applicable to compiled and reviewed financial statements prepared on an other comprehensive basis of accounting. However, in July 2007, the Accounting and Review Services Committee issued SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services*.

SSARS No. 15 says in Paragraph 1 that it amends SSARS No. 1 "by eliminating certain references to auditing literature and, where deemed appropriate, incorporating guidance similar to that originally referenced." One of the amendments was to delete footnote 6. As a result of the amendment, SSARS No. 1 now provides no guidance on disclosures in compiled or reviewed financial statements that are prepared on an other comprehensive basis of accounting.

It is believed the deletion of footnote 6 was because the Accounting and Review Services Committee believes the adequacy of disclosures in financial statements prepared on an other comprehensive basis of accounting should be evaluated differently depending on whether the statements are audited, reviewed, or compiled. Also, it should be noted that Interpretation No. 14 of SAS No. 62 was developed with the understanding that SSARS No. 1 would effectively incorporate its guidance. Accordingly, this course is written with the perspective that the adequacy of disclosures in cash, modified cash, or income tax basis financial statements that are compiled or reviewed should continue to be evaluated following the guidance in SAS No. 62 and Interpretation No. 14, and practitioners should follow that guidance when preparing financial statements for fiduciary entities.

Guidance for engagements to compile or review OCBOA financial statements continues to evolve.

Disclosures in OCBOA Fiduciary Statements. SAS No. 62 (AU 623) requires audited financial statements to disclose the basis of accounting used to prepare the financial statements and to describe how that basis differs from GAAP. However, SAS No. 62 does not require quantification of the differences between the OCBOA and GAAP. In addition, only significant differences need to be described. The authors believe the disclosure only needs to address the substance of the differences between the bases of accounting; thus, a detailed discussion of the GAAP treatment of an item is unnecessary. Normally, trusts and estates present the disclosure of the basis of accounting at the beginning of the summary of significant accounting policies under a heading such as "Basis of Accounting."

While the SSARS provide no guidance regarding disclosures in OCBOA financial statements, it is believed those disclosures should also be made in compiled or reviewed financial statements following the format in Interpretation No. 14 of SAS No. 62.

Because disclosures in OCBOA financial statements are similar to those in GAAP presentations, the following discussion summarizes some of the GAAP disclosure requirements for trusts and estates. Although SSARS No. 1 allows the client to omit substantially all disclosures only in a compilation engagement, that reporting alternative is not encouraged because the accounting conventions for estates or trusts are not widely known by the public. Also, certain GAAP accounting conventions can be peculiar to each entity, depending on the requirements of the governing instrument. Whenever possible, accountants should recommend that the financial statements include the following note disclosures:

a. The basis of accounting and how it differs from GAAP.

b. A summary of significant accounting principles that explains the OCBOA's accounting conventions used and any peculiar accounting required by the governing document (or state law).

c. A disclosure of significant transactions that do not affect the amount (or assets) for which the fiduciary is accountable, for example, disclosure in a note (or parenthetically on the face of the statement) of any debt that is secured by a deed of trust on assets of the estate or trust. The Committee on National Fiduciary Accounting Standards encourages such disclosure.

d. A description of the methods used to determine current values.

e. A disclosure of major subsequent events. For example, a major decline in the current values of an asset (like common stock) that occurred between the financial statement date and the date that the report is issued should be disclosed.

Basis of Accounting. OCBOA financial statements should state the basis of accounting used and describe material differences from GAAP. Apparently, disclosure need only deal with the substance of the differences between the bases, thus avoiding a detailed discussion of the GAAP treatment of an item. The following disclosures may be appropriate under the modified cash or tax basis of accounting:

- *Modified Cash Basis:*

The accompanying financial statements have been prepared on the modified cash basis of accounting. Under that basis, certain revenues and the related assets are recognized when received rather than when earned, and certain expenses are recognized when paid rather than when the obligation is incurred. That basis differs from generally accepted accounting principles primarily because the Trust (Estate) has not recognized accounts receivable from related entities and accounts payable relating to administration of the trust (estate) and their related effects on earnings in the accompanying financial statements.

- *Tax Basis:*

Illustration 1:

The Trust's policy is to prepare its financial statements on the income tax basis of accounting; consequently, certain revenues are recognized when received rather than when earned, and certain expenses and purchases of assets are recognized when cash is disbursed rather than when the obligation is incurred.

Other differences between the income tax basis of accounting and generally accepted accounting principles (GAAP) include the use of accelerated methods and shorter lives for depreciation of certain property and equipment for tax purposes and investments in joint ventures are accounted for by the cost method rather than the equity method.

Illustration 2:

The accompanying financial statements have been prepared on the accrual basis of accounting used for federal income tax reporting purposes. That basis of accounting differs from generally accepted accounting principles primarily as follows: (a) no unrealized gains and losses on investments in marketable securities have been recorded, (b) intangible drilling costs are charged to operations rather than being capitalized and amortized against future operations, (c) the investment in Acme Company is accounted for by the cost method rather than the equity method of accounting, (d) the investment in FYI, Incorporated is accounted for by the cost method of accounting rather than consolidated with the Trust financial statements, and (e) the Trust's investment in Internet Unlimited Corporation common and preferred stock are recorded at their cost basis rather than at fair value.

Illustration 3:

The Trust for the Estate of Joan Smith is a cash basis taxpaying entity, thus income is recognized when received and expenses are recognized when paid.

Illustration 2 highlights one of the more problematic issues surrounding describing differences from GAAP since GAAP is not well defined for trusts and estates. The fiduciary accounting principles that may be considered GAAP, do not include use of the fair value standards in FASB Statements Nos. 115 and 133 since recognition of gains or losses associated with investments would only be recorded when realized. However, this illustrative disclosure describes use of the fiduciary entity's cash basis recognition of income on sale (which may be considered GAAP) as a difference from GAAP. Accountants must use judgment when determining how to describe differences from GAAP, especially since GAAP for fiduciary entities is not well defined. In this case, the financial statements were that of a grantor trust that largely used traditional GAAP accounting principles and measurement for a basis of presentation or comparison.

Depreciation—Tax Basis. GAAP requires depreciating cost over an asset's estimated useful life using an acceptable method, such as straight-line, double declining balance, or sum-of-the-years' digits, but tax regulations require using the Accelerated Cost Recovery System (ACRS) for assets acquired after 1980. Basically, this prescribes the depreciation period and the depreciation method. In addition, salvage value is ignored for ACRS but not for GAAP. (Straight-line elections over prescribed periods are also permitted.) Note that ACRS is only appropriate for GAAP reporting if it does not cause a material distortion of either depreciation expense or book value. The following illustrate disclosures of the basis of accounting relating to property, equipment, and depreciation:

Property and Equipment (Summary of Significant Accounting Policies):

- Property and equipment are stated at cost, net of depreciation. Depreciation of property and equipment is determined using methods of depreciation acceptable for federal income tax purposes.

- Depreciation of properties is computed by the straight-line, declining balance, Accelerated Cost Recovery System (ACRS) and Modified Accelerated Cost Recovery System (MACRS) methods over various lives allowed for federal income tax purposes. Under GAAP, the ACRS and MACRS methods would not be utilized and the properties would be depreciated over the estimated useful lives of the respective assets.

Significant Accounting Policies Issues—Tax Basis. GAAP disclosure requirements for significant accounting policies in accordance with FASB ASC 235-10-50 (formerly APB Opinion No. 22) were discussed previously. However, applying FASB ASC 235-10-50 (formerly APB Opinion No. 22) to income tax basis financial statements results in some policies being disclosed that normally would not be disclosed in GAAP financial statements.

Just as the selection from existing acceptable alternatives would be disclosed under GAAP, selections from alternatives that exist for income tax reporting should be disclosed under the tax basis when applicable. (In some of these areas, alternatives do not exist under GAAP.) The following are some common examples of these items:

- Depletion.

- Intangible drilling costs.

- Installment method.

- Construction contracts.

The tax basis counterpart to the FASB ASC 235-10-50 (formerly APB Opinion No. 22) requirement to disclose unusual or innovative applications is the disclosure of items for which GAAP and income tax regulations clearly prescribe a different accounting treatment. However, sufficient disclosure for those items usually is provided in the basis of accounting note when the items result in significant differences between GAAP and the income tax basis of accounting. Therefore, additional disclosure of those items usually is not required in the summary of significant accounting policies note.

The significant reasons for the difference between the tax provision in an entity's financial statements and the amount that would result from applying statutory rates to pretax income should be disclosed in the notes to the financial statements. Accordingly, some disclosure of nontaxable revenues and nondeductible expenses is necessary in a taxable entity's financial statements if the amounts are material. However, that disclosure could be as simple as noting that the significant difference is primarily due to tax-exempt income without disclosing any amounts. The disclosure might be as follows:

NOTE X—INCOME TAXES

The income tax provision differs from the expense that would result from applying statutory tax rates to income before income taxes because of capital gains, distributions to beneficiaries, and utilization of investment tax credit carryforwards. Distributions to beneficiaries are allowed as a deduction from taxable income in arriving at taxable income for the Trust. Distributions to beneficiaries flow through to the individual returns of the beneficiaries as taxable income.

The summary of significant accounting policies might include the following disclosure:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income Taxes

Certain income and expense items are not fully taxable or deductible for federal income tax purposes and are therefore excluded from taxable income. Those items include exempt interest income, disallowed passive losses, the investment interest expense limitation, itemized deduction limitations, capital loss limitations, and at-risk loss limitations. These excluded items are reflected in the statement of revenues and expenses as an increase or decrease in taxable income. The corresponding increase or decrease is reflected in the statement of trust (estate) equity.

Subsequent Events Considerations—Tax Basis. Disclosure of subsequent events under FASB ASC 855-10 also applies to financial statements prepared on the cash or tax basis. Whether subsequent events should be considered in measuring assets and liabilities in income tax basis financial statements depends on tax positions the entity takes in its income tax returns. For example, subsequent events would be considered in determining whether a liability should be recognized for expenses deducted under the recurring item exception. To illustrate, assume that an estate includes a sole proprietorship business that offers its customers a warranty and deducts warranty costs following the recurring item exception. Subsequent payments through the period covered by the exception would be considered in measuring the liability for warranty costs at year-end, but other subsequent warranty payments would not be considered.

However, if disclosure of subsequent events is necessary to keep the financial statements from being misleading, the financial statements should either disclose the information that would be required under generally accepted accounting principles or disclose information that communicates the substance of those requirements. For example, disclosure of a subsequent further deterioration of the financial condition of a major customer of the sole proprietorship business in the previous example may be necessary to keep the financial statements from being misleading even if management has not yet determined whether the principal outstanding under the customer's trade account at year-end is worthless. As an observation, the subsequent further deterioration would not be considered in measuring the trade account at year-end because any write-off would only be deductible in the period the account becomes worthless.

Subsequent Events Considerations—Modified Cash Basis Financial Statements. Since modifications of the pure cash basis should generally conform with generally accepted accounting principles, subsequent events should be considered in measuring the assets and liabilities recognized through those modifications.

If disclosure of subsequent events is necessary to keep modified cash basis financial statements from being misleading, the financial statements should either disclose the information that would be required under generally accepted accounting principles or disclose information that communicates the substance of those requirements. For example, disclosure of a subsequent event that indicates a material balance due from a customer of the sole proprietorship business in the previous example at year-end is impaired may be necessary to keep the financial statements from being misleading even though customer receivables are not recognized under the modifications of the pure cash basis.

Other Disclosures—OCBOA Statements. Other disclosures generally are similar to those items normally disclosed in GAAP financial statements, as discussed earlier in this section. Illustrative disclosures relating to income taxes are included in the preceding paragraph.

SELECTED ACCOUNTING TOPICS

The FASB Accounting Standards Codification

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification ™ and the Hierarchy of Generally Accepted Accounting Principles*, to replace SFAS No. 162 and to establish the FASB Accounting Standards Codification (FASB ASC or the Codification) as the source of authoritative accounting principles recognized by the FASB to be used by nongovernmental entities when preparing financial statements in accordance with GAAP in the United States. SFAS No. 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009; although certain entities are permitted a later effective date with regard to authoritative guidance relating to revenue recognition previously included in an AICPA Technical Practice Aid at TIS 5100.

SFAS No. 168 essentially reduces the GAAP hierarchy to two levels: authoritative and nonauthoritative. Authoritative GAAP is contained in the Codification and, except for certain grandfathered and transitional standards, non-SEC accounting literature that is not contained in the Codification is considered nonauthoritative. In creating the Codification, the FASB arranged the existing sources of historical GAAP, such as Statements of Financial Accounting Standards (SFASs), Statements of Position (SOPs), and other pronouncements that populated the prior GAAP hierarchy into a topical structure maintained in an online research platform. Upon the effective date of SFAS No. 168, all existing sources of non-SEC accounting and reporting standards are superseded, except for certain grandfathered and transitional standards awaiting integration into the Codification.

All guidance in the Codification is deemed to have the same level of authority. That differs from the prior GAAP hierarchy which categorized authoritative literature into different levels of authority. If the accounting treatment for a transaction or event is not covered by a source of authoritative GAAP for a reporting entity, the entity should first consider accounting principles for similar transactions or events within a source of GAAP applicable to the entity before giving consideration to nonauthoritative guidance from other sources. Nonauthoritative accounting guidance and literature includes the following:

- Practices widely recognized and generally prevalent or prevalent in the industry.
- FASB Concepts Statements.
- AICPA Issues Papers.
- International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB).
- Pronouncements of professional associations or regulatory agencies.
- Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids.
- Accounting textbooks, handbooks, and articles.

Entities are prohibited from following the accounting treatment specified in accounting guidance for similar transactions or events in situations where the accounting principle prohibits its application to the particular transaction or event or where the accounting principle indicates it should not be applied by analogy.

Grandfathered Guidance. Certain exceptions exist to the GAAP hierarchy as discussed above. If an entity has followed and continues to follow accounting guidance that was set forth in either category (c) or (d) of the previous GAAP hierarchy (which includes the following: AICPA Accounting Standards Executive Committee Practice Bulletins cleared by the FASB, consensus positions of the FASB Emerging Issues Task Force, Appendix D of the EITF Abstracts, Implementation guides issued by the FASB staff, AICPA Accounting Interpretations, AICPA Industry Audit and Accounting Guides and Statements of Position not cleared by the FASB, and practices that are widely recognized and prevalent generally or in the industry) as of March 15, 1992, that entity is not required to change to an accounting treatment in a higher category [category (b) or (c) of that hierarchy now included in the Codification] if its effective date was prior to March 15, 1992. For example, if an entity followed prevalent industry practice as of March 15, 1992 [which was previously included in category (d) of the GAAP hierarchy], that entity does not have to change to a pronouncement that was previously in category (b) or (c) which had an effective date prior to March 15, 1992. An entity should follow the guidance in the Codification for standards with an effective date after March 15, 1992, and when initially applying a principle after March 15, 1992 (except for certain EITF consensus positions).

Additionally, in the past some accounting standards have permitted an entity to continue applying superseded accounting standards for transactions that have an ongoing impact on an entity's financial statements, such as a business combination. That guidance is considered grandfathered and remains authoritative for those transactions even though it has not been integrated into the Codification. The following list, while not comprehensive, represents examples of such grandfathered guidance. (This information is provided to give a general understanding of the Codification. Not all this guidance will apply to fiduciary entities.)

- Pooling of interests in a business combination described in SFAS No. 141, *Business Combinations*, Paragraph B217.

- Pension transition assets or obligations described in SFAS No. 87, *Employer's Accounting for Pensions*, Paragraph 77.

- Employee stock ownership plan shares purchased and held as of December 31, 1992, as described in AICPA SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans*, Paragraphs 97 and 102.

- Loans restructured in a troubled debt restructuring before the effective date of SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, described in SFAS No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, Paragraph 24.

- Stock compensation for nonpublic and other entities described in SFAS No. 123R, *Share-Based Payment*, Paragraph 83.

- For nonpublic entities electing the deferral of FIN 48, *Accounting for Uncertainty in Income Taxes*; SFAS No. 109, *Accounting for Income Taxes*; and related standards.

- For business combinations with an acquisition date prior to the first annual reporting period beginning on or after December 15, 2008, SFAS No. 141 and related standards.

- Pooling of interests under APB Opinion No. 16, *Business Combinations*, for nonprofit entities until the effective date of SFAS No. 164, *Not-for-Profit Entities: Mergers and Acquisitions*.

- For goodwill and intangible assets arising from combinations between nonprofit entities or acquired in an acquisition of a for-profit business by a nonprofit entity until the effective date of SFAS No. 164, APB Opinion No. 16 and APB Opinion No. 17, *Intangible Assets*.

Transitional Standards. On July 1, 2009, the FASB released the authoritative version of the Codification. At that time, certain standards issued by the FASB in 2009 had not been integrated into the Codification. Those standards are considered authoritative until they have been integrated into the Codification and include the following pronouncements:

- SFAS No. 164, *Not-for-Profit Entities: Mergers and Acquisitions*.

- SFAS No. 166, *Accounting for Transfers of Financial Assets*.

- SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*.

- SFAS No. 168, *The FASB Accounting Standards Codification ™ and the Hierarchy of Generally Accepted Accounting Principles*.

At the time this course was completed, SFAS No. 168 had been integrated into the Codification as Topic 105, *Generally Accepted Accounting Principles*.

The Organization of the Codification. The Codification is organized as follows:

a. *Topics.* Topics represent a collection of related guidance, such as leases. The following are the main types of topics:

   (1) *General Principles (Topic Codes 105–199).* These topics relate to broad conceptual matters, such as generally accepted accounting principles.

   (2) *Presentation (Topic Codes 205–299).* These topics relate only to presentation matters and do not address recognition, measurement, or derecognition matters. Such topics include income statement, balance sheet, statement of cash flows, etc.

   (3) *Financial Statement Accounts (Topic Codes 305–700).* These topics are organized in a financial statement order including assets, such as receivables and inventory; liabilities; equity; revenue, such as revenue recognition; and expenses.

(4) *Broad Transactions (Topic Codes 805–899).* These topics relate to multiple financial statement accounts and are generally transaction-oriented. Such topics include business combinations, derivatives, nonmonetary transactions, etc.

(5) *Industries (Topic Codes 905–999).* These topics relate to accounting that is unique to an industry or type of activity. Such topics include airlines, software, real estate, etc.

b. *Subtopics.* Subtopics represent subsets of a topic and are generally distinguished by type or by scope. For example, operating leases and capital leases are two subtopics of the leases topic distinguished by type of lease. Each topic contains an overall subtopic that generally represents the pervasive guidance for the topic. Each additional subtopic represents incremental or unique guidance not contained in the overall subtopic. Subtopics unique to a topic use classification numbers between 00 and 99.

c. *Sections.* Sections represent the nature of the content in a subtopic such as recognition, measurement, disclosure, and so forth. Every subtopic uses the same sections, unless there is no content for a particular section. The sections of each subtopic are as follows, where XXX = topic, YY = subtopic, and ZZ = section:

XXX-YY-00	Status
XXX-YY-05	Overview and Background
XXX-YY-10	Objectives
XXX-YY-15	Scope and Scope Exceptions
XXX-YY-20	Glossary
XXX-YY-25	Recognition
XXX-YY-30	Initial Measurement
XXX-YY-35	Subsequent Measurement
XXX-YY-40	Derecognition
XXX-YY-45	Other Presentation Matters
XXX-YY-50	Disclosure
XXX-YY-55	Implementation Guidance and Illustrations
XXX-YY-60	Relationships
XXX-YY-65	Transition and Open Effective Date Information
XXX-YY-70	Links to Grandfathered Material
XXX-YY-75	XBRL Definitions

An "S" precedes the section number in the case of SEC content. Within sections, paragraphs are numbered with a two-part number in which the first part represents the section and the second part is a sequential number. The content of a paragraph may be amended, but the paragraph number will remain constant. For example, the classification codes for leases are as follows:

840	Leases (Topic)
840-10	Overall (Subtopic)
840-10-15	Scope and Scope Exceptions (Section)
840-10-50	Disclosure (Section)
840-20	Operating Leases (Subtopic)
840-20-15	Scope and Scope Exceptions (Section)
840-20-50	Disclosure (Section)
840-30	Capital Leases (Subtopic)
840-30-15	Scope and Scope Exceptions (Section)
840-30-50	Disclosure (Section)

New standards issued will be in the form of an Accounting Standards Update composed of the background and basis for conclusions along with an appendix of Accounting Standards Update Instructions. The title of the combined set of standard and instructions will be Accounting Standards Update YYYY-XX, where YYYY is the year issued and XX is the sequential number for each Update, such as 2009-01, 2009-02, etc. All authoritative GAAP issued by the FASB will be issued in this format, regardless of the form in which such guidance may have been issued previously (for example, EITF Abstracts, FASB Staff Positions, FASB Statements, FASB Interpretations, etc.).

Upon its release, an Accounting Standards Update will not be authoritative but will merely be a transient document to initiate the FASB's process of creating Accounting Standards Update Instructions. Those Instructions will be the source used to update the Codification and will be available on the Codification website. As the FASB and SEC amend existing Codification paragraphs, both the current paragraph and the updated paragraph will reside in the Codification until such time that the new guidance is completely effective. When the newly amended paragraph is fully effective, the outdated guidance will be removed from the paragraph and the amended paragraph will remain. Eventually, when the process is fully operational, the Codification Research System will be updated concurrent with the release of a new Accounting Standards Update.

The FASB's Fair Value Initiative

The Financial Accounting Standards Board (FASB) began the first of the fair value projects seeking to resolve the problems practitioners faced in dealing with varying definitions of fair value, dispersed among many accounting standards—a situation made more confusing by limited guidance in applying those standards. As a result, FASB ASC 820-10 (formerly SFAS No. 157, *Fair Value Measurements*) was issued. Later, in an effort to improve financial reporting and expand the use of the fair value measurement, the FASB issued FASB ASC 825-10 (formerly SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*). Because of their potential applicability to accounting issues related to estates and trusts, those Statements are discussed in the following paragraphs.

The FASB's fair value guidance provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and expands the disclosures about fair value measurements. However, it does not create any new fair value measurements. Instead, it applies under other existing accounting pronouncements that require or permit fair value measurements.

Scope of SFAS No. 157. The guidance applies under other existing accounting pronouncements that either require or permit fair value measurements. However, it does not:

- Apply to accounting pronouncements that address share-based payment transactions [i.e., FASB ASC 505 and FASB ASC 718 (formerly SFAS No. 123R, *Share-Based Payment*)].

- Eliminate the practicability exceptions to fair value measurements that are permitted by existing accounting pronouncements.

- Apply to accounting pronouncements that either require or permit measurements similar to, but not intended to represent, fair value.

Measuring Fair Value. The FASB guidance defines *fair value* as the price that would be received to sell an asset or the price that would be paid to transfer a liability in an orderly transaction involving market participants at the measurement date. Although the definition focuses on assets and liabilities, it also applies to instruments that are measured at fair value and classified in stockholders' equity.

Fair value is measured for a particular asset or liability, which may be a stand-alone asset or liability or a group of assets or liabilities. Measurement requires consideration of attributes that are specific to the asset or liability, such as its condition or location, when measuring fair value. Whether an asset or liability is measured on a stand-alone basis or as a group is determined by the provisions of the accounting pronouncement that requires or permits the asset or liability to be measured at fair value.

A fair value measurement assumes that an asset or liability is exchanged in an orderly transaction. That means the hypothetical transaction to sell the asset or transfer the liability is assumed to be usual and customary for the type of asset or liability and not a forced liquidation or distress sale. The transaction is considered from the perspective of the entity holding the asset or liability, with the objective of determining the price that would be received or paid to sell the asset or transfer the liability. That is, fair value is based on an exit price, which may differ from the price paid to acquire the asset or received to assume the liability (i.e., an entry price).

Fair value should be measured using valuation techniques consistent with the market, income, or cost approaches, consistently applied. The assumptions used should be those that market participants would use in pricing the asset or liability. The Statement helps users accomplish that by providing a fair value hierarchy consisting of three levels—levels 1, 2, and 3—generally ranging from the most objective determination of fair value to the most subjective.

a. Level 1 measurements use quoted prices in active markets for *identical* assets or liabilities that the reporting entity has the ability to access at the measurement date.

b. Level 2 measurements generally use available indirect information, such as quoted prices for *similar* assets or liabilities in active markets, or quoted prices for identical or similar assets or liabilities in markets that are not active.

c. Level 3 measurements are the most subjective, generally based on the entity's own assumptions developed using the best information available in the circumstances.

Fair value measurements generally should be based on the most objective information available. For example, level 1 measurements should be used whenever possible, and level 3 measurements should only be used when level 1 or level 2 measurements cannot be made. This three-level hierarchy should accommodate most fair value measurements of small and midsize nonpublic entities. However, this fair value guidance does not eliminate the notion in other FASB guidance that, depending on the facts and circumstances, it may not be practicable to determine the fair value of certain financial instruments.

Inactive Markets. When little or no market activity for an asset occurs at the measurement date, the fair value objective discussed previously still applies, that being the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date. However, in an inactive market, it is not appropriate to assume that all market activity represents forced liquidations or distressed sales or to automatically assume transaction prices reflect fair value. Instead, fair value is dependent on the facts and circumstances and may involve significant judgment as to whether market activity represents forced liquidations or distressed sales.

When measuring the fair value of a financial asset, it may be appropriate to use the entity's own assumptions about future cash flows and risk-adjusted discount rates when relevant observable inputs are not available. Also, Level 2 observable inputs may require significant adjustment based on unobservable data, and thus making the result a Level 3 fair value measurement. For example, if trading activity has significantly declined, prices have varied significantly, or prices are not current, observable market inputs may not be relevant and might require significant adjustment. No matter which valuation technique is used, there must be appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.

For inactive markets, broker or pricing service quotes are not necessarily determinative of fair value. In determining whether a broker quote is an appropriate input to a fair value measurement, less reliance should be placed on quotes that do not reflect actual market transactions. Further, the nature of the quote should be considered when weighing available evidence. For example, some quotes may only be an indication of interest rather than the actual price a market participant would purchase or sell the asset.

New Guidance for Low Volume Markets. FASB Staff Position FAS 157-4 (codified as FASB ASC 810-10-65-4) amends FASB ASC 820-10 (formerly SFAS No. 157) to provide further details on determining fair value when the volume or level of activity for an asset or liability has significantly decreased. The guidance includes several factors to evaluate when assessing the significance of the decrease, such as—

- Few recent transactions.
- Price quotes that are not based on current information.
- Price quotes that vary significantly over time or among brokers.
- A wide spread between bid and ask prices.

Other factors are also included. Practitioners should consider all of these factors and, based on all of the evidence, determine whether a significant decrease in the volume and level of activity has occurred.

If the practitioner determines that a significant decrease has occurred, quoted prices or other value indicators obtained may not be truly reflective of fair value. Thus, after further analysis it may be determined that adjustments to those prices or values are necessary to properly indicate fair value. The adjustments should consider the uncertainty in the cash flows of the asset or liability, which is referred to as a *risk premium*.

FASB ASC 820-10-65-4 (formerly FSP FAS 157-4) is effective for interim and annual reporting for periods ending after June 15, 2009.

ASU No. 2009-05, Fair Value Measurements and Disclosures: Measuring Liabilities at Fair Value. In August 2009, the FASB issued ASU No. 2009-05 that amends FASB ASC 820-10 to provide further details on measuring the fair value of liabilities. The guidance in ASU No. 2009-05 is effective for reporting periods beginning after August 2009.

Essentially, if a quoted price in an active market for an identical liability is not available, fair value must be measured by either—

- a valuation method that uses a quoted price of an identical liability or similar liability when traded as an asset (such as a debt obligation), or

- another valuation method consistent with the fair value approach, such as the income approach or market approach (See *PPC's Guide to Business Valuation* for a detailed discussion of these valuation approaches.)

Note that the quoted price of an identical liability or similar liability when traded as an asset are Level 1 measurements when obtained in an active market and no adjustments to the quoted price are required.

Disclosures. The disclosures generally are designed to enable users of financial statements to assess how fair values are determined. The Statement groups its required disclosures into two categories, those for recurring fair value measurements and those for nonrecurring measurements.

a. Each category generally requires disclosure of the related assets and liabilities measured at fair value, the level within the fair value hierarchy used, information about any level 3 measurements, and the valuation technique used.

b. The category for recurring measurements requires additional disclosure of unrealized gains and losses arising from changes in fair value

c. The category for nonrecurring measurements requires additional disclosure of the reasons for the measurements.

The Effect of the Fair Value Measurement Guidance on Estate and Trust Financial Statements. Determining what is GAAP for fiduciary accounting is difficult due to (a) the lack of specific standards addressing fiduciary accounting, (b) inconsistent application of the Uniform Principal and Income Act from state to state, and (c) the ability of the governing document (i.e., the will or trust agreement) to establish unique accounting conventions for each estate or trust. However, fiduciary accounting principles, regardless of whether accountants characterize them as GAAP, essentially provide for an accounting on the modified cash basis. An informal survey indicates the modified cash basis of accounting is predominantly used in practice and is often labeled as GAAP for reporting purposes.

<u>Effect on Financial Statements Prepared Using the Modified Cash Basis (Whether Labeled as GAAP or an OCBOA).</u> If an entity modifies the pure cash basis of accounting to recognize an asset or a liability that generally accepted accounting principles require to be measured at fair value, the modification should consider the fair value measurement guidance after its effective date. However, preparers should consider fiduciary accounting principles relating to determining the fiduciary acquisition value and reflecting current values at the beginning and ending of the accounting period. Under fiduciary accounting principles, an asset's carrying value is rarely changed during the administration of the entity. (As a practical matter, modifications of the cash basis to conform with generally accepted accounting principles that require fair value measurements are likely to only be for debt and equity securities within the scope of FASB ASC 320-10, which generally prescribe level 1 measurements.)

Effect on Financial Statements Prepared Using the Tax Basis. The measurement guidance in the Statement will have no effect on amounts reported in the face of financial statements prepared using the income tax basis of accounting because any fair value measurements should be determined following the requirements for income tax reporting. However, the measurement guidance in the Statement may affect—

a. supplemental disclosure of the fair value of financial instruments.

b. the description of differences between the income tax basis and generally accepted accounting principles in the event that an asset or liability is required to be reported at fair value under both generally accepted accounting principles and the income tax basis. However, as a result of SFAS No. 157, the way fair value is determined is different for income tax reporting.

The Effect of the Fair Value Disclosure Guidance on Estate and Trust Financial Statements. The disclosure requirements should be considered in financial statements prepared on the modified cash (whether labeled as GAAP or an OCBOA) or income tax basis of accounting in which one or more assets and liabilities are measured at fair value, either for determining amounts to report in the financial statements or for determining amounts to disclose. As a practical matter, depending on the facts and circumstances, the characteristics of those assets and liabilities are likely to be such that the determination of their fair values falls within level 1.

The Fair Value Option. FASB ASC 825-10 (formerly SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*) permits entities to choose to measure prescribed financial instruments at fair value. Generally, the Statement permits the fair value option for all financial assets and financial liabilities other than financial assets and financial liabilities that are specifically excluded.

Generally, a financial asset is defined as a financial instrument that conveys a right to the entity, and a financial liability is defined as a contract that imposes an obligation on the entity. For example, an entity could elect the fair value option for an investment that would otherwise be accounted for using the cost of equity method. Similarly, an entity could elect the fair value option for a fixed-rate long-term note.

The disclosure requirements only apply if an entity has elected the fair value option. Those requirements generally look at how the election affects the measurement of those assets and liabilities. For example, the Statement requires disclosure of the reason for electing the fair value option and information about differences between the fair values and contractual cash flows. In addition, the measurement and disclosure requirements (discussed later) apply to those assets and liabilities.

The Effect of the Fair Value Option on Estate and Trust Financial Statements. As discussed throughout this course, determining what is GAAP for fiduciary accounting is difficult and other bases of accounting are often used. It is believed that the modified cash basis of accounting seems predominantly used in practice and is often labeled as GAAP for reporting purposes.

Effect on Financial Statements Prepared Using the Modified Cash Basis (Whether Labeled as GAAP or an OCBOA). The guidance in FASB ASC 825-10 is provided with the perspective that the financial statements are prepared using generally accepted accounting principles. It is believed that a modification of the pure cash basis should be in conformity with generally accepted accounting principles and that the option of using fair value as an alternative to the measurement required by generally accepted accounting principles should not be considered. Depending on the basis of accounting used for trust and estates, many assets may already be valued at fair value due to fiduciary accounting principles.

Effect on Financial Statements Prepared Using the Tax Basis. The Statement cannot affect financial statements prepared on the income tax basis. Whether assets and liabilities are measured at fair value in those financial statements depends on the requirements for income tax reporting.

Uncertainty in Income Tax Accounting

FASB ASC 740-10 [formerly Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*] requires entities to evaluate each of their tax positions prior to recognizing any benefit from those positions in their financial statements. If those tax positions do not meet certain defined criterion, the entity cannot recognize any benefit from them in its financial statements. Furthermore, entities must disclose certain information in the notes to the financial statements regarding such unrecognized benefits.

Evaluating Tax Positions. Tax positions are items reported on an entity's tax return for which the entity receives an economic benefit, such as a reduction in the amount of income taxes payable. Different tax positions often have different degrees of uncertainty. Generally, that uncertainty relates to whether the tax position will be sustained upon examination by a taxing authority, such as the IRS.

FASB ASC 740-10 requires the evaluation of tax positions using a two-step process. An entity must first determine whether a tax position should be recognized. If so, the Interpretation provides guidance on measuring the amount of the benefit related to the tax position. As to recognition, an entity must evaluate the technical merits of a tax position and determine whether it is *more likely than not* to be sustained upon examination. Plus, the entity must presume the tax position will be examined by the relevant taxing authority and that that authority will have full knowledge of all pertinent information. The likelihood of a taxing authority actually evaluating the tax position is irrelevant to this analysis.

If the tax position meets the more-likely-than-not threshold, the entity should measure the benefit associated with the position. However, if the tax position is not more likely than not to be sustained, the benefit of that position cannot be reported in the financial statements. FASB ASC 740-10 indicates *more likely than not* represents a likelihood greater than 50%. Essentially, the reporting entity must make a positive assertion that it believes it is entitled to the benefits of the tax position.

A tax position that meets the recognition criteria must then be measured according to the provisions of the Interpretation. The entity may only recognize the largest amount of the tax benefit that is more than 50% likely of being realized upon ultimate settlement with a taxing authority. Again, the entity must presume that taxing authority has complete knowledge of all pertinent information.

Disclosures. Disclosure requirements regarding tax positions have generated a fair amount of controversy. Among other things, originally entities were required to disclose, in tabular form, a reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the reporting period. However, Accounting Standards Update 2009-6 (issued in September 2009) to the FASB Codification removed this requirement for nonpublic entities. Basically, entities must disclose the total amount of tax positions they included in their tax returns that do not meet the more-likely-than-not recognition requirements of Interpretation 48.

Effective Date. On October 15, 2008, the FASB approved a second one-year deferral of the effective date of FIN 48 for nonpublic companies. The revised effective date allows nonpublic companies to defer the guidance until annual periods beginning after December 15, 2008.

Other Accounting Developments

Following is a summary of various projects on the FASB's agenda.

Leases. This joint FASB-IASB project would reconsider the guidance in FASB ASC 840 (formerly SFAS No. 13, *Accounting for Leases*) including subsequent amendments and interpretations. The need for a comprehensive reconsideration of lease accounting and reporting grew from continued criticism that existing guidance was incomplete and not sufficiently transparent (for example, the off-balance sheet financing nature of operating leases). Initially, the scope of the project will include those arrangements currently affected by FASB ASC 840, but eventually may be extended to include arrangements that convey a right to use another entity's asset. Lease accounting issues the Board expects to cover include lessee obligations (e.g., maintenance), variable lease payments, residual value guarantees, lease options (e.g. to extend usage or extend or terminate lease term), initial and subsequent recognition (by lessee and lessor) of the right to use an asset and the related obligation, and revenue recognition. An exposure draft is expected to be released in the second half of 2010.

Revenue Recognition. This joint FASB-IASB project was added to the FASB's technical agenda in 2002. Objectives of the project are to—

- Establish a single, comprehensive standard on revenue recognition.
- Eliminate inconsistencies and voids within current standards and accepted practices.
- Develop conceptual guidance that would address potential future revenue recognition issues.
- Converge US and international revenue recognition guidance.

While it is expected that the standard would apply to all business entities, certain transactions or industries requiring additional study may be excluded from the scope and addressed separately. The FASB staff plans to issue an exposure draft in the first half of 2010. Both the FASB and IASB consider this a high priority project and anticipate a final standard within the second quarter of 2011.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Concerning basic financial statements prepared in traditional format for a fiduciary entity, which of the following is correct?

    a. Financial statements must be referenced to the notes.

    b. Comparative statements must reflect the same level of service for all years presented.

    c. The title "Balance Sheet" is more common than "Statement of Financial Position."

9. Concerning order of presentation on basic financial statements prepared in traditional format for a fiduciary entity, which of the following is correct?

    a. Notes receivable appear before marketable securities.

    b. Deferred charges appear before intangible assets.

    c. Current notes payable appear before accounts payable.

    d. Accrued expenses appear before current notes payable.

10. A statement of cash flows is required for financial statements prepared on an OCBOA basis.

    a. True.

    b. False.

11. Which of the following is **not** reflected in one of the basic elements of a statement of cash flows?

    a. Non-cash investing activities.

    b. Net change in equity.

    c. Investing activities.

    d. Financing activities.

12. Which basis of reporting results in the shortest traditional format fiduciary statement presentation?

    a. Pure cash.

    b. Tax.

    c. GAAP.

13. Who has responsibility for the notes to the fiduciary financial statements?

    a. The practitioner.

    b. The remainder beneficiary.

    c. The trust or estate.

    d. The court.

14. Which of the following disclosures is considered optional concerning basic information about the fiduciary entity?

    a. General information concerning beneficiaries.

    b. Identification of the trustee or executor.

    c. Date of fiduciary entity creation.

    d. General information concerning distribution of fiduciary assets.

15. Which of the following items related to FASB ASC 323-10 and 323-15-3 (formerly APB Opinion No. 18) guidance concerning investments policies and disclosures is a difference between traditional format financial statements prepared for a fiduciary entity versus those prepared for a commercial entity?

    a. Disclosure of percentage of ownership in investee's stock is not required.

    b. Disclosure is required when using the cost method for investments of more than 20%.

    c. Commercial materiality guidelines may not be appropriate for fiduciary entities.

    d. The extent of disclosures depends on the significance to the invested entity.

16. Which of the following statements is correct concerning SAS 62 and disclosure of the basis of accounting used in fiduciary reports prepared on an OCBOA?

    a. Primary differences to GAAP should be disclosed.

    b. Primary differences to GAAP should be quantified.

    c. Primary differences to GAAP must be reconciled to GAAP.

17. Which of the following statements is **not** a result of FASB's fair value guidance?

    a. The guidance establishes a framework to measure fair value within GAAP.

    b. The guidance defines fair value for all.

    c. The guidance expands fair value measurement disclosures.

    d. The guidance creates new fair value measurements.

18. Which of the following statements concerning the FASB's fair value hierarchy is correct?

    a. Level 2 measurements are based primarily on entity assumptions.

    b. Nonpublic entities are less likely to find the hierarchy useful.

    c. Level 1 measurements are preferred.

    d. This fair value guidance overcomes the notion of other FASB guidance that valuation may be impractical.

19. What are the two categories of disclosures that are designed to enable financial statement users to assess how fair values are determined?

    a. Fair value and non-fair value measurements.

    b. Recurring and non-recurring fair value measurements.

    c. Direct and indirect fair value measurements.

    d. Actual and estimated fair value measurements.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Concerning basic financial statements prepared in traditional format for a fiduciary entity, which of the following is correct? **(Page 166)**

   a. Financial statements must be referenced to the notes. [This answer is incorrect. It is common practice to do so either by reference to specific items in the financial statements or by a general reference, but it is not a GAAP requirement.]

   b. Comparative statements must reflect the same level of service for all years presented. [This answer is incorrect. Different levels of service can be presented per GAAP. This can be indicated parenthetically in either the statement heading or in the column headings.]

   c. The title "Balance Sheet" is more common than "Statement of Financial Position." [This answer is correct. Because more accountants use the title "Balance Sheet", it is more common, but both titles are acceptable.]

9. Concerning order of presentation on basic financial statements prepared in traditional format for a fiduciary entity, which of the following is correct? **(Page 168)**

   a. Notes receivable appear before marketable securities. [This answer is incorrect. Accounts receivable and notes receivable appear after marketable securities because marketable securities would be converted into cash sooner than the accounts and notes receivable.]

   b. Deferred charges appear before intangible assets. [This answer is incorrect. Deferred charges appear after intangible assets, and both appear after fixed assets because intangible assets are considered more liquid than deferred charges.]

   c. Current notes payable appear before accounts payable. [This answer is correct. The current portion of notes payable appears before accounts payable because notes payable are considered to mature before accounts payable.]

   d. Accrued expenses appear before current notes payable. [This answer is incorrect. Accrued expenses appear after both current notes payable and accounts payable since accrued expenses would mature later than notes payable.]

10. A statement of cash flows is required for financial statements prepared on an OCBOA basis. **(Page 171)**

    a. True. [This answer is incorrect. Per FASB ASC 230-10 (formerly SFAS No. 95), financial statements prepared on the basis of GAAP must have a statement of cash flows when they purport to present both the financial position and results of operations of the entity.]

    b. False. [This answer is correct. FASB ASC 230-10 (formerly SFAS No. 95) addresses statements prepared on a GAAP basis and states that the cash flow statement is required for GAAP presentation. However, financial statements prepared on an OCBOA basis are not required to include a statement of cash flows.]

11. Which of the following is **not** reflected in one of the basic elements of a statement of cash flows? **(Page 171)**

    a. Non-cash investing activities. [This answer is incorrect. Non-cash investing and financing activities, such as acquiring assets by assuming liabilities, should be included by disclosing separately rather than within the body of the statement.]

    b. Net change in equity. [This answer is correct. Net change in cash is reflected in the statement of cash flows; net change in equity is not.]

    c. Investing activities. [This answer is incorrect. The statement of cash flows reflects cash receipts from investing activities, such as the sale of property and collections on loans.]

    d. Financing activities. [This answer is incorrect. Financing activities are one of several elements reflected in the statement of cash flows. They include repayment of short or long-term debt.]

12. Which basis of reporting results in the shortest traditional format fiduciary statement presentation? **(Exhibit Page 173)**

    a. Pure cash. [This answer is correct. Because there are no liabilities and only one asset, the fiduciary report prepared on the pure cash basis requires only a statement of cash receipts and disbursements. There is no need to prepare a statement of assets, liabilities, and equity.]

    b. Tax. [This answer is incorrect. Fiduciary reports prepared on a tax basis still require presentation of information related to the balance sheet and income statement.]

    c. GAAP. [This answer is incorrect. Fiduciary reports prepared on the GAAP basis will likely require more statements and supporting schedules than those prepared on other bases.]

13. Who has responsibility for the notes to the fiduciary financial statements? **(Page 176)**

    a. The practitioner. [This answer is incorrect. The involvement of the practitioner in the preparation of the notes may range from small to great, but the practitioner is not responsible for the notes to the fiduciary financial statements because the practitioner is never responsible for the content.]

    b. The remainder beneficiary. [This answer is incorrect. Fiduciary financial statements and the accompanying notes are prepared by others for the benefit of the principal and income beneficiaries.]

    c. The trust or estate. [This answer is correct. Regardless of the level of involvement by the practitioner, the trust or estate is the client and as such, is responsible for the content of the notes to the fiduciary financial statements.]

    d. The court. [This answer is incorrect. The court makes no representations concerning the financial statements. They are the readers of the statements.]

14. Which of the following disclosures is considered optional concerning basic information about the fiduciary entity? **(Page 179)**

    a. General information concerning beneficiaries. [This answer is incorrect. Such information is one of several elements to be included in either the first note or in the summary of significant accounting policies in order to identify the fiduciary entity.]

    b. Identification of the trustee or executor. [This answer is correct. Indicating the identity of the fiduciary is permitted but not required in order to provide full disclosure of information that is important to the interested parties.]

    c. Date of fiduciary entity creation. [This answer is incorrect. The date of fiduciary entity creation and information concerning how and when it will terminate is important to those parties interested in the trust or estate and thus, must be included.]

    d. General information concerning distribution of fiduciary assets. [This answer is incorrect. How assets will be distributed is of interest to beneficiaries and other third-party users of the fiduciary report and must be included.]

15. Which of the following items related to FASB ASC 323-10 and 323-15-3 (formerly APB Opinion No. 18) guidance concerning investments policies and disclosures is a difference between traditional format financial statements prepared for a fiduciary entity versus those prepared for a commercial entity? **(Page 183)**

    a. Disclosure of percentage of ownership in investee's stock is not required. [This answer is incorrect. The guidance indicates this disclosure is appropriate for both commercial and fiduciary entities.]

    b. Disclosure is required when using the cost method for investments of more than 20%. [This answer is incorrect. This would be considered a departure from the requirement that investments of 20% or more be accounted for under the equity method, and should be disclosed in statements prepared for either type of entity.]

c. **Commercial materiality guidelines may not be appropriate for fiduciary entities. [This answer is correct. Because a court or the beneficiaries may consider *all* fiduciary entity transactions with heightened importance, the materiality guidelines may be different.]**

d. The extent of disclosures depends on the significance to the invested entity. [This answer is incorrect. For either a commercial entity or an estate or trust, the extent of disclosure is correlated to the significance of the investment to the invested entity.]

16. Which of the following statements is correct concerning SAS 62 and disclosure of the basis of accounting used in fiduciary reports prepared on an OCBOA? **(Page 186)**

a. **Primary differences to GAAP should be disclosed. [This answer is correct. Primary differences include those considered material on an individual basis. These differences do not have to be qualified. The primary intent is to warn the readers.]**

b. Primary differences to GAAP should be quantified. [This answer is incorrect. Per SAS No. 62, quantifying the difference is not required.]

c. Primary differences to GAAP must be reconciled to GAAP. [This answer is incorrect. There is no requirement within authoritative literature to reconcile the OCBOA presentation to GAAP. Any required disclosure is to warn the readers.]

17. Which of the following statements is **not** a result of FASB's fair value guidance? **(Page 195)**

a. The guidance establishes a framework to measure fair value within GAAP. [This answer is incorrect. The guidance addressed the existence of limited guidance in applying varying definitions of fair value under different accounting standards.]

b. The guidance defines fair value for all. [This answer is incorrect. One of the reasons for issuing the guidance was the large number of varying definitions of fair value existing in accounting standards.]

c. The guidance expands fair value measurement disclosures. [This answer is incorrect. Part of the reason for issuing the guidance was to expand the use of fair value measurement.]

d. **The guidance creates new fair value measurements. [This answer is correct. The guidance applies under other existing accounting pronouncements that require or permit fair value measurements. It does not create any new fair value measurements.]**

18. Which of the following statements concerning the FASB's fair value hierarchy is correct? **(Page 195)**

a. Level 2 measurements are based primarily on entity assumptions. [This answer is incorrect. This is a definition of Level 3 measurements. Level 2 measurements generally use available indirect information concerning similar items to establish valuations.]

b. Nonpublic entities are less likely to find the hierarchy useful. [This answer is incorrect. The hierarchy should meet most fair valuation needs of small and midsize nonpublic entities.]

c. **Level 1 measurements are preferred. [This answer is correct. Level 1 measurement requires current, direct evidence concerning identical items to establish valuations and should be used whenever possible because fair value measurements should be based on the most objective information available.]**

d. This fair value guidance overcomes the notion that other FASB guidance that valuation may be impractical. [This answer is incorrect. There still remains the other FASB guidance that determining the fair value of certain financial instruments may be impractical.]

19. What are the two categories of disclosures that are designed to enable financial statement users to assess how fair values are determined? **(Page 197)**

    a. Fair value and non-fair value measurements. [This answer is incorrect. Although other FASB guidance contains the notion that fair value measurement of certain financial instruments may be impractical, these are not the two categories of disclosures that are designed to enable financial statement users to assess how fair values are determined.]

    b. Recurring and non-recurring fair value measurements. [This answer is correct. The category for recurring measurements requires additional disclosures of unrealized gains and losses arising from changes in fair value, and the category for nonrecurring measurements requires additional disclosure of the reasons for the measurements. Required disclosures include the fair value hierarchy level used, the valuation technique used, etc.]

    c. Direct and indirect fair value measurements. [This answer is incorrect. Such measurements are contained within the fair value hierarchy, but they are not the two categories of disclosures that are designed to enable financial statement users to assess how fair values are determined.]

    d. Actual and estimated fair value measurements. [This answer is incorrect. These elements are contained within the fair value hierarchy, but they are not the two categories of disclosures that are designed to enable financial statement users to assess how fair values are determined.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (AETTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following is correct concerning formal and informal fiduciary accountings?

   a. Informal accountings require transaction details for receipts, disbursements, etc.

   b. Formal accountings are also known as family settlement agreements.

   c. Informal accountings may provide more privacy for fiduciary entity information.

   d. Formal accounting requirements are consistent between the various jurisdictions.

2. Why are traditional financial statements **not** prepared for an estate as a general rule?

   a. GAAP is clear-cut and makes the use of other reporting formats more viable.

   b. Formal accountings are often prepared for third parties.

   c. Statement preparation is costly and resources are not allocated to optional formats.

   d. The duration of trusts is better suited to a summary of account format.

3. Absent guidance or stipulations to the contrary, which basis is used most frequently for fiduciary accounting and reporting?

   a. Accrual.

   b. Tax.

   c. Pure cash.

   d. Modified cash.

4. The Summary of Account statement most closely resembles which of the following?

   a. Statement of Changes in Equity.

   b. Statement of Cash Flows.

   c. Income Statement.

   d. Balance Sheet.

5. A separate accounting for income and principal should be presented when the income beneficiary is the remainder beneficiary.

   a. True.

   b. False.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

6. Under the summary of account format developed for UFAP, which of the following supporting schedules is considered optional according to the text?

   a. Gains and Losses on Sales or Other Dispositions.

   b. Information Schedules—Principal.

   c. Receipts of Principal.

   d. Proposed Distributions to Beneficiaries.

7. Match these estate terms with the correct definition. (Hint: more than one definition may apply to a term).

1. Testator	i. An individual who receives the income from the estate assets during the estate administration
2. Fiduciary	ii. An individual who will eventually receive the estate assets when the estate expires.
3. Remainder beneficiary	iii. An individual to whom assets or power is given for the benefit of another individual. The other individual is called a beneficiary.
4. Income beneficiary	iv. An individual making a will.
	v. The decedent.

   a. 1 iv and v; 2 iii; 3 ii; 4 i.

   b. 1 v; 2 ii; 3 i; 4 iii.

   c. 1 iv and v; 2 iii; 3 i; 4 ii.

   d. 1 iv; 2 v; 3 iii; 4 i.

8. Which of the following is correct regarding traditional format basic financial statements prepared for a fiduciary entity?

   a. Account form is preferred over report form for the balance sheet.

   b. Liabilities section should be excluded from the balance sheet.

   c. The multi-step format is preferred for the statement of earnings.

   d. The legal name of the fiduciary entity is included in the heading.

9. Which of the following statements is correct concerning the statement of trust equity?

   a. Presentation on the face of the balance sheet is preferred.

   b. Combining with the statement of earnings is appropriate for two beneficiary classes.

   c. The total equity format is preferred when there are two beneficiary classes.

   d. The component format presents equity components in columnar format.

10. Which of the following statements regarding FASB ASC 230-10 (formerly SFAS No. 95) and the statement of cash flows is correct?

    a. The guidance specifies a title for the statement of cash flows.

    b. A comparative presentation of statement of cash flows is not prepared for a trust.

    c. The predominant title is "Statement of Cash Flows."

    d. The guidance does not permit alternative formats for cash flows from operations.

11. The direct method is preferred for a statement of cash flows prepared for a fiduciary entity.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

12. SAS 62 does **not** require modification of statement titles for traditional format fiduciary reports produced on which basis?

    a. GAAP.

    b. Tax.

    c. Modified cash.

    d. Pure cash.

13. Which of the following statements is correct concerning notes and captions used in traditional format fiduciary financial statements?

    a. The practitioner takes responsibility for the notes.

    b. SSARS No. 1 allows for the omission of substantially all disclosures in a compilation engagement.

    c. The order of presentation in notes is not important so long as all necessary disclosures are made.

    d. Captions for each note in the fiduciary report should use numbers rather than letters.

14. Which of the following accounting policy disclosures is **not** required in traditional format fiduciary financial statements?

    a. Cash equivalents.

    b. Accounting policies.

    c. Income tax.

    d. Do not select this answer choice.

15. Which of the following statements is correct concerning a classified fiduciary balance sheet prepared in traditional format?

    a. Current notes payable should not be disclosed or included.

    b. Long-term debt should be disclosed or included.

    c. Related-party disclosures should exclude beneficiary receivables.

    d. Receivables where title has not yet passed should be included on the face of the statement.

16. Which of the following depreciation methods may **not** always be appropriate for GAAP?

    a. Sum-of-the-years' digits.

    b. Double declining balance.

    c. Straight-line.

    d. ACRS.

17. Which of the following statements is correct concerning fair value measurement under FASB's fair value guidance?

    a. The guidance applies only to instruments measured and classified in the stockholders' equity section of the balance sheet.

    b. The guidance encompasses forced liquidations and distressed sales, and considers the transaction from the viewpoint of the prospective buyer.

    c. Market, income, or cost approaches may be used to establish fair value under SFAS 157, so long as they are consistently applied.

    d. Do not select this answer choice.

18. Which level of the SFAS 157 fair value hierarchy is the most subjective?

    a. Level 1.

    b. Level 2.

    c. Level 3.

    d. Level 4.

19. Which of the following statements is correct concerning fair value measurement guidance?

    a. The amounts reported on the face of the income tax basis financials are not affected.

    b. Supplemental disclosures of the fair values of financial instruments are not affected.

    c. Descriptions of income tax and GAAP bases fair value differences are not affected.

    d. Do not select this answer choice.

Lesson 2: Reporting

INTRODUCTION

The accountant's service on financial presentations of estates and trusts depends on the form of the presentation and his association with it. This lesson discusses:

- The standards that govern accountants' services and their applicability to estate and trust engagements.

- The reports that accountants might issue on fiduciary financial presentations, and how the format and basis of accounting of such financial presentations affect the level of service and reports.

Practitioners have the same reporting alternatives for fiduciary financial presentations as they do for the financial statements of commercial business enterprises. Depending on the level of service practitioners provide, they must compile, review, or audit the financial presentations of estates and trusts. The following sections discuss issues that should be considered when preparing compilation, review, or audit reports on fiduciary financial presentations. Agreed-upon procedures engagements are also discussed.

Learning Objectives:

Completion of this lesson will enable you to:
- Describe level of service issues related to the accountant and the fiduciary entity.
- Identify various requirements for a compilation.
- Describe issues and considerations involved in GAAP reporting; discuss, in general terms, issues related to OCBOA report engagements; and recognize considerations related to engagements involving incomplete statements or those not prepared in conformity with GAAP or OCBOA.
- Discuss issues related to tax return engagements; summarize issues related to compilations of management-use-only financial statements; discuss issues related to fiduciary statements involving an accountant acting in a fiduciary role; and describe forms of engagement reports related to fiduciary entities.
- Describe presentation of financial statement elements in various types of engagement reports; and identify considerations involved in restricting the use of engagement reports.

Organization of This Lesson

This lesson is organized as follows:

- The levels of services provided when presenting financial information in the form of financial statements and the standards that govern services provided by CPAs. The focus of the section is to direct practitioners to the section of the professional standards that apply in certain circumstances.

- The performance of compilation engagements.

- How the practitioner reports on GAAP financial statements. It addresses standard and modified compilation, review, and audit reports on such financial statements, or accountings.

- Compilation, review, and audit reports on financial statements prepared on an other comprehensive basis of accounting (i.e., the cash basis, modified cash basis, and tax basis).

- How to report on the basis of accounting specified in an agreement.

- How the standards apply to engagements to prepare the estate or trust tax return.

- An exemption from the compilation reporting requirements of SSARS No. 1 that applies when the financial statements are for management's use only.

- Submission of financial statements by an accountant acting as trustee or executor.

- Reporting on financial statements presented on a form designed by the body using the statements. Such prescribed forms typically do not call for GAAP measurements or disclosures.
- Reports on presentations of financial data that are less than full financial statements.

Compilation, Review, and Audit Levels of Service

As mentioned earlier, the following levels of service are discussed in this lesson:

- Compilations of financial statements.
- Reviews of financial statements.
- Audits of financial statements.
- Reporting on other presentations: tax returns and presentations in prescribed forms, and elements, accounts, or items of a financial statement.

Compilation and review engagements are similar to audit engagements in many ways. In all three types of engagements, the CPA performs certain procedures in accordance with authoritative literature before issuing a report on a set of client financial statements. The major difference among those engagements is the level of procedures applied and the resulting level of assurance the practitioner provides in his or her report.

An audit report provides the highest level of assurance. An unqualified audit opinion is based on detailed tests and provides positive assurance that the financial statements present fairly in all material respects the financial information of the entity in conformity with the specified basis of accounting.

A review report provides less assurance than an audit report but also requires less work by the practitioner, resulting in a lower fee. A review report expresses limited assurance that no material modifications to a set of financial statements are needed for them to be in conformity with a particular basis of accounting. This is sometimes referred to as "negative assurance." The procedures performed in a review (primarily inquiry and analytical procedures) are substantially less in scope than those performed in an audit engagement.

A compilation report expresses no assurance about the financial statements. In this type of engagement, the practitioner merely presents client information in a set of financial statements. The verification procedures required on a compilation engagement are minimal. However, if the practitioner becomes aware of departures from the particular basis of accounting used or learns that the information supplied to him is inaccurate, incomplete, or misleading, some additional procedures are required. SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services 1, "Compilation and Review of Financial Statements*," allows the CPA to submit compiled financial statements without a compilation report when the statements are to be used only by management. SSARS No. 8 and its applicability to estates and trusts is discussed later.

Most CPAs who provide a professional service on the financial presentations of trusts and estates compile them. CPAs may also be engaged to review or audit the financial statements of these entities. In addition, practitioners may be engaged to perform other services such as reporting on tax returns and presentations in prescribed forms, and elements, accounts, or items of a financial statement.

LEVEL OF SERVICE ISSUES

An engagement might be governed by:

- Statements on Standards for Accounting and Review Services
- Statements on Auditing Standards
- Statements on Standards for Attestation Engagements
- Statements on Standards for Consulting Services

This lesson discusses the applicability of the various standards and the form of report on financial presentations of estates and trusts.

Determining What Level of Service Is Required

Certain fiduciary entities may be required by applicable state or local laws, regulations, or the governing document to submit reviewed or audited financial statements. For example, the state probate code could require estates to submit compiled financial statements to the applicable local court. The trust instrument may require that the CPA submit audited GAAP financial statement to the beneficiaries. The fiduciary and/or the attorney for the fiduciary entity is responsible for determining what level of service is required and engaging the CPA to perform that service. However, an engagement letter is required when providing audit services and the CPA should obtain that understanding in writing. If the CPA becomes aware that the planned level of service does not meet relevant legal, regulatory, or the requirements specified in the governing document, best practices indicate that he should inform the client in writing. If done orally, it should be documented in the engagement workpapers.

Compiled or Reviewed Financial Statements—Does SSARS No. 1 Apply?

Statements on Standards for Accounting and Review Services (SSARS) might apply to financial presentations of estates and trusts, depending on whether:

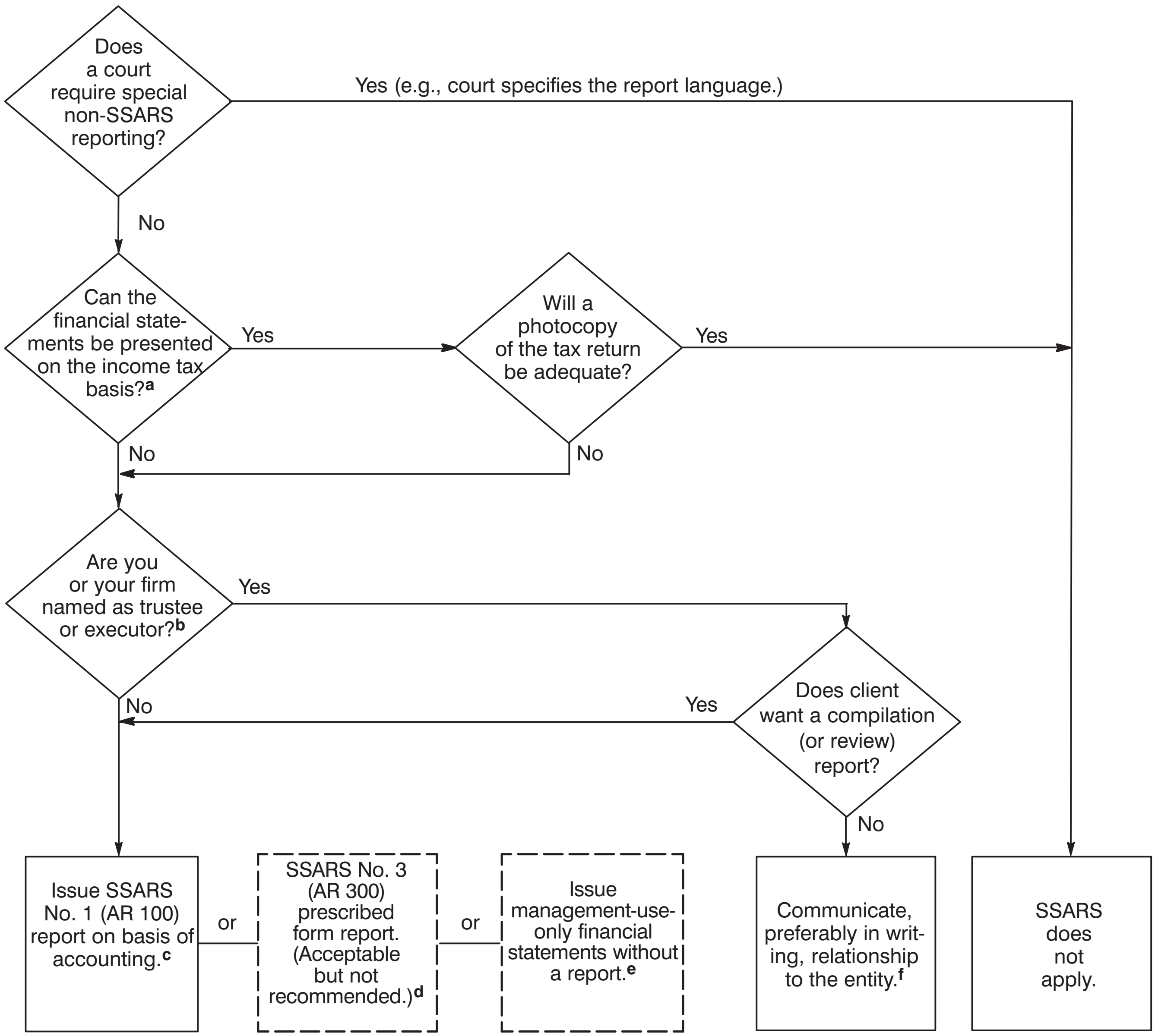
- The presentation is a financial statement.
- The accountant submits the financial statement.
- The financial statements are submitted to a court of law.
- The accountant is functioning as a public accountant.
- The accountant is acting as an executor, trustee, or employee of the fiduciary entity.

SSARS No. 1, *Compilation and Review of Financial Statements*, provides basic guidance and procedures applicable to all compilation and review services. When SSARS No. 1 applies, the accountant must at a minimum compile the statements in accordance with standards and, unless the conditions specified in SSARS No. 8 exist (discussed later), issue a compilation report in a standard format. The report must also indicate any material misstatements the accountant becomes aware of. If SSARS do not apply, the procedures performed and report issued, if any, are more flexible, and can be determined by the accountant and client.

Exhibit 2-1 summarizes reporting alternatives for estates and trusts.

Exhibit 2-1

Reporting Alternatives When Submitting Financial Statements for Estates and Trusts



Notes:

[a] Use of the income tax basis of accounting would rarely be appropriate for court accountings, unless such basis was specified in the governing document.

[b] A CPA who is not in public practice cannot issue a SSARS compilation (or review) report but can issue a communication describing his or her relationship to the entity.

[c] Fiduciary entities may use any of the following bases of accounting:

- Generally accepted accounting principles (GAAP).
- Agreed-upon basis specified in an agreement.

- Cash basis.
- Modified cash basis.
- Tax basis.

[d] As discussed later, SSARS No. 3 is only applicable to reports on compilation engagements.

[e] SSARS No. 8 allows the issuance of management-use-only financial statements without a compilation report only if certain criteria are met, meaning opportunities to use the SSARS No. 8 exemption for trust and estate engagements are likely limited.

[f] An example of this communication is found later in the lesson.

* * *

Is the Presentation a Financial Statement?

SSARS No. 1, AR 100.04, defines a *financial statement* as:

> A presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles (GAAP) or an OCBOA.

The same paragraph states that "A financial statement may be, for example, that of . . . an estate or trust . . . " So, it is clear that financial statements of estates and trusts are covered by SSARS No. 1. However, not all financial presentations that may be prepared in fiduciary engagements are financial statements; SSARS only applies to financial statements.

Accountants are most often engaged to perform services relating to fiduciary accountings (as financial presentations) for a court of law. These accountings generally have some attributes of financial statements and might be considered financial statements. However, determining whether such presentations are financial statements is not always clear cut. The most common accountings (that is, those in the summary of account format and, of course, traditional financial statement format) represent financial statements, although they are typically far more detailed than financial statements prepared for commercial business enterprises and often do not include typical financial statement disclosures.

For a presentation to be a financial statement it must be complete. Sometimes financial presentations consist only of elements, accounts, or items of a financial statement, rather than a statement of financial position or statement of earnings. In that case, SSARS No. 1 does not apply. SSARS No. 13 (AR 110), *Compilation of Specified Elements, Accounts, or Items of a Financial Statement*, was issued to address the compilation of specified elements, accounts, or items of a financial statement within the professional standards, but generally such partial presentations are rarely used in fiduciary accountings.

The output of the accountant's service might be a listing of accounts, rather than a formal financial statement. Determining whether a listing of accounts represents a financial statement or merely something analogous to a trial balance requires judgment but ultimately affects whether the accountant must follow SSARS No. 1. Though the provisions of SSARS No. 1 apply when the accountant submits financial statements to clients or others, they do not apply when the accountant submits a trial balance. The question then is, "How do you determine if a presentation is a financial statement or a trial balance?" Interpretation 15 to SSARS No. 1, "Differentiating a Financial Statement Presentation From a Trial Balance," (AR 9100.54–.57) provides guidance for determining whether an account listing is a financial statement. It also lists attributes of financial statements and trial balances. Although the interpretation focuses on traditional business financial statements, it applies to estates and trusts, though it takes some insight to apply it to those entities. Some of the terminology might not be applicable to estate and trust financial statements, but the concepts such as grouping of accounts, the articulation, and format of the statements are equally relevant to estate and trust presentations. The attributes are summarized in Exhibit 2-2.

Exhibit 2-2

Attributes of Financial Statements and Trial Balances

Item	Attribute of a financial statement	Attribute of a trial balance
Presentation format	• Similar general ledger accounts are combined to create classifications or account groupings with corresponding subtotals and totals of dollar amounts are combined. • Contra accounts are generally netted against the related primary accounts in financial statement presentations.	• All general ledger accounts and their corresponding debit or credit balances are listed.
Typical title of presentation	• Balance Sheet • Statement of Earnings • Statement of Trust or Estate Equity • Statement of Cash Flows • Statement of Changes in Trust or Estate Equity • Statement of Assets and Liabilities[a] • Statement of Revenue and Expenses • Statement of Cash Receipts and Disbursements	• Trial Balance • Working Trial Balance • Adjusted Trial Balance • Listing of General Ledger Accounts
Basic relationships presented	• Asset, liability,[a] and equity accounts are segregated and presented to demonstrate that: Assets = Liabilities[a] + Trust or Estate Equity • Elements of the statement of earnings and their relationship to net income are presented based on the following basic example equation: Revenues − Expenses + Gains − Losses = Net Income	• No attempt to establish a mathematical relationship among the elements except that: Total Debits = Total Credits
Format of income statement	• "Net Income" or "Net Revenues over Expenses" identifies the net results of operations.	• No similar caption

Item	Attribute of a financial statement	Attribute of a trial balance
Format of balance sheet	• Assets and liabilities[a] are presented in the order of their liquidity and maturity, respectively.	• Accounts are listed in account number order.
Relationship between statements	• Results of trust or estate activities (operations) are reflected and net income is closed to trust or estate equity.	• Net results of trust or estate activities (operations) are not reflected and the trust or estate equity is the balance as of the beginning of the period.

Note:

[a] This financial statement or account title assumes that liabilities are presented in the financial statements. As discussed previously, many fiduciary financial statements, especially those presented in a summary of account format, do not include liabilities.

* * *

In many cases the accountant might be involved with an initial draft of a presentation that has some attributes of each type of presentation. In that case, the interpretation notes that the accountant should consider "the preponderance of the attributes of the financial presentation." That is, it might be a trial balance even if it has some attributes of a financial statement, or vice versa. The primary message of Interpretation No. 15 is that accountants should avoid presentations that fall somewhere between financial statements and trial balances. The accountant should attempt to eliminate ambiguous features of a presentation so it is clear whether the procedure and reporting rules of SSARS No. 1 need to be applied. If the presentation cannot be modified to clearly identify it as either a financial statement or a trial balance, the accountant should apply SSARS and report accordingly.

Some estate or trust accountings are merely chronological lists of transactions. SSARS No. 1 does not explicitly discuss this situation, but such a listing essentially may be viewed as a glorified general ledger or cash receipts and disbursements journal and, thus, not covered by the SSARS. When, on the other hand, similar types of transactions are grouped in such a listing it begins to resemble a financial statement then the accountant needs to consider whether SSARS apply. For example, when using the summary of account format, transactions are usually grouped by type of transaction with the detailed transactions presented in supporting schedules.

Other types of presentations are governed by different reporting rules. Other sections of this lesson discuss:

- Tax returns.
- Financial statements presented on prescribed forms.
- Elements, accounts, or items of a financial statement.

Is the Accountant Acting as a Public Accountant?

An accountant might provide professional services under SSARS or management services as an executor, trustee, or employee of the fiduciary entity. Interpretation No. 21 to SSARS No. 1, "Applicability of SSARS No. 1 When Performing Controllership or Other Management Services" (AR 9100.80–.84) discusses the accountant's reporting responsibility when he or she is also an owner, director, or employee of an organization. Under Interpretation No. 21, the accountant's reporting responsibility is based on:

a. Whether he is in public practice, and

b. Whether he is acting as an employee, director, or owner of the entity.

Prior to the issuance of Interpretation No. 21, it often was difficult to determine whether the accountant was acting as a public accountant in his or her role with the fiduciary entity. Good arguments existed for both positions in various situations. The issuance of Interpretation No. 21 resolves the conflicting viewpoints and presents a definitive approach to examining the roles and relative responsibilities under professional standards of accountants providing services to fiduciary entities.

Definition of the Practice of Public Accountancy. The AICPA Code of Professional Conduct defines the practice of public accountancy as follows:

> The practice of public accounting consists of the performance for a client, by a member or a member's firm, while holding out as CPA(s), of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council, such as Statements of Financial Accounting Standards, Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statements on Standards for Consulting Services, Statements of Governmental Accounting Standards, and Statements on Standards for Attestation Engagements.
>
> However, a member or a member's firm, while holding out as CPA(s), is not considered to be in the practice of public accounting if the member or the member's firm does not perform, for any client, any of the professional services described in the preceding paragraph. (ET 92.25)

Thus, if a firm provides these services for *any* client it is considered to be in the practice of public accounting.

Reporting Options under Interpretation No. 21. The accountant's reporting options are summarized in Exhibit 2-3.

Exhibit 2-3

Reporting Options under Interpretation No. 21

Practicing Public Accounting?	Acting as an Executor, Trustee, or Employee of the Entity?	Minimum Reporting Requirements (assuming the accountant submits the financial statements)
Yes	No	SSARS compilation report[a]
Yes	Yes	SSARS compilation report modified to note a lack of independence[a] or Communication, preferably in writing, of the CPA's relationship to the entity
No	Yes	No specific responsibility under professional standards. May provide a communication of the CPA's relationship to the entity. Cannot provide a SSARS compilation report.

Note:

[a] If the financial statements are for management-use only, the accountant may submit them without a report as discussed later.

* * *

When an accountant is hired by a fiduciary to perform an accounting that results in financial statements, it would seem the provisions of SSARS No. 1 should apply (absent a contrary reporting requirement of a court of law). In such an engagement, most accountants would agree that the accountant is practicing public accounting but is not acting as an employee or member of management.

If a CPA who is practicing public accounting acts as executor or trustee, he may be engaged to provide a standard SSARS report. However, the report should be modified to indicate his or her lack of independence. If a compilation report is not needed, the CPA may merely communicate his or her relationship with the entity. Such communication may be oral, but it is preferable to make the communication in writing.

The reporting options discussed in the preceding paragraphs are illustrated in the following examples:

Example 2-1: Accountant is hired by fiduciary.

John Smith, Trustee of the Daniel Family Trust hires Jones and Tucker, LLP, a CPA firm, to compile the financial statements for the Trust. Jones and Tucker are in the practice of public accounting and they are acting as the independent accountants. Jones and Tucker, LLP should issue a compilation report when they submit the financial statements of the Trust.

Example 2-2: Accountant in public practice is the executor.

Tom Smits' will names John Henry, CPA, as his executor. John is a partner with Henry and Wells, CPAs, the firm that prepares Tom's tax return. If John Henry or his firm submit financial statements for the Estate of Tom Smits, they must either (a) issue a SSARS compilation report that indicates they are not independent or (b) communicate, preferably in writing, their relationship (i.e., executor) to the entity.

Example 2-3: Accountant not in public practice is the executor.

Jenny Johnson's will names Cindy Flaherty, CPA, as her executor. Cindy is the controller of a nonprofit organization and is not in the practice of public accounting. Therefore, she has no specific responsibilities under SSARS when she submits financial statements for the Estate and is prohibited from issuing a compilation report. However, she may provide a communication or transmittal with such statements where she could disclose her relationship (i.e., executor) to the entity.

When Does the Accountant Submit the Financial Statements?

The accountant needs to apply SSARS No. 1 if he or she submits the financial statements to the client or to others. SSARS No. 1 (AR 100.04) defines submission as follows:

> Presenting to the client or third parties financial statements that the accountant has prepared either manually or through the use of computer software.

Not all accountants' services on financial statements involve submission. Services that do not constitute submission include:

- Reading client-prepared financial statements.
- Typing or reproducing client-prepared financial statements without modification as an accommodation to a client.
- Proposing correcting journal entries or disclosures to the financial statements, either orally or in written form, that materially change client-prepared financial statements, as long as the accountant does not directly modify the client-prepared financial statements.
- Preparing standard monthly journal entries.
- Providing a client with a financial statement format that does not include dollar amounts, to be used by the client to prepare financial statements.

- Advising a client about the selection or use of computer software that the client will use to generate statements.

- Providing the client with the use of or access to computer hardware or software that the client will use to generate statements.

SSARS No. 1 does not define the term *prepared*. Consequently, there is diversity in practice as to what level of effort by the accountant constitutes *preparing* the financial statements. Some accountants would argue they can do all of the data entry and review; and as long as the client prints the financial statements, then the accountant has not prepared them. Others take a more stringent view. To achieve greater consistency in practice, the AICPA issued a TPA, *Determining Whether Financial Statements Have Been Prepared by the Accountant*, (TIS 9150.25) to help clarify the accountant's role. The TPA indicates accountants should consider the following when deciding whether they have prepared the financial statements or management has prepared them:

- The process used to create the financial statements, that is, the accountant's involvement in putting the data in a financial statement format.

- Whether the client engaged the accountant to prepare financial statements or reasonably expected financial statements to be a product of the engagement.

- The extent of work effort the accountant contributed to the financial statements, including their involvement in the accounting process.

- Where the underlying accounting information resides, including whether the accounting or bookkeeping software utilized is the accountant's or the client's.

SSARS No. 1 also does not indicate when a practitioner has *presented* the financial statements to clients or others. That presentation can take numerous forms. For example, practitioners may present financial statements by handing printed statements or a disk containing such statements to a client. Practitioners may also present financial statements by electronically transmitting them by email.

Situations in which practitioners prepare financial statements without presenting them to clients will be rare. One exception is in an engagement to prepare a tax return, where practitioners might prepare financial statements without presenting them to the client. For instance, they might prepare financial statements for the purposes of preparing the tax return and provide the client only with a copy of the tax return. In that case, since the accountants have not presented the statements, they have not submitted under SSARS No.1; therefore, they do not have to comply with SSARS No. 1.

In any case, the accountant should not consent to the use of his name in a document or written communication containing unaudited financial statements of a trust or estate unless:

a. He has compiled or reviewed the financial statements and his report accompanies them; i.e., when SSARS apply, or

b. The financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that he assumes no responsibility for them; i.e., when SSARS do not apply (e.g., the client might place a legend directly on the financial statements that states "Jones and Smith, CPAs, have not compiled or reviewed these financial statements and assume no responsibility for them").

The accountant may submit draft financial statements without attaching a compilation or review report as long as the draft financial statements indicate they are a draft. Each page should carry a notification such as "Draft," "Preliminary Draft," "Draft—Subject to Changes," or "Working Draft." However, Interpretation 17 to SSARS No. 1, "Submitting Draft Financial Statements," (AR 9100.61–.62) warns that, in using this exception, the accountant must intend to issue statements in final form along with a compilation or review report. It notes that, in the rare circumstance where the accountant intended to but never submitted final financial statements, the accountant may want to document the reasons why he was unable to submit those financial statements.

Reporting Directly to a Court of Law

A common form of engagement for estates and trusts involves preparing an accounting (a financial statement) for a court of law. The laws of testimony, evidence, and proceeding peculiar to each legal jurisdiction can have a bearing on the type of report, if any, that can accompany the accounting. In fact, situations have been encountered where a probate judge refuses to accept a SSARS No. 1 (AR 100) report that accompanies unaudited accountings. If a court specifies a form of report other than SSARS, the accountant might find the guidance in Interpretation No. 20 to SSARS No. 1, "Applicability of Statements on Standards for Accounting and Review Services to Litigation Services," (AR 9100.76–.77) helpful. It states:

> SSARS do not apply to financial statements submitted in conjunction with litigation services that involve pending or potential formal legal or regulatory proceedings before a "trier of fact" in connection with the resolution of a dispute between two or more parties when the . . . accountant's work under the rules of the proceedings is subject to detailed analysis and challenge by each party to the dispute.

Some accountants might argue that, while the winding up of an estate might not involve a *dispute*, in such proceedings, like those envisioned in the interpretation, (a) parties with competing interests will often analyze and challenge the accountant's work and (b) the trier of fact might dictate the form of report, if any.

If the court requests a report different from that required by SSARS, the accountant should generally comply with the court.

When Auditing Standards Apply

The auditing standards apply only when the accountant is specifically engaged to provide services under the Statements on Auditing Standards (SASs), such as audits of financial statements or elements of a financial statement. However, such engagements are performed less frequently than compilations and reviews for estates and trusts.

Procedures. Practitioners who are engaged to audit the financial statements of an estate or trust should apply the appropriate procedures and issue the reports required by generally accepted auditing standards (GAAS). However, practitioners should keep in mind that courts and other interested parties sometimes use the word "audit" imprecisely, without meaning a GAAS audit. For example, the word "audit" might be used to describe:

- An undefined level of scrutiny of the accounting submitted to the court and related testimony from interested parties prior to the court's approval.

- A listing of all pertinent information concerning an estate, including matters such as the location of properties, data about the deceased, and names of beneficiaries.

Though GAAS audits of fiduciary entities are not common, a court might order an audit if there appear to be errors in the accounting provided to the court or there is an unexpected shortfall in funds available. Another reason for an audit would be situations where there is a beneficiary request. In addition, an audit requirement may be included in the governing document. There is no exemption for litigation services in the auditing literature. A practitioner engaged to audit the financial statements in connection with litigation should comply with GAAS and provide the reports called for in the SASs. In addition, practitioners should be careful that their oral testimony in such cases does not provide more assurance than provided in the standard auditor's report.

Communications. A GAAS audit involves communications in addition to the report on the financial statements. The auditor is also required to make the following communications as a result of the audit, although the communications may be oral if they are documented in the workpapers:

- Matters required to be communicated to those charged with governance. [SAS No. 114 (AU 380)]

- Any significant deficiencies or material weaknesses identified in internal control. [SAS No. 115 (AU 325)]

- When the auditor determines fraud may exist, SAS No. 99 (AU 316) requires the auditor to communicate the matter to the appropriate level of management, even if the matter is considered inconsequential (for example, theft of an immaterial amount of petty cash by a low-level employee). Fraud involving senior management (regardless of the amount involved), or fraud that results in a material misstatement should be reported to the audit committee.

- Illegal acts (except those that are clearly inconsequential) that come to the auditor's attention. If senior management is involved in an illegal act, the auditor should communicate the act directly to the audit committee (or equivalent). [SAS No. 54 (AU 317)] The committee should be informed of the following matters regarding illegal acts:

  - A description of the act.

  - The circumstances of the act's occurrence.

  - The effect on the financial statements.

In the case of fiduciary entity, because an audit committee (or equivalent) may not exist, generally such communications should be made to the executor or trustee. In situations where the fraudulent or illegal act involves the fiduciary, best practices indicate that the auditor should consult with the auditor's legal counsel and consider withdrawing from the engagement. It is unclear whether the auditor has a duty to communicate such issues to the probate or other court. Because potential conflicts with the auditor's ethical and legal obligations for confidentiality are complex, the auditor may wish to consult with legal counsel.

Communication with Those Charged with Governance. SAS No. 114, *The Auditor's Communication with Those Charged With Governance*, establishes requirements and provides guidance on the auditor's communication with the individuals responsible for an entity's governance. The communication requirements of SAS No. 114 apply in relation to a financial statement audit and to all entities regardless of their governance structure or size. The paragraphs below summarize the requirements of SAS No. 114.

The SAS defines those charged with governance as the persons "with responsibility for overseeing the strategic direction of the entity and its obligations related to the accountability of the entity. This includes overseeing the financial reporting process." For an estate or trust, *those charged with governance* will likely be the executor or trustee, or those individuals appointed by the executor or trustee. The SAS further states that those charged with governance encompasses a board of directors or audit committee referred to in other auditing standards.

SAS No. 114 does not establish requirements for communication with management or owners unless they are also charged with a governance role. However, the standard does provide specific considerations for situations where all of those charged with governance are also involved in managing the entity.

If the appropriate person(s) with whom to communicate is not clearly identifiable, the auditor should consult with the engaging party to make this determination. Also, if all those charged with governance are involved in managing the entity, the auditor should consider whether communication with the person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise have to communicate because of their governance role.

Many governing bodies have subgroups, i.e., audit committees or similar groups. The auditor should evaluate whether communication with a subgroup of those charged with governance (or with an individual), adequately meets the auditor's responsibility to communicate with those charged with governance.

The primary purposes of communication with those charged with governance are to:

- Clearly communicate an overview of the audit scope, the timing of the audit, and the auditor's responsibilities.

- Provide timely observations arising from the audit that are relevant to oversight of the financial reporting process.

- Obtain relevant audit-related information from those charged with governance.

As indicated by the third bullet point in the previous paragraph, SAS No. 114 addresses two-way communication—communication from those charged with governance as well as the auditor's communication to those charged with governance. Effective two-way communication assists both the auditor and those charged with governance to understand matters related to the audit and develop a constructive working relationship. It also enables those charged with governance to fulfill their responsibility to oversee the financial reporting process. Further, the auditor may be able to obtain important information from those charged with governance that is relevant to understanding the client and its environment, identifying sources of audit evidence, and obtaining information about specific events and transactions.

Matters to Be Communicated. The auditor must clearly communicate matters that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The matters required to be communicated under SAS No. 114 are as follows:

a. *Auditor Responsibility.* The auditor's responsibilities under generally accepted auditing standards.

b. *Planned Scope and Timing of the Audit.* An overview of the planned scope and timing of the audit that is not so detailed as to compromise audit effectiveness.

c. *Significant Findings from the Audit.* The auditor's views about findings or issues that the auditor considers to be significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

Timing of the Communication. The timing of communications will vary with the circumstances of the engagement. In deciding the timing, the auditor should consider the significance and nature of the matter and the action expected to be taken by those charged with governance. Also, the auditor's communication should be sufficiently timely to enable those charged with governance to take appropriate action.

Forms of Communication. The form of communication (i.e., oral or written, detailed or summarized, formal or informal) depends upon many factors. However, SAS No. 114 requires written communication of significant findings when, in the auditor's professional judgment, oral communication would not be adequate. Significant findings that were communicated with those charged with governance and subsequently resolved do not need to be included. Other communications may be oral or written and may be formal or informal, including discussions. An engagement letter may be used to communicate some of the required communications as long as it is provided to those charged with governance.

When the communication is written, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management and is not intended and should not be used by anyone other than these specified parties.

When a significant matter is discussed with an individual member of those charged with governance, the auditor may want to consider summarizing it in later communications so that all persons charged with governance are fully informed.

Evaluation of the Adequacy of the Auditor's Communication. SAS No. 114 requires the auditor to evaluate whether the communication between the auditor and those charged with governance has been adequate. The evaluation may be based on the auditor's observations.

If, in the auditor's judgment, the communication with those charged with governance was not adequate, it may indicate that the auditor has not obtained sufficient appropriate evidence to form an opinion on the financial statements. The auditor should take appropriate action to address the effectiveness of the communication process. Also, the auditor should consider the effect, if any, on the assessment of the risks of material misstatement and may want to discuss the situation with those charged with governance. If the situation cannot be resolved, the auditor may take other actions such as:

- Modifying the opinion to reflect a scope limitation.
- Obtaining legal advice about the consequences of different actions.
- Communicating with third parties.
- Withdrawing from the engagement.

Documentation of Communications. SAS No. 114 requires the auditor to document matters that have been communicated orally. This documentation may include a copy of minutes prepared by the entity. When matters have been communicated in writing, the auditor should retain a copy of the communication.

Communicating Internal Control Related Matters under SAS No. 115. SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*, establishes requirements for auditors to communicate certain control deficiencies that they have identified during the audit. Control deficiencies which, in the auditor's judgment, are *significant deficiencies* or *material weaknesses* must be communicated in writing to management and those charged with governance. SAS No. 115 establishes two unconditional requirements:

- The auditor must evaluate identified control deficiencies and determine whether, individually or in combination, they are significant deficiencies or material weaknesses.
- The auditor must communicate, in writing, to management and those charged with governance all significant deficiencies or material weaknesses identified during the audit, including those communicated in prior audits if they have not been corrected.

Definitions. SAS No. 115 contains the following definitions:

- *Control Deficiency.* A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
- *Significant Deficiency.* A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
- *Material Weakness.* A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

The auditor must evaluate identified control deficiencies and determine whether these deficiencies, individually or in the aggregate, are significant deficiencies or material weaknesses. The significance of a deficiency in internal control depends on the potential for a misstatement, not on whether a misstatement actually has occurred. (Therefore, the absence of an identified misstatement does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses.) The auditor's evaluation of whether control deficiencies, individually or in the aggregate, are significant deficiencies or material weaknesses should take into consideration the likelihood and magnitude of potential misstatement as well as the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit.

Other Engagements under SASs. The accountant could be asked to audit a set of financial statements or elements, accounts, or items of a financial statement.

What Other Standards Might Apply?

***Code of Professional Conduct*—Ethics.** Ethics standards are contained in the AICPA Code of Professional Conduct. The Code of Professional Conduct, which applies to all AICPA members, includes principles, rules, interpretations, and rulings dealing with a variety of issues including independence, integrity, acts discreditable, advertising, etc. Some of these are further discussed.

Rule 201 of the Code of Professional Conduct (ET 201.01)applies to all public accounting services. It requires:

- *Professional Competence.* Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.
- *Due Professional Care.* Exercise due professional care in the performance of professional services.
- *Planning and Supervision.* Adequately plan and supervise the performance of professional services.
- *Sufficient Relevant Data.* Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

Consulting. Statements on Standards for Consulting Services (SSCS) could apply to specialized services that CPAs provide to estates and trusts. According to CS 100.05d, consulting services might include:

> *Transaction services*, in which the practitioner's function is to provide services related to a specific client transaction, generally with a third party. Examples of transaction services are insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger or acquisition, and litigation services.

Discussion of the SSCS is beyond the scope of this course.

Attestation. The CPA might be engaged to report on a fiduciary's compliance with the terms of the governing document or state or local law. In that case, the accountant should look to Statements on Standards for Attestation Engagements (SSAE) No. 10 (AT 601), *Compliance Attestation*, for guidance on examining or applying agreed-upon procedures in compliance engagements. Other types of engagements, such as reviewing or applying agreed-upon procedures to elements, accounts, or items of a financial statement, also fall under the Statements on Standards for Attestation Engagements. *PPC's Guide to Nontraditional Engagements* provides guidance on performing attestation engagements.

Current Developments of the Accounting and Review Services Committee of the AICPA

The basic task of ARSC is to keep the existing SSARS up to date as changes are made in other authoritative literature and to make sure current standards coincide with recent developments in technology and regulation. From time to time, ARSC also will issue interpretations, develop technical practice aids, or issue other guidance to address recurring practice problems relating to existing SSARS. The following paragraphs provide a brief discussion on some of the recent ARSC developments.

Issuance of TIS 9150.25, *Determining Whether Financial Statements Have Been Prepared by the Accountant*. The Technical Practice Aid clarifies the term *prepare* as used in AR 100.04, which states that submission of financial statements is considered presenting to a client (e.g., the fiduciary entity) or third parties (e.g., the court and beneficiaries) financial statements that the accountant has *prepared* either manually or through the use of computer software. The TPA states that determining whether financial statements have been *prepared* is a matter of professional judgment and lists four factors that an accountant may consider when making that judgment.

Issuance of Interpretation No. 31, *Preparation of Financial Statements for Use by an Entity's Auditors*. Interpretation No. 31 of AR section 100 (AR 9100.136) addresses the situation where a client engages an accountant other than its auditor to prepare unaudited financial statements on behalf of management and where those financial statements are provided by management (e.g., the executor/trustee) to its outside auditor, for the purposes of the annual audit. In such instances, the client's outside auditor is not deemed to be a third party using the financial statements, as he or she does not rely on those financial statements to conclude as to the entity's financial position or results of operations. Accordingly, the accountant is permitted to follow the SSARS No. 8 guidance.

Issuance of SSARS No. 18, *Applicability of Statements on Standards for Accounting and Review Services*. In February 2009, ARSC issued Statement on Standards for Accounting and Review Services No. 18, *Applicability of*

Statements on Standards for Accounting and Review Services (SSARS No. 18). SSARS No. 18 amends AR 100 and states that the SSARS are not applicable to reviews of interim financial information when all of the following conditions are met:

a. The entity's latest annual financial statements have been audited.

b. The accountant has been engaged to audit the entity's current year financial statements, or they audited the prior year financial statements and expect to be engaged to audit the current year financial statements.

c. The client prepares its interim statements using the same financial reporting framework as that used to prepare its year-end statements.

In these instances, the accountant should perform the interim reviews in accordance with SAS No. 116 (AU 722), *Interim Financial Information*. SSARS No. 18 is effective for periods beginning after December 15, 2009. Early application is permitted.

SSARS Exposure Draft. The Accounting and Review Services Committee issued an exposure draft of three proposed SSARSs—

- *Framework and Objectives for Performing and Reporting on Compilation and Review Engagements*
- *Compilation of Financial Statements*
- *Review of Financial Statements*

As of the date of this course, the most significant changes from existing standards that would result from the issuance of the proposed standards are as follows—

- Separate the compilation standards from the review standards.
- Introduction of the terms *review evidence*, *risk awareness*, and *materiality* to the SSARS literature.
- Requirement for a written engagement letter for all compilations and reviews.
- Requirement to document significant, unusual matters considered by the accountant during the performance of the compilation procedures, including their disposition.
- Expanded guidance with respect to the performance of analytical procedures in a review engagement.
- Requirement in a review that the accountant document management's responses to—
  - the accountant's inquiries regarding fluctuations or relationships that are inconsistent with other information or that differ from expectations by a significant amount.
  - significant matters covered in the accountant's inquiry procedures.
- Changing the reporting language for both compilation and review reports.

At the date of this course, ARSC needs to consider a large number of comment letters received addressing the exposure draft. ARSC's plan is to issue final SSARS in the fourth quarter of 2009. If issued as planned, the new SSARS would be effective for compilations and reviews of financial statements for periods beginning on or after December 15, 2010, with early implementation permitted.

The original exposure draft also included three additional items. As of the date of this course, ARSC has tentatively decided to not include the following items in the final guidance:

- Use of the term *moderate assurance* versus *limited assurance*.

- Allowing the accountant to include a general description in the accountant's compilation report as to the reason(s) for an independence impairment.

- Allowing the accountant to perform a review and issue a review report in the instances when independence is impaired due to the performance of internal control services.

AICPA's Compilation and Review Alert. The AICPA staff prepares a compilation and review alert each year, which is a nonauthorative practice aid designed to help accountants plan and perform their compilation and review engagements. The AICPA's 2008/2009 *Compilation and Review Alert* clarifies existing SSARS, suggests ways of implementing SSARS in special circumstances, points out various pitfalls that frequently occur in compilation and review engagements, and addresses emerging issues and practice problems. Although guidance in the AICPA's alert is not authoritative, it is designed to help accountants plan and perform their compilation and review engagements. Copies of the alert can be obtained from the AICPA at **www.cpa2biz.com**.

Other AICPA Compilation and Review Practice Aids. Other AICPA compilation and review practice aids include—

- *Compilation and Review Engagements—Essential Questions and Answers*.

- *Review Engagements—New and Expanded Guidance on Analytical Procedures, Inquiries, and Other Procedures*.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. Which of the following reports presents the highest level of assurance for statements presented in the traditional format?

    a. Compilation.

    b. Audit.

    c. Review.

21. Which of the following statements is correct concerning SSARS?

    a. SSARS No. 1 only applies to financial statements.

    b. SSARS No. 1 considers the trial balance a component of the financial statements.

    c. SSARS No. 1 was issued to address management-only reviews.

    d. SSARS No. 13 was issued to address fiduciary reporting.

22. The CPA should not consent to the use of his or her name in any document containing unaudited fiduciary statements unless such statements have been compiled or reviewed by the CPA and are accompanied by the related report.

    a. True.

    b. False.

23. Which of the following statements is **incorrect** concerning the SAS No. 114 which establishes requirements and provides guidance concerning the auditor's communications with the client?

    a. Such communications are between the auditor and those charged with governance.

    b. Such communication includes the planned scope of the audit.

    c. Such communications are to be formal, detailed, and in writing.

    d. Timing of such communications may vary.

24. Which of the following statements is correct concerning SAS No. 115 (AU 325), *Communicating Internal Control Related Matters identified in an Audit*?

    a. Deficiencies are determined to be significant on an aggregate basis.

    b. Material weaknesses are control deficiencies.

    c. The significance of a deficiency is based on whether a misstatement has occurred.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

20. Which of the following reports presents the highest level of assurance for statements presented in the traditional format? **(Page 212)**

    a. Compilation. [This answer is incorrect. A compilation requires the least amount of work on the part of the practitioner, and the report expresses no assurance about the financial statements.]

    b. Audit. [This answer is correct. The audit requires more work on the part of the practitioner than either the review or the compilation and also provides the highest level of assurance for the reader of the financial statements. An unqualified opinion is based on detailed tests and provides positive assurance that the financial statements present fairly in all material respects the financial information of the entity in conformity with the specified basis of accounting.]

    c. Review. [This answer is incorrect. On a scale of 1 to 3 with 3 being the highest level of assurance, a review would be rated at 2. It provides neither the most nor the least level of assurance to the reader of the financial statements. A review report expresses limited assurance that no material modifications to a set of financial statements are needed for them to be in conformity with the specified basis of accounting.]

21. Which of the following statements is correct concerning SSARS? **(Page 215)**

    a. SSARS No. 1 only applies to financial statements. [This answer is correct. Some practitioner judgment is required to determine whether SSARS No. 1 applies to a particular presentation, since it does not apply to incomplete financial presentations such as an account listing.]

    b. SSARS No. 1 considers the trial balance a component of the financial statements. [This answer is incorrect. SSARS No. 1 excludes the trial balance from consideration because SSARS No. 1 applies only to complete financial presentations.]

    c. SSARS No. 1 was issued to address management-only reviews. [This answer is incorrect. SSARS No. 8 addresses management-only financial reports.]

    d. SSARS No. 13 was issued to address fiduciary reporting. [This answer is incorrect. SSARS No. 13 addresses compilations of specified elements, accounts, or items of a financial statement and its use in fiduciary reports is rare.]

22. The CPA should not consent to the use of his or her name in any document containing unaudited fiduciary statements unless such statements have been compiled or reviewed by the CPA and are accompanied by the related report. **(Page 220)**

    a. True. [This answer is incorrect. There are exceptions to this general rule. For example, an accountant may consent to the use of his name if the financial statements are accompanied by an indication that the accountant has not compiled or reviewed them and that he assumes no responsibility for them.]

    b. False. [This answer is correct. There is another way that the accountant can consent to the use of his name. The fiduciary statements may be accompanied by an indication that the CPA has not compiled or reviewed the statements and assumes no responsibility for them.]

23. Which of the following statements is **incorrect** concerning the SAS No. 114 which establishes requirements and provides guidance concerning the auditor's communications with the client? **(Page 223)**

    a. Such communications are between the auditor and those charged with governance. [This answer is incorrect. SAS No. 114 communications are between the auditor and those charged with governance. This communication is two-way, as the auditor may seek and receive information from the governing body while also imparting relevant and important information to that body regarding oversight of the financial reporting process.]

    b. Such communication includes the planned scope of the audit. [This answer is incorrect. Such communications include both the planned scope and the timing of the audit, but not in such detail that it would compromise the audit process and results.]

    c. SAS No. 114 requires communications to be formal, detailed, and in writing. [This answer is correct. The form of communication between the auditor and those charged with governance can vary based on what is being communicated. Under SSARS No. 114, significant findings require written communication, if in the auditor's opinion; a less formal communication is not adequate. Other communications may be oral or informal or even a discussion.]

    d. Timing of such communications may vary. [This answer is incorrect. The timing of such communications depends on individual engagement circumstances and considers factors such as the significance and nature of the matter communicated, the action expected from the governing body, and the need for timeliness so that those charged with governance can respond appropriately.]

24. Which of the following statements is correct concerning SAS No. 115 (AU 325), *Communicating Internal Control Related Matters identified in an Audit*? **(Page 224)**

    a. Deficiencies are determined to be significant on an aggregate basis. [This answer is incorrect. Deficiencies may also be considered significant on an individual basis. An individual deficiency may have the likelihood and magnitude of potential misstatement of the financial statements.]

    b. Material weaknesses are control deficiencies. [This answer is correct. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected on a timely basis.]

    c. The significance of a deficiency is based on whether a misstatement has occurred. [This answer is incorrect. The significance of a deficiency is based on the potential for a misstatement of the financial statements.]

COMPILATION PROCEDURES

As discussed earlier, most CPAs who perform professional services related to financial presentations of trusts and estates provide compilation services. Consequently, this section discusses the procedures that are generally appropriate when performing compilation services for estates and trusts.

Since the definition of a compilation engagement indicates that the CPA is merely putting information supplied by the client into proper financial statement form without expressing any assurance, it is logical to assume that required procedures are minimal. SSARS No. 1 (AR 100.10) clearly states that the accountant ". . . is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity." Likewise, accountants have no obligation to obtain an understanding of or communicate deficiencies in internal control or to assess control risk. This, of course, does not reduce the accountants' obligation to obtain additional or revised information if they become aware that information supplied to them is inaccurate, incomplete, or misleading. Nor does it reduce the accountants' responsibilities when departures from generally accepted accounting principles (GAAP) are known to them. Also, if the accountant becomes aware of significant weaknesses in the client's internal control, it is only prudent that the accountant communicate those findings to the client.

Compilation Performance Requirements

SSARS No. 1 establishes the performance requirements for compilations. A practitioner engaged to compile financial statements should:

a. Establish an understanding with the organization regarding the services to be performed, and the report the accountant expects to render (AR 100.05).

b. Have, or obtain, knowledge of the accounting principles and practices of the organization's industry, and a general understanding of certain matters related to the organization itself (AR 100.08–100.09).

c. Consider whether it will be necessary to perform other accounting services, such as assistance in adjusting the books of account or consultation on accounting matters (AR 100.09).

d. Take certain actions when the accountant becomes aware that information supplied by the organization is incorrect, incomplete, or otherwise unsatisfactory (AR 100.10).

e. Read the compiled financial statements and consider whether they appear to be appropriate in form and free from obvious material error (AR 100.11).

It should be noted that the SSARS standards apply to interim financial statements as well as annual financial statements.

Degree of Responsibility in Performance of Engagement. SSARS No. 16 (AR 20) defines the degree of responsibility that accountants have in the performance of compilation and review engagements in a manner similar to SAS No. 102 for audit engagements:

- *Unconditional requirements* are defined as requirements with which accountants are required to comply in all cases in which the circumstances exist to which the requirement applies. Such requirements are introduced by the words *must* or *is required*.

- *Presumptively mandatory requirements* are requirements with which accountants are required to comply in all cases in which the circumstances exist to which the requirement applies. However, accountants may depart from such a requirement if they justify the departure and how alternative procedure(s) performed in the circumstances were sufficient to achieve the objectives of the requirement. Such requirements are introduced by the word *should*.

SSARS Exhibits. The AICPA has issued the following exhibits to the SSARS codification to provide nonauthoritative guidance to assist practitioners performing compilation and review engagements.

- Exhibit A, *Analytical Procedures in a Review Engagement*. This exhibit illustrates how an accountant might document expectations in a review engagement.

- Exhibit B, *Going Concern Considerations*. This exhibit provides accounting guidance with respect to an entity's ability to continue as a going concern.

- Exhibit C, *Subsequent Events Considerations*. This exhibit provides accounting guidance with respect to an entity's consideration of subsequent events.

The FASB issued FASB ASC 855-1 (formerly SFAS No. 165, *Subsequent Events*) in May 2009. The guidance is effective for interim or annual financial periods ending after June 15, 2009, and applies to the accounting for and disclosure of subsequent events not addressed in other applicable generally accepted accounting principles.

Services to Be Performed. SSARS No. 1 (AR 100.05) requires the accountant to establish an understanding, preferably in writing, with the client when unaudited financial statements of a nonpublic entity are involved. This understanding is usually established through an engagement letter. The understanding should include the following items:

- A description of the nature and limitations of the services.

- A description of the report the accountant expects to render.

- A statement that the engagement cannot be relied on to detect errors, fraud, or illegal acts.

- A statement that the accountant will inform the appropriate level of management of any material errors that come to his or her attention and any fraud or illegal acts that come to his or her attention, unless they are clearly inconsequential.

Knowledge of the Industry and Understanding of the Organization. The accountant should have or obtain knowledge of the accounting principles and practices of estates and trusts and a general understanding of certain matters related to the specific estate or trust. The level of knowledge of the accounting principles and practices of estates and trusts must be sufficient to enable the accountant to compile the financial statements in the appropriate form. The required knowledge of the accounting principles and practices of estates and trusts does not have to be present to accept the engagement. However, the accountant must acquire the knowledge before completing the engagement.

The other prerequisite concerns understanding of the specific estate or trust, rather than estates and trusts in general. Again, the accountant does not have to possess an understanding of the specific estate or trust to accept the engagement. However, the accountant must possess the requisite knowledge of the entity before completing the engagement. The accountant can normally acquire this understanding through observation and inquiry of fiduciary personnel.

SSARS No. 1 (AR 100.09) lists the following specific areas of the entity about which the accountant should have a general understanding:

a. *Nature of the Entity's Business Transactions.* This refers to receipts and distributions of principal and income.

b. *Form of Its Accounting Records.* This means knowledge of books of original entry, as well as all records supporting the books of original entry.

c. *Stated Qualifications of Its Accounting Personnel.* This suggests knowledge of the education, training, and experience of personnel involved in the recordkeeping function. (The word "stated" permits the accountant to rely on representations made by client personnel.)

d. *Accounting Basis on Which the Financial Statements Are to Be Presented.* This refers to GAAP or some other comprehensive basis of accounting, such as the tax basis or cash basis.

e. *Form and Content of the Financial Statements.* This suggests application of knowledge of both the individual estate or trust, estates and trusts in general, applicable state or local laws and regulations, and the governing document so that the statements can be presented in proper form.

Other Accounting Services. SSARS No. 1 (AR 100.09) requires the accountant to consider, on the basis of his or her knowledge of the estate or trust, whether to provide other accounting services such as assistance in journalizing, posting, or adjusting the books. The accountant should not compile financial statements from records that he or she suspects, because of his or her knowledge of the client, to be an inadequate basis for such statements. The accountant should instead provide the accounting services necessary to complete the accounting records.

Actions Necessary When the Information Is Incorrect, Incomplete, or Otherwise Unsatisfactory. Although it is not a requirement, the accountant may have made inquiries or performed other procedures to verify, corroborate, or review information supplied by the client. Based on the results of these inquiries or procedures, previous knowledge, or the financial statements themselves, the accountant may become aware that the information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory for the purpose of compiling financial statements. In such a case, the accountant should obtain additional or revised information. If the client refuses to provide the requested information, the accountant should withdraw from the engagement.

Reading the Compiled Financial Statements. The *reading* of the financial statements that is required by SSARS No. 1 (AR 100.11) stipulates an inspection of the statements after their preparation. The inspection is a review of the final product before release. In many firms, this procedure is performed by requiring a review by the partner signing the statements or a second partner review. The reading should be directed toward identifying material departures from GAAP (including inadequate disclosure) that are observable on the face of the financial statements, given the accountant's knowledge of the specific estate or trust and estates in trusts in general, and mathematical or clerical errors.

Engagement Letters. More firms are requiring an engagement letter on every engagement, including compilation engagements. The understanding of the compilation engagement can be an undocumented oral arrangement with the client; however, a written clarification of the terms of the engagement and the fees helps reduce legal exposure and fee disputes. More importantly, accountants who perform nonattest services for their compilation or review clients are required by ET Interpretation 101-3 (ET 101.05), "Performance of Nonattest Services," to document in writing their understanding with that client of the nature of the nonattest services. Since the Interpretation does not specify how the written understanding is to be documented, specifying the understanding within the engagement letter is acceptable.

Engagement Acceptance. Before a firm accepts an engagement to prepare compiled financial statements, it should carefully consider whether it should be associated with the client or engagement. This decision is normally based on factors such as the following:

a. The client's integrity.

b. The firm's ability to service the client properly.

c. The client's financial strength.

d. The fee arrangements.

e. Independence.

f. The client's potential for growth.

g. Information obtained from predecessor accountants.

An "Engagement Acceptance Form—Estates and Trusts" is designed to assist a firm in making this decision. This form can also be used to evaluate the desirability of continuing to perform an engagement for an existing client, particularly when a situation arises that initially would have caused the firm to reject the client or engagement.

When making client acceptance and continuance decisions, the accountant should consider the engagement acceptance and continuance guidance (at QC 10.27–.28) provided by Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control*. While the AICPA's quality control standards relate to the conduct of a firm's entire accounting practice rather than the conduct of specific engagements, they do provide relevant guidance that may improve engagement performance.

Estates and Trusts Information Form. An "Estates and Trusts Information Form" is designed to document compliance with AR 100.08–.09 regarding the knowledge required for a compilation, and AR 100.26–.30 regarding the level of knowledge necessary for a review engagement. The knowledge required for the latter is somewhat more comprehensive than the former. However, rather than use two separate forms, one form can be designed that meets both requirements, since the time necessary to complete the additional review engagement information is minimal. The form should generally be reviewed annually by the personnel assigned to the client and updated annually for any changes in the client's programs or activities.

Compilation Procedures, Review, and Approval Form. The "Compilation Procedures, Review, and Approval Form—Estates and Trusts" provides documentation of compliance with professional standards and peer review requirements. The form generally should be completed by the professional staff person in charge of the compilation engagement.

Various steps on the form should include expanded discussions or *memory joggers*, highlighting items accountants should consider when completing compilation engagements.

Compilation Procedures, Review, and Approval Form for Management-use-only Financial Statements. The "Compilation Procedures, Review, and Approval Form for Management-use-only Financial Statements—Estates and Trusts" provides documentation of compliance with professional standards related to the compilation of management-use-only financial statements. The form generally should be completed by the professional staff person in charge of the compilation engagement.

Various steps on the form should include expanded discussions or *memory joggers*, highlighting items accountants should consider when completing compilation engagements on management-use-only financial statements.

Compilation Reporting Checklist. This form should be designed to document the reporting considerations required by SSARS and present common reporting requirements for compiled financial statements. It should be emphasized, however, that this checklist cannot be a substitute for an accountant's exercise of professional judgement and knowledge of SSARS.

Routing Instructions for Processing Financial Statements. The "Routing Instructions for Processing Financial Statements—Estates and Trusts" form details the steps normally needed to get the financial statements *out the door*, that is, word processing, proofing, binding, etc. This form is designed for larger firms that must route the work through several departments.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Which of the following items was **not** indicated by the text concerning SSARS No. 1 and the engagement letter for unaudited financials of a nonissuer?

    a. The understanding with the client must be established in writing.

    b. The understanding should indicate the limitations of the services to be provided.

    c. The understanding should include a disclaimer concerning errors, fraud or illegal acts.

    d. The understanding should indicate the CPA's duty to inform management of material errors.

26. According to authoritative literature, the CPA should not prepare a compilation when the accountant has also performed services related to completion of fiduciary accounting records such as journalizing, posting, or adjusting the books.

    a. True.

    b. False.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. Which of the following items was **not** indicated by the text concerning SSARS No. 1 and the engagement letter for unaudited financials of a nonissuer? **(Page 233)**

    a. The understanding with the client must be established in writing. [This answer is correct. SSARS No. 1 requires the accountant to establish an understanding with the client when unaudited financial statements of a non-public entity are involved. A written understanding is preferred, but not required, and is usually accomplished via the engagement letter.]

    b. The understanding should indicate the limitations of the services to be provided. [This answer is incorrect. A description of the nature of services to be provided and an indication of related limitations should be included in the understanding per SSARS No. 1.]

    c. The understanding should include a disclaimer concerning errors, fraud, or illegal acts. [This answer is incorrect. The understanding should include a statement that the engagement cannot be relied upon to detect errors, fraud or illegal acts per SSARS No. 1.]

    d. The understanding should indicate the CPA's duty to inform management of material errors. [This answer is incorrect. According to SSARS No. 1, the understanding should indicate that the CPA will inform the client of any material errors that come to the CPA's attention during the engagement including any fraud or illegal acts.]

26. According to authoritative literature, the CPA should not prepare a compilation when the accountant has also performed services related to completion of fiduciary accounting records such as journalizing, posting, or adjusting the books. **(Page 234)**

    a. True. [This answer is incorrect. The accountant should not prepare a compilation from information that he believes to be incomplete or incorrect. SSARS No. 1 indicates that the accountant should provide the accounting services necessary to complete the accounting records and then he can issue the compilation report.]

    b. False. [This answer is correct. If the accountant has reason to suspect the information being used to prepare the compilation is inadequate, he should provide the accounting services necessary to complete the accounting records, and still issue the compilation report per SSARS No. 1.]

REPORTING ON GAAP FINANCIAL STATEMENTS

When the accountant concludes that the financial statements (i.e., fiduciary accounting presentations) are presented based on GAAP, or the accounting conventions that constitute GAAP in a given industry, the *reporting requirements* are the same as that of any entity that follows GAAP. Of course the report should reflect the proper terminology used for financial statements of an estate or trust.

Compilation Reports

A report on compiled financial statements should state that:

- A compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
- A compilation is limited to presenting in the form of financial statements information that is the representation of the trustee or executor.
- The financial statements have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.

Addressee. Reports should be addressed to the client, who generally is the executor or trustee.

References to Financial Statements. Financial statement titles should reflect the type of fiduciary entity reported on and the type of financial statements presented. Estate and trust financial statements may be accompanied by additional supporting schedules. If the accountant elects to view related schedules as supplementary financial information, the report should be modified as discussed later in this lesson.

The financial statements should have all notes necessary for a fair presentation in conformity with GAAP.

Additional Procedures. Any other procedures that the accountant might have performed before or during the compilation engagements should not be described in the report. This might lead the reader of the financial statements to conclude that the accountant is, in fact, offering some form of assurance.

Dating the Report. The date of completion of the compilation should be used as the date of the accountant's report.

Reference to the Compilation Report. Each page of the financial statements and supporting schedules compiled by the accountant should include a reference to the report such as "See Accountant's Compilation Report."

Illustration. The following is an example of a report on the compilation of the financial statements of an estate.

> To John M. Davidson, Executor[a]
>
> Estate of David C. Connon, Deceased
>
> We have compiled the accompanying summary of account[b] of the Estate of David C. Connon, Deceased, and the related schedules on pages ______ to ______ as of July 15, 20X1 and for the period December 10, 20X0, to July 15, 20X1, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of the executor.[c] We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.
>
> [Firm's Signature] [d]
>
> August 5, 20X1

Notes:

[a] In a report on a trust, the report should be addressed to the trustee. In addition, the first paragraph should refer to the name of the trust.

[b] In this example, the financial statements take the form of a summary of account. If a more traditional presentation format were used (e.g., balance sheet, statement of earnings, statement of assets and liabilities), the report should refer to the statements actually presented.

[c] Although the term "executor" is used in this example, in some jurisdictions the individual might have a different title, such as "administrator" or "personal representative." For a trust, the report should refer to the trustee.

[d] The accounting firm's signature or the accountant's signature is required. The signature may be manual, stamped, electronic, or typed.

Review Reports

A review report should state that:

a. A review was performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

b. All information included in the financial statements is the representation of the trustee or executor of the fiduciary entity.

c. A review consists principally of inquiries of the fiduciary and other personnel involved with managing the trust or estate and analytical procedures applied to financial data.

d. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements taken as a whole and, accordingly, no such opinion is expressed.

e. The accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, other than those modifications, if any, indicated in the review report.

Addressee. Reports should be addressed to the client, which is generally the executor or trustee.

References to Financial Statements. Financial statement titles should reflect the type of fiduciary entity reported on and the financial statements presented. Estate and trust financial statements may be accompanied by additional supporting schedules. If the accountant elects to view related schedules as supplementary financial information, the report should be modified as discussed later.

The financial statements should have all notes necessary for a fair presentation in conformity with GAAP. If notes are not complete, the report should be modified as discussed later.

Additional Procedures. Any other procedures that the accountant might have performed before or during the review engagement, including those applied in connection with a compilation of the statements, should not be described in his report.

Dating the Report. The date of completion of the review procedures performed should be used as the date of the accountant's report.

Reference to the Review Report. Each page of the financial statements reviewed by the accountant should include a reference to the report such as "See Accountant's Review Report."

Illustration. The following is an example of a report on the review of the financial statements of an estate.

To John M. Davidson, Executor[a]

Estate of David C. Connon, Deceased

We have reviewed the accompanying summary of account[b] of the Estate of David C. Connon, Deceased, and the related schedules on pages _______ to _______ as of July 15, 20X1, and for the period December 10, 20X0 to July 15, 20X1, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the executor.

A review consists principally of inquiries of the executor[c] and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

[Firm's Signature] [d]

August 5, 20X1

Notes:

[a] In a report on a trust, the report should be addressed to the trustee. In addition, the first paragraph should refer to the name of the trust.

[b] In this example, the financial statements take the form of a summary of account. If a more traditional presentation format were used (e.g., balance sheet, statement of earnings, statement of assets and liabilities, etc.), the report should refer to the statements actually presented.

[c] Although the term "executor" is used in this example, in some jurisdictions the individual might have a different title, such as "administrator" or "personal representative." For a trust, the report should refer to the trustee

[d] The accounting firm's signature or the accountant's signature is required. The signature may be manual, stamped, electronic, or typed.

Audit Reports

The auditor's standard report on audited financial statements identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. SAS No. 58 (AU 508), *Reports on Audited Financial Statements*, lists the following basic elements of the standard report:

a. A title that includes the word *independent*.

b. A statement that the financial statements identified in the report were audited. Each financial statement audited should be specifically identified.

c. A statement that the financial statements are the responsibility of the trustee or executor and that the auditor's responsibility is to express an opinion on the financial statements based on the audit. This statement should be included even if the document containing the auditor's report includes a statement by the trustee or executor regarding his responsibility for the presentation of the financial statements.

d. A statement that the audit was conducted in accordance with generally accepted auditing standards (GAAS) and an identification of the United States of America as the country of origin of those standards.

e. A statement that GAAS requires that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

f. A statement that an audit includes the following:

    (1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

    (2) Assessing the accounting principles used and significant estimates made by the trustee or executor.

    (3) Evaluating the overall financial statement presentation.

g. A statement that the auditor believes the audit provides a reasonable basis for the opinion.

h. An opinion as to whether the financial statements present fairly, in all material respects, the accounting of the estate or trust as of the financial statement date and its activity for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles.

i. The manual or printed signature of the auditor's firm.

j. The date of the audit report.

Addressee. The auditor's report should be addressed to the client, which is generally the executor or trustee.

References to Financial Statements. Financial statement titles should reflect the type of fiduciary entity reported on and the financial statements presented. Estate and trust financial statements are frequently accompanied by additional supporting schedules. If the accountant elects to view related schedules as supplementary financial information, the report should be modified as discussed later.

The financial statements should have all notes necessary for a fair presentation in conformity with GAAP. If the notes are not complete, the report should be modified as discussed later.

Dating the Report. The audit report date represents the date that the auditors have obtained sufficient appropriate audit evidence to support the opinion on the financial statements. Among other things, such evidence includes evidence that:

a. The audit work has been reviewed.

b. The financial statements, including disclosures, have been prepared.

c. Management has taken responsibility for the financial statements.

The auditor cannot simply use the date that the audit team left the field unless he or she has sufficient appropriate audit evidence at that date.

Illustration. The following is an example of the auditor's standard report on the financial statements of an estate.

INDEPENDENT AUDITOR'S REPORT

To John M. Davidson, Executor[a]

Estate of David C. Connon, Deceased

We have audited the accompanying summary of account[b] of the Estate of David C. Connon, Deceased, as of December 31, 20X1, and the related schedules on pages _____ to _____ as of December 31, 20X1 and for the year then ended. These financial statements are the responsibility of the executor.[c] Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the executor, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the summary account and related schedules referred to above present fairly, in all material respects, the assets, liabilities,[d] and estate equity of the estate of David C. Connon as of December 31, 20X1, and the receipts, disbursements and distributions, and the estate equity transactions and adjustments for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Firm's Signature]

January 31, 20X2

Notes:

[a] In a report on a trust, the report should be addressed to the trustee. In addition, the first paragraph should refer to the name of the trust.

[b] In this example, the financial statements take the form of a summary of account. If a more traditional presentation format were used (e.g., balance sheet, statement of earnings, statement of assets and liabilities, etc.), the report should refer to the statements actually presented.

[c] Although the term "executor" is used in this example, in some jurisdictions the individual might have a different title, such as "administrator" or "personal representative." For a trust, the report should refer to the trustee. The report should use the title appropriate in the circumstances.

[d] The reference to liabilities assumes that liabilities are presented in the financial statements. As discussed previously, many fiduciary financial statements, especially those presented in a summary of account format, do not include liabilities. For a traditional financial statement format, the opinion paragraph would refer to "the assets, liabilities, and estate equity of [Name of Fiduciary Entity] as of [Date] , and its revenues and expenses and changes in estate equity. . ."

The audit report date represents the date that the auditors have obtained sufficient appropriate audit evidence to support the opinion on the financial statements.

The auditor cannot simply use the date that the audit team left the field unless he or she has sufficient appropriate audit evidence at that date.

GAAP Departures

In most engagements, the accountant should not encounter GAAP departures. However, in certain interim engagements, the executor/trustee may not desire to present an item strictly in conformity with GAAP. An example might be the failure to reflect both the current values determined at the date an estate was originally created and the current values at the interim statement date. (The fiduciary may believe it is not prudent for the fiduciary entity to incur the cost of obtaining new appraisals at the interim date.) Another departure at the interim date might be the fiduciary's wish not to attempt to distinguish between principal and income receipts and disbursements. Although these examples are based on accounting conventions unique to trust and estates, many practitioners believe that the nature of these items is GAAP for such entities. Regardless, whenever there is a material GAAP departure, the accountant's report should be modified accordingly.

Measurement Departures. Measurement departures result from use of inappropriate accounting principles, incorrect application of accounting principles, or unreasonable accounting estimates.

Compilation or Review. If, in the course of performing a compilation or review engagement, the accountant becomes aware of material *measurement* departures from GAAP, he has three possible courses of action:

a. persuade the client to revise the statements to conform with GAAP,

b. refer to the departure in the report, or

c. withdraw from the engagement.

Revision of the statements is the preferred course of action. If revision is not feasible, reporting the departure in the accountant's report is appropriate unless the practitioner concludes that the fiduciary's intention is to mislead the reader. If modification of the report to disclose the departure is not adequate and the client refuses to revise the statements, the accountant should withdraw from the engagement and consider consulting legal counsel.

If modification of the accountant's report is appropriate, the nature of the departure from GAAP should be disclosed in a separate paragraph, and the effects (including the dollar amount) of the departure should be disclosed, if known. If the effects are not known, the accountant is not required to determine them, but the compilation or review report should state that the effects of the departure have not been determined. However, when the GAAP departure is believed to be significant, an explanatory report paragraph in addition to the separate paragraph may be necessary as discussed shortly.

In a *compilation report*, the second paragraph should be modified to indicate that the accountant became aware of a material GAAP departure. The departure should be described in a separate additional paragraph. The following is an example of the modified second paragraph and additional explanatory paragraph of a compilation report modified for a GAAP departure. It assumes that the governing document or state law requires the financial statements distinguish between principal and income transactions.

> (Standard first paragraph)
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of the executor. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, we did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.
>
> As disclosed in Note X, the financial statements do not distinguish between transactions applicable to principal and those applicable to interest. Generally accepted accounting principles require that activity be categorized as affecting either principal or interest amounts. The effect of this departure from generally accepted accounting principles on the summary of account has not been determined.

In a *review report*, the third paragraph should be modified to indicate that the accountant became aware of a material GAAP departure. The conclusion should state that except for the departure, nothing came to the accountant's attention to indicate the financial statements do not conform to GAAP. The departure should be described in a separate additional paragraph. The following is an example of the modified third paragraph and additional explanatory paragraph of a review report modified for a GAAP departure where the impact of the departure has been determined.

> (Standard introductory and scope paragraphs)
>
> Based on our review, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.
>
> As disclosed in Note X, the estate's assets include a $15,000 receivable from Amanda Dawn, a beneficiary of the estate. The executor has informed us the receivable is not evidenced by a signed promissory note or any other documentation and that collection of the receivable may not be enforceable. A valuation allowance for uncollectible receivables has not been provided by the Trustee. Generally accepted accounting principles require that a valuation allowance be provided for receivables that probably will not be collected.

This example assumes that the accounting principles considered to be GAAP allow receivables to be reported. Receivables are generally not reported for fiduciary entities since transactions are often recorded on a cash basis.

Interpretation No. 7 of SSARS No. 1, "Reporting When There Are Significant Departures From GAAP," (AR 9100.23–.26) indicates that an accountant *cannot* issue an adverse opinion in a compilation or review engagement. An adverse opinion can only be expressed in an audit engagement. The interpretation says that the accountant may wish to emphasize the limitations of financial statements having significant GAAP departures (whether measurement or disclosure) in a separate explanatory paragraph in the report. The explanatory paragraph is in addition to the separate paragraph that describes the departure discussed earlier. In deciding whether to include an explanatory paragraph, the accountant should consider:

a. the possible dollar magnitude of the effects of the departures,

b. the significance of the affected items to the fiduciary entity,

c. the pervasiveness and overall impact of the misstatement, and

d. whether disclosure has been made of the effects of the departure.

The separate explanatory paragraph, which generally would be presented as the last paragraph of a compilation or review report, might read as follows:

> Because the significance and pervasiveness of the matters discussed above make it difficult to assess their impact on the financial statements taken as a whole, users of these financial statements should recognize that they might reach different conclusions about the estate's summary of account and related schedules if they had access to revised financial statements prepared in conformity with generally accepted accounting principles.

In a more traditional financial statement presentation, reference to related schedules will generally be to "the [Estate/Trust] 's financial position, results of [Estate/Trust] activities, and the cash flows."

The explanatory paragraph shown above is optional and should only be used in rare situations when a departure, individually or when viewed with other departures, becomes so pervasive that the financial statements lose their ability to communicate to the user. The failure to determine the dollar impact of a departure may or may not cause such a pervasive impact on the financial statements and, accordingly, would not automatically call for the use of the optional paragraph.

Audit. If the financial statements are materially affected by a departure from GAAP, the auditor should express either a qualified or adverse opinion, depending on the significance of the matter, its pervasiveness, and the effect of the misstatement on the financial statements taken as a whole. A disclaimer of opinion is not an appropriate form of report modification for a GAAP departure.

A report with an opinion qualified because of a GAAP departure differs from the standard report as follows:

- An explanatory paragraph inserted between the scope and opinion paragraphs describes all of the substantive reasons for the qualification. The magnitude of the effects on the financial statements should be disclosed, if practicable. If the effects are not reasonably determinable, the report should so state.

- The opinion paragraph refers to the explanatory paragraph and states that "except for the effects of" (or "with the exception of") the departure, the financial statements conform with GAAP. Other terms, such as "with the foregoing explanation" or "fairly stated when read in conjunction with Note X" should not be used.

The following illustrates the explanatory and opinion paragraphs of a qualified report:

> (Standard introductory and scope paragraphs)
>
> As disclosed in Note X, the real estate assets are recorded at original acquisition cost. Generally accepted accounting principles require that assets be reported at market value as of the date of the decedent's death. The effect of this departure from generally accepted accounting principles on the summary of account has not been determined.
>
> In our opinion, except for the effects of reporting the real estate assets at original cost, as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the accounting of the Estate of David C. Connon as of December 31, 20X1, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

An adverse opinion because of a GAAP departure differs from the standard report as follows:

- An explanatory paragraph inserted between the scope and opinion paragraphs describes all of the substantive reasons for the adverse opinion. The magnitude of the effects on the financial statements should be disclosed, if practicable. If the effects are not reasonably determinable, the report should so state.

- The opinion paragraph refers to the explanatory paragraph and states that the financial statements do not conform to GAAP.

If there has been a change in accounting principles or the method of their application that affects consistency and the change has a material effect on the comparability of financial statements, the auditor should refer to the change in a separate explanatory paragraph in the report. The explanatory paragraph, which should follow the opinion paragraph, does not affect the opinion. The following is an example of an explanatory paragraph:

> As discussed in Note X to the financial statements, the Trust changed its method of allocating amounts between principal and interest in 20X2.

Lack of Disclosure. If required disclosures are omitted, the report should be modified as for measurement departures. The accountant should include in the report all of the omitted disclosures or, if the details to be disclosed have not been determined, the specific nature of the omitted disclosures.

SSARS No. 1 provides a special form of report when the client elects to omit substantially all disclosures in a *compilation* engagement. Interpretation No. 22 of SSARS No. 1, "Use of 'Selected Information—Substantially All Disclosures Required By Generally Accepted Accounting Principles Are Not Included,'" (AR 9100.85–.88) helps to define what constitutes *substantially all* by noting that when the financial statements include more than a few disclosures, substantially all disclosures required by generally accepted accounting principles have *not* been omitted. Therefore, if the notes include *more than a few* disclosures, the accountant would need to treat each omitted disclosure as a departure from GAAP. This form of report may be used only in a compilation and only when the accountant has no reason to believe that the disclosures were omitted in an attempt to mislead potential users of the financial statements.

The following paragraph is added to the end of the compilation report when substantially all disclosures have been omitted.

> The trustee has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Trust's financial position, results of trust activities, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

As a practical matter, this reporting alternative is not encouraged because the accounting conventions for estates or trusts are not widely known by the public. Also, certain GAAP accounting conventions can be specific to each entity, depending on the requirements of the governing instrument. Whenever possible, the accountant should recommend that the financial statements include the following note disclosures:

a. A summary of significant accounting principles that explains the GAAP accounting conventions used and any peculiar accounting required by the governing instrument (or state law).

b. A disclosure of significant transactions that do not affect the amount (or assets) for which the fiduciary is accountable. For example, disclosure is encouraged in a note (or parenthetically on the face of the statement) of any debt that is secured by a deed of trust on assets of the estate or trust.

c. A description of the methods used to determine the current values.

d. A disclosure of major subsequent events. For example, a major decline in the current values of an asset (like common stock) that occurred between the financial statement date and the date that the SSARS report is issued should be disclosed.

Departure to Prevent the Financial Statements from Being Misleading. Rule 203 of the AICPA Code of Professional Conduct addresses a rare situation in which accountants are associated with financial statements that contain a departure from GAAP because compliance with GAAP would result in misleading financial statements. Rule 203 states that:

> If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

SAS No. 58 (AU 508), *Reports on Audited Financial Statements*, contains guidance for applying this rule. Interpretation No. 19 of SSARS No. 1, "Reporting When Financial Statements Contain a Departure From Promulgated Accounting Principles That Prevents the Financial Statements From Being Misleading," (AR 9100.73–.75) states that, when the circumstances contemplated by Rule 203 are present in a review engagement, the practitioner should include a separate paragraph in the review report that contains the information required by the rule. However, Rule 203 does not apply to compilation engagements. Interpretation No. 19 states that when confronted with this situation in a compilation engagement, practitioners should treat the item as a departure from GAAP and report accordingly.

Scope Limitations

Compilation. If the accountant is precluded from applying all the procedures considered necessary in a compilation, he cannot issue a compilation report or submit the financial statements. Instead, the accountant should withdraw from the engagement. When considering whether a report can be issued, the accountant should determine if the scope restriction is client-imposed. SSARS No. 1 (AR 100.10) requires that the accountant withdraw from the engagement if the client refuses to provide additional or revised information. A scope restriction resulting from inadequate accounting records should normally be considered a client-imposed scope restriction.

An accountant may be engaged to compile only a single financial statement, such as a statement of trust or estate assets, and not the related financial statements, such as the activity since the previous statement. In that case, he may issue a standard compilation report on the single statement.

Review. When an accountant is prevented from applying all of the inquiry and analytical procedures he considers necessary, including obtaining the required representation letter, there is a scope limitation. In that case he cannot issue a review report and should ordinarily withdraw from the engagement.

In some cases, the accountant can issue a compilation report after considering whether the information affected by the scope limitation might be incorrect, incomplete, or otherwise unsatisfactory. However, if the scope limitation arises because of the client's refusal to provide a representation letter, it is ordinarily inappropriate to step down to a compilation.

An engagement to review one financial statement, but not the related statements, (for example a review of a statement of trust assets but not of the statement of earnings) is not a scope limitation, but rather a limited-reporting engagement. The accountant can issue a review report on the single statement as long as the scope of the inquiry and analytical procedures has not been restricted. However, if the accountant submits the related statements or they are included in the package containing the review report, he should compile them.

Audit. A scope limitation results in either a qualified opinion or a disclaimer of opinion, depending on the circumstances. A disclaimer is generally issued in either of the following circumstances:

- The potential effect on the financial statements of the evidence the auditor was unable to obtain is large or pervasive.
- The scope limitation is caused by a client-imposed restriction.

Opinion Qualified for a Scope Limitation. An opinion qualified for a scope limitation differs from the standard report as follows:

- The scope (second) paragraph begins, "Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America."
- An explanatory paragraph, placed between the scope and opinion paragraphs, describes the scope limitation. The paragraph should describe all of the substantive reasons for the qualification.
- The opinion paragraph refers to the explanatory paragraph and the possible effects on the financial statements. The qualification should be phrased, "In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to . . . ." The qualification should be based on the possible effects of the scope restriction, not the restriction itself.

Disclaimer. When the scope limitation causes the auditor to disclaim an opinion, the resulting report differs from the standard report as follows:

- The introductory (first) paragraph states that "We were engaged to audit . . ." rather than "We have audited. . .
- The last sentence of the introductory paragraph, "Our responsibility is to express an opinion on these financial statements based on our audit," is omitted.
- The scope (second) paragraph of the report is omitted entirely.
- An explanatory paragraph, placed between the introductory and opinion paragraphs, describes the scope limitation. The paragraph should describe all of the substantive reasons for the disclaimer.
- The opinion paragraph disclaims an opinion.

An accountant may be engaged to audit only a single financial statement, such as a statement of trust or estate assets, and not the related financial statements, such as the activity since the previous statement. The accountant can issue an audit report on the single statement provided the scope of his audit procedures has not been restricted. The introductory (first) paragraph would refer only to the statements presented.

If more than one basic financial statement is presented, but only one is audited, the auditor is still associated with the other two. Accordingly, the auditor should report on them as well by issuing a disclaimer of opinion.

Going Concern Issues

Audit. In an audit, the auditor is generally required to add an explanatory paragraph to the audit report if there is substantial doubt about whether the entity will continue in existence for a reasonable period of time after the date of the financial statements. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, provides guidance for evaluating going concern uncertainties and for reporting when an entity's ability to continue in existence is in question.

Compilation and Review. Accountants are not required to add an explanatory paragraph for going concern matters to their compilation or review report. However, SSARS No. 1 (AR 100.54), and Interpretation 29 of SSARS No. 1 (AR 9100.120–.129), "Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern," note that an emphasis paragraph may be added when a going concern uncertainty exists. This is especially relevant in cases where a going concern uncertainty exists and the accountant believes the matter has not been adequately disclosed in the financial statements. In those cases, SSARS No. 1 (AR 100.56) requires an accountant to consider modification of the standard compilation or review report when he or she becomes aware of a material departure from GAAP (which includes adequate disclosure). Interpretation No. 29 of SSARS No. 1 discusses reporting on an uncertainty about an entity's ability to continue as a going concern. It states that, although permitted, accountants are not required to add an explanatory paragraph to the standard compilation or review reports for going-concern matters provided that financial statement disclosure is adequate. (Disclosure requirements with respect to uncertainties are included in FASB ASC 275-10-50 (formerly Statement of Position 94-6, *Disclosure of Certain Risks and Uncertainties*) and FASB ASC 450-20-25-2 (formerly SFAS No. 5, *Accounting for Contingencies*) and other authoritative literature. Exhibit B to the SSARS provides specific guidance on disclosure of uncertainties caused by concern about an entity's ability to continue as a going concern.) As discussed previously, however, the authors believe an emphasis paragraph may be added when a going-concern uncertainty exists, although disclosure in a note is sufficient. (See also TIS 9150.14.) Accountants should modify their reports due to a GAAP departure if going-concern matters are not adequately disclosed in the financial statements.

Relevance to Fiduciary Entities. Most for-profit and nonprofit business entities are organized under the assumption that they will continue in existence indefinitely. However, fiduciary entities are generally intended to exist for only a limited period of time. Estates, in particular, have a short duration. Subject to several exceptions, the IRS presumes that an estate's administration has been "unduly prolonged" if the estate remains open more than two years after the decedent's death. As with an estate, the winding up of a trust cannot be unduly prolonged. However, trusts may have a long-term existence before termination.

Because of the nature of fiduciary entities and the purpose of fiduciary accounting, the going concern guidance in the literature is generally not applicable to fiduciary entities. This is consistent with the nature of fiduciary entities, which exist to liquidate the assets of a decedent and/or to invest assets in order to provide for stated beneficiaries over a specified period of time followed by the ultimate distribution of the assets. One of the primary purposes of fiduciary accounting is to provide an accounting of the assets for which the fiduciary is responsible. This accounting is generally provided for the courts, beneficiaries, taxing authorities, and other interested parties. All of these parties should already have an understanding of the nature of the estate or trust and reporting on the fiduciary entity's ability to continue as a going concern would not be meaningful.

Independence

Accountants may compile financial statements for a client without being independent of the client. However, to provide audit or review services the accountant must be independent of the estate or trust. Exhibit 2-4 presents relevant AICPA ethics rulings regarding independence.

Exhibit 2-4

Ethics Rulings Related to Service as an Executor or Trustee

<u>Member as Executor or Trustee</u>

.021Question—A member has been designated to serve as an executor or trustee of the estate of an individual who owns the majority of the stock of a corporation. Would the independence of the member be considered to be impaired with respect to the corporation?

.022Answer—The mere designation of a member to become executor or trustee would not be considered to impair the independence of the member. Actual service would be considered to impair the member's independence.

<u>Member as Trustee</u>

.023Question—A charitable foundation is the sole beneficiary of the estate of the foundation's deceased organizer. If a member becomes a trustee of the foundation, would the independence of the member be considered to be impaired with respect to (1) the foundation or (2) the estate?

.024Answer—If a member served as trustee of the foundation, independence of the member would be considered to be impaired with respect to both the foundation and the estate.

(ET 191.021–.024)

* * *

An accountant acting as an executor or trustee, for example, is not independent and may not provide audit or review services on the financial statements of the estate or trust. However, the accountant may provide a compilation service if the following sentence is added to the compilation report:

We are not independent with respect to <u>[Name of Estate or Trust]</u>

The reason for the lack of independence should not be described.

The accountant who lacks independence because he is an executor, trustee, or employee of the estate or trust may, alternatively, provide the communication described later in this lesson when submitting the financial statements.

REPORTING ON OCBOA FINANCIAL STATEMENTS

Other comprehensive bases of accounting that might be used in estate and trust financial statements include:

- Cash and modified cash basis.
- Income tax basis.

Cash and Modified Cash Basis

The cash basis and modifications of the cash basis having substantial support are considered other comprehensive bases of accounting and many state statutes include language implying that fiduciary financial presentations should be prepared on a cash or modified cash basis of accounting. State statutes often constitute substantial support for modifying the cash basis of accounting. Use of such bases does not affect (a) accountant's responsibility to report, (b) the requirements to modify the report for material departures from measurement or disclosure principles underlying the bases, or (c) the requirement to modify the report or withdraw if there is a scope limitation. The principal effect of the use of the cash or modified cash basis is on the form of the report.

Compilation. A compilation report on financial statements that use the cash or modified cash basis of accounting should be revised to appropriately identify the statements presented, since the titles of such statements are different from those used for GAAP financial statements.

For example, the following is a compilation report on financial statements prepared using the modified cash basis, where the basis of accounting is disclosed in the financial statements:

> We have compiled the accompanying statement of assets, liabilities,[a] and trust equity—modified cash basis of [Legal Name of Trust] as of December 31, 20X1, and the related statement of revenues received and expenses paid for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of the trustee. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.
>
> **Note:**
>
> [a] The reference to liabilities assumes that liabilities are presented in the financial statements.

If the financial statements do not indicate the basis of accounting, the following sentence should be added to the introductory paragraph:

> The financial statements have been prepared on the modified cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

If the financial statements omit substantially all disclosures and do not disclose the basis of accounting used, the compilation report should state the basis of accounting. For example, in addition to adding the sentence just discussed to the introductory paragraph, the following paragraph might be added:

> The trustee has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the cash basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Trust's assets, liabilities[a], trust equity, revenues received, and expenses paid. Accordingly, these financial statements are not designed for those who are not informed about such matters.
>
> **Note:**
>
> [a] The reference to liabilities assumes that liabilities are presented in the financial statements.

Review. A review report on financial statements that use the cash or modified cash basis of accounting should be revised to appropriately identify the statements presented, since the titles of such statements are different from those used for GAAP financial statements.

For example, the following is a review report on financial statements prepared using the modified cash basis:

> We have reviewed the accompanying statement of assets, liabilities,[a] and trust equity—modified cash basis of [Legal Name of Trust] as of December 31, 20X1, and the related statement of revenues received and expenses paid for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the trustee of [Legal Name of Trust].
>
> A review consists principally of inquiries of the trustee and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the modified cash basis of accounting, as described in Note X.

Note:

[a] The reference to liabilities assumes that liabilities are presented in the financial statements.

Audit. An audit report on cash basis or modified cash-basis financial statements differs from the standard audit report in that it includes a paragraph that:

- States the basis of presentation and refers to the note to the financial statements that describes the basis, and

- States that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.

In addition, the opinion refers to the basis of accounting used rather than GAAP.

The following is an example of an audit report on modified cash basis financial statements:

> We have audited the accompanying statement of assets, liabilities, and trust equity-modified cash basis of [Legal Name of Trust] as of December 31, 20X1, and the related statement of revenues received and expenses paid for the year then ended. These financial statements are the responsibility of the trustee. Our responsibility is to express an opinion on these financial statements based on our audit.
>
> We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the trustee, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
>
> As described in Note X, these financial statements were prepared on the modified cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.
>
> In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and trust equity of the Trust as of December 31, 20X1, and its revenue collected, expenses paid, and changes in trust equity for the year then ended, on the basis of accounting described in Note X.

Income Tax Basis

The basis of accounting used to file the estate's or trust's income tax return is considered an other comprehensive basis of accounting. Use of this basis does not affect (a) the accountant's responsibility to report, (b) the requirements to modify the report for material departures from measurement or disclosure principles underlying the basis, or (c) the requirement to modify the report or withdraw if there is a scope limitation. The principal effect of the use of the tax basis is on the form of the report.

The form of accountant's report to be used for tax basis financial statements should be essentially the same as for cash basis statements, except that the name of the financial statements should clarify that the tax basis was used.

Regulatory Basis of Accounting

The regulatory basis is "a basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a government regulatory agency to whose jurisdiction the entity is subject." While some accountants might consider a basis of accounting specified by the state or court to be a regulatory basis, presentations prepared on an "agreed-upon basis" or a contractual basis do not meet SAS No. 62's definition of the regulatory basis and should not be treated as regulatory basis records or financial presentations. Reporting on a basis specified in an agreement and prescribed forms are discussed below.

REPORTING ON FINANCIAL STATEMENTS PREPARED ON A BASIS SPECIFIED IN AN AGREEMENT

When an agreement specifies a basis of accounting that is not considered to be GAAP or an OCBOA, the accountant can still compile, review, or audit the financial statements by following the guidance in the following paragraphs. As a practical matter, the basis of accounting specified in the governing document is deemed to be the basis specified in an agreement.

Previous discussion includes the measurement, presentation, and disclosure issues for financial statements prepared on a basis specified in an agreement. This section discusses the effects of such basis on the accountant's report.

Compilation or Review

Estate and trust financial statements often are prepared in compliance with the governing document (i.e., will or trust instrument) or the requirements of a court. Such statements might take the form of a financial presentation that does not result in a presentation in conformity with GAAP or an other comprehensive basis of accounting. Or, the presentation might be incomplete but is otherwise prepared in conformity with GAAP or an other comprehensive basis of accounting.

Use of such bases does not affect (a) the accountant's responsibility to report, (b) the requirements to modify the report for material departures from measurement or disclosure principles underlying the bases, or (c) the requirement to modify the report or withdraw if there is a scope limitation. The principal effect of the use of such a basis is on the form of the report.

Basis Specified in Will or Trust Documents Not in Conformity with GAAP or OCBOA. A basis of accounting specified only in a governing document is not an OCBOA because the criteria used to prepare the financial statements do not have the substantial support required by SAS No. 62 (AU 623) and SSARS No. 1 (AR 100.04). Interpretation No. 28 of SSARS No. 1, "Special-Purpose Financial Statements to Comply with Contractual Agreements or Regulatory Provision" (AR 9100.115–.119) allows an accountant to compile or review special-purpose financial statements prepared in conformity with a governing document that does not conform to GAAP or OCBOA. In these cases, the accountant's report should be expanded to include the following two explanatory paragraphs.

- The first additional paragraph should:
    - Explain what the presentation is intended to present, refer to a note to the financial statements that describes the basis of presentation, and explain that the presentation is not intended to be a presentation in conformity with GAAP or an OCBOA. In a compilation engagement in which the entity chooses to omit substantially all of the disclosures and does not disclose in the financial statements the basis of presentation, the accountant should disclose the basis in the compilation report.
    - Describe any significant interpretations made about the governing document by the executor or trustee.
- The second additional paragraph should state that the distribution of the report is restricted to those within the entity, to parties to the governing document or agreement, or to those with whom the entity is negotiating directly. Restricted use reports in compilation and review engagements are discussed later.

The following is an example of a compilation report on financial statements prepared on a basis specified in an agreement:

> We have compiled the special-purpose statement of assets and liabilities of [Name of Fiduciary Entity] as of December 31, 20X1 and the related special-purpose statements of revenues and expenses and of cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of the trustee. We have not audited or reviewed the accompanying special-purpose financial statements and, accordingly, do not express an opinion or any form of assurance on them.
>
> The accompanying special-purpose financial statements were prepared for the purpose of complying with the [Name of Governing Document] described in Note A, and are not intended to be a presentation in conformity with generally accepted accounting principles.
>
> This report is intended solely for the information and use of the trustee and [Other Specified Parties] and is not intended to be and should not be used by anyone other than these specified parties.

The following is an example of a review report on financial statements prepared on a basis specified in an agreement:

> We have reviewed the accompanying special-purpose statement of assets and liabilities of [Name of Fiduciary Entity] as of December 31, 20X1, and the related special-purpose statements of revenues and expenses and of cash flows for the year then ended in accordance with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the trustee.
>
> A review consists principally of inquiries of the trustee and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.
>
> The accompanying special-purpose financial statements were prepared for the purpose of complying with [Name of Governing Document] as discussed in Note A, and are not intended to be a presentation in conformity with generally accepted accounting principles.
>
> Based on our review, we are not aware of any material modifications that should be made to the accompanying special-purpose financial statements in order for them to be in conformity with the basis of accounting described in Note A.
>
> This report is intended solely for the information and use of the trustee and [Other Specified Parties] and is not intended to be and should not be used by anyone other than these specified parties.

Incomplete Presentation, but Otherwise in Conformity with GAAP or OCBOA. An accountant may be engaged to compile or review a special-purpose financial presentation that does not constitute a complete presentation of the entity's assets, liabilities, revenues, and expenses [as defined in SSARS No. 1 (AR 100.04)], but is otherwise prepared in conformity with GAAP or an OCBOA. In those circumstances, practitioners should follow the reporting guidance provided by Interpretation No. 28 of SSARS No. 1 (AR 9100.111–.114).

The compilation or review report should include two additional paragraphs:

a. The first additional paragraph should:

   (1) Explain what the presentation is intended to present and reference a note to the financial statements that describes the basis of accounting. In a compilation engagement in which the entity chooses to

omit substantially all of the disclosures and does not disclose in the financial statements the basis of presentation, the accountant should disclose the basis in the compilation report.

(2) Indicate that the presentation is not intended to be a complete presentation of the fiduciary entity's assets, liabilities, revenues, and expenses.

b. The second additional paragraph should:

(1) State that the distribution of the report is restricted to those within the entity, to parties to the contract or agreement (governing document), for filing with a regulatory agency (or court), or to those with whom the entity is negotiating directly. Restricted use reports in compilation and review engagements are discussed later.

(2) If the report is filed with regulatory agencies and is a matter of public record, state that the restriction is not intended to limit the distribution of the report, which is a matter of public record.

The following is an example of a compilation report on financial statements prepared on a basis specified in an agreement:

> We have compiled the accompanying Third Accounting of the Personal Representative of the Estate of John Jones, Deceased, as of December 31, 20X1, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of the personal representative. We have not audited or reviewed the accompanying statement and, accordingly do not express an opinion or any form of assurance on it.
>
> The accompanying statement was prepared to present the transactions of the Estate pursuant to the provisions of the Will of John Jones described in Note A, and is not intended to be a complete presentation of the Estate's assets.
>
> This report is intended solely for the information and use of the personal representative and [Other Specified Parties] and is not intended to be and should not be used by anyone other than these specified parties.

The following is an example of a review report on financial statements prepared on a basis specified in an agreement:

> We have reviewed the accompanying Third Accounting of the Personal Representative of the Estate of John Jones, Deceased, as of December 31, 20X1, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information in this statement is the representation of the personal representative.
>
> A review consists principally of inquiries of the personal representative and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the statement taken as a whole. Accordingly, we do not express such an opinion.
>
> The accompanying statement was prepared to present the transactions of the Estate pursuant to the provisions of the Will of John Jones described in Note A, and is not intended to be a complete presentation of the Estate's assets.
>
> Based on our review, we are not aware of any material modifications that should be made to the accompanying Third Accounting of the Personal Representative of the Estate of John Jones, Deceased, in order for it to be in conformity with the basis of accounting described in Note A.

> This report is intended solely for the information and use of the personal representative and [Other Specified Parties] and is not intended to be and should not be used by anyone other than these specified parties.

The compiled or reviewed financial statements should—

a. Include disclosure of the basis of presentation, as required by SSARS No. 1.

b. Differ from a complete set of GAAP (or OCBOA) financial statements only to the extent necessary to meet the special purpose for which they are prepared.

c. Contain similar informative disclosures when the presentation contains items that are the same as, or similar to, those contained in a complete set of financial statements.

d. Be titled to avoid any implication that the special-purpose financial statements are intended to present financial position, results of trust or estate activities, or cash flows.

Audit

Similar to compilation and review engagements, in audit engagements, the basis specified in the governing document may (a) not be in conformity with GAAP or an OCBOA, or (b) be incomplete but otherwise in conformity with GAAP or an OCBOA.

Basis Specified in Will or Trust Instrument Not in Conformity with GAAP or an OCBOA. A basis of accounting that is not in conformity with GAAP might be specified in a will or trust instrument. Such a basis is not an OCBOA because the criteria used to prepare such financial statements do not have substantial support, as required by SAS No. 62, *Special Reports* (AU 623). Nonetheless, the auditor can report on financial statements that use such a basis of accounting.

The audit report is the same as a standard audit report except that there are the following additional paragraphs:

- A paragraph that—
  - Explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation.
  - States that the presentation is not intended to be a presentation in conformity with generally accepted accounting principles.
- A paragraph that includes a description and the source of significant interpretations, if any, made by the executor or trustee relating to the provisions of the relevant governing document.
- A paragraph that restricts the use of the report to those within the entity, the parties to the agreement or to those with whom the entity is negotiating directly.

In addition, the opinion paragraph should express an opinion related to the fair presentation, in all material respects, of the information the presentation is intended to present in conformity with GAAP or with an OCBOA.

The report should use the appropriate financial statement titles and the opinion should refer to the basis of accounting used.

The following is an example of an audit report on financial statements that do not conform with GAAP or an OCBOA, but are prepared on a basis specified in the governing document.

> We have audited the special-purpose statement of assets, liabilities, and trust equity of [Name] as of December 31, 20X1, and the related special-purpose statements of revenues and expenses and of cash flows for the years then ended. These financial statements are the responsibility of the

Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the trustee, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with the [Name of Governing Document] described in Note A, and are not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the special-purpose financial statements referred to above present fairly, in all material respects, the assets, liabilities, and trust equity of [Name] at December 31, 20X1, and the revenues, expenses and cash flows for the years then ended, on the basis of accounting described in Note A.

This report is intended for the information and use of the trustee and [Other Specified Parties] and should not be used for any other purpose.

Financial Statements That Are Incomplete but Otherwise in Conformity with GAAP or OCBOA. If the agreement calls for financial statements to depart only from GAAP or an OCBOA because they are incomplete (for example, they exclude certain activities) the accountant can use a standard report modified as follows. The audit report is the same as a standard audit report except that there are two additional paragraphs:

- A paragraph that—
  - Explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation.
  - If the basis of presentation is in conformity with generally accepted accounting principles, states that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues and expenses.
- A paragraph that restricts the use of the report to those within the entity, to the parties to the contract or agreement, for filing with a regulatory agency (or court) or to those with whom the entity is negotiating directly.

The report should use the appropriate financial statement titles and the opinion should refer to the basis of accounting used.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. Which of the following statements is correct concerning a compilation report?

    a. A report on fiduciary financials must be addressed to the beneficiaries of the fiduciary entity.

    b. Fiduciary financials in the report must be accompanied by all supporting schedules.

    c. The report must not discuss additional procedures performed before or during compilation.

    d. The accountant's compilation report must be dated as of the date that all fieldwork has ended.

28. Which of the following statements is correct concerning an audit report?

    a. The fiduciary financial statements audited can be identified as a collective group in the audit report.

    b. A statement indicating who is responsible for the financials may be used in lieu of including a similar statement in the audit report.

    c. Including the country of origin in the report is not necessary if the country of origin is the United States of America.

    d. The report date is the date sufficient appropriate audit evidence has been obtained for the auditor to support the opinion on the financial statements.

29. Which of the following statements is correct concerning a report on financial statements containing a material GAAP departure?

    a. In a compilation report, the third paragraph should be modified to discuss such a departure.

    b. The preferred course of action is to revise the financial statements prior to issuing the auditor's report.

    c. If the client refuses to revise the statements and modification of the report is not adequate, the auditor can continue on the engagement.

30. Which of the following actions is **not** appropriate concerning an audit of financial statements containing a material departure from GAAP?

    a. Issue a disclaimer of opinion.

    b. Issue a qualified opinion.

    c. Issue an adverse opinion.

31. When reporting on OCBOA estate and trust financial statements, the use of the modified cash basis affects which of the following?

    a. The accountant's responsibility to report.

    b. The requirement to modify the report for material measurement departures.

    c. The requirement to modify the report or withdraw for a scope limitation.

    d. The form of the report.

32. When an accountant uses the basis of accounting specified in the governing document that is not considered GAAP or an OCBOA, does the accountant still has a responsibility to modify the report or withdraw if there is a scope limitation.

    a. Yes.

    b. No.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. Which of the following statements is correct concerning a compilation report? **(Page 239)**

    a. A report on fiduciary financials must be addressed to the beneficiaries of the fiduciary entity. [This answer is incorrect. The report should be addressed to the client. In the case of an estate or trust, this is usually the executor or trustee.]

    b. Fiduciary financials in the report must be accompanied by all supporting schedules. [This answer is incorrect. Although inclusion of supporting schedules with estate and trust financial statements is acceptable, it is not required.]

    c. The report must not discuss additional procedures performed before or during compilation. [This answer is correct. To do so might mislead the reader to conclude the accountant is offering some form of assurance.]

    d. The accountant's compilation report must be dated as of the date that all fieldwork has ended. [This answer is incorrect. The date of the accountant's report is the date the compilation is completed.]

28. Which of the following statements is correct concerning an audit report? **(Page 242)**

    a. The fiduciary financial statements audited can be identified as a collective group in the audit report. [This answer is incorrect. The fiduciary statements audited must be individually identified per SAS No. 58.]

    b. A statement indicating who is responsible for the financials may be used in lieu of including a similar statement in the audit report. [This answer is incorrect. The statement explaining the responsibility for financial statements must be included in the report, per SAS No. 58. It cannot be supplanted.]

    c. Including the country of origin in the report is not necessary if the country of origin is the United States of America. [This answer is incorrect. Per SAS No. 58, the opinion should include an identification of the United States of America as the country of origin of the generally accepted accounting principles.]

    d. The report date is the date sufficient appropriate audit evidence has been obtained for the auditor to support the opinion on the financial statements. [This answer is correct. According to SAS No. 58, the date fieldwork ended cannot be used unless sufficient appropriate audit evidence was obtained as of that date.]

29. Which of the following statements is correct concerning a report on financial statements containing a material GAAP departure? **(Page 244)**

    a. In a compilation report, the third paragraph should be modified to discuss such a departure. [This answer is incorrect. The second paragraph of a compilation report should be modified to discuss a material departure from GAAP in the financial statements.]

    b. The preferred course of action is to revise the financial statements prior to issuing the auditor's report. [This answer is correct. If the client refuses to revise the statements, the auditor must then determine whether to issue a modified opinion or withdraw from the engagement.]

    c. If the client refuses to revise the statements and modification of the report is not adequate, the auditor can continue on the engagement. [This answer is incorrect. The auditor should withdraw from the engagement and consider legal counsel.]

30. Which of the following actions is **not** appropriate concerning an audit of financial statements containing a material departure from GAAP? **(Page 245)**

    a. Issue a disclaimer of opinion. [This answer is correct. A disclaimer of opinion is not an appropriate form of report modification for a GAAP departure. An opinion must be expressed as either qualified or adverse.]

    b. Issue a qualified opinion. [This answer is incorrect. If the client refuses to revise the financials, a modified report with a qualified opinion would be the next option to consider. The accountant would insert an explanatory paragraph between the scope and opinion paragraphs describing the substantive reasons for the qualification.]

    c. Issue an adverse opinion. [This answer is incorrect. An adverse opinion would be an option, if the departure is significant, pervasive, or effects the financial statements taken as a whole.]

31. When reporting on OCBOA estate and trust financial statements, the use of the modified cash basis affects which of the following? **(Page 250)**

    a. The accountant's responsibility to report. [This answer is incorrect. Many state statutes imply that fiduciary financial presentations should be prepared on a cash or modified cash basis. The use of this basis will not affect the accountant's responsibility to report. All reporting requirements remain the same.]

    b. The requirement to modify the report for material measurement departures. [This answer is incorrect. Material departures concerning measurement or disclosure principles require report modification regardless of which basis is used.]

    c. The requirement to modify the report or withdraw for a scope limitation. [This answer is incorrect. Scope limitations require report modification or withdrawal, and whether the modified cash basis is used has no bearing on the decision.]

    d. The form of the report. [This answer is correct. The form of the report will generally look quite different than a GAAP presentation. One of the revisions required pertains to the identification of the statements presented.]

32. When an accountant uses the basis of accounting specified in the governing document that is not considered GAAP or an OCBOA, does the accountant still has a responsibility to modify the report or withdraw if there is a scope limitation. **(Page 253)**

    a. Yes. [This answer is correct. Use of such bases does not affect (a) the accountant's responsibility to report, (b) the requirements to modify the report for material departures from measurement or disclosure principles underlying the bases, or (c) the requirement to modify the report or withdraw if there is a scope limitation. The principal effect of the use of such a basis is on the form of the report.]

    b. No. [This answer is incorrect. Estate and trust financial statements are often prepared in compliance with the governing document. Such statements might take a the form of a financial presentation that does not result in a presentation in conformity with GAAP or an other comprehensive basis of accounting. However, using such bases does not affect the requirement to modify the report or withdraw if there is a scope limitation. The effect of the use of such a basis is on the form of the report.]

TAX RETURN ENGAGEMENTS

Often the accountant's only involvement with an estate or trust is to prepare the entity's income tax return. In such an engagement, the executor, trustee, or beneficiaries may ask the accountant for a photocopy of the tax return. SSARS No. 1 does not establish standards or procedures for preparing tax returns nor does it encompass reporting on financial presentations included in tax returns (SSARS No. 1, AR 100.04). Consequently, when the accountant is engaged to prepare a tax return, it is not necessary to attach a compilation (or review) report or mark each page of the tax return, "See accountant's compilation report." Even if photocopies of the tax return are supplied to the aforementioned parties, such photocopies are not considered to be financial statements under SSARS No. 1 (AR 100), and, accordingly, it is unnecessary to attach a compilation or review report to them unless the client requests such a report. Interpretation No. 10 of SSARS No. 1, "Reporting on Tax Returns," (AR 9100.31–.32) makes it clear that the use of the tax return for purposes other than filing with the taxing authority does not affect the accountant's reporting responsibilities.

If the client requests the accountant to issue a compilation or review report on the financial information included in the tax return, the accountant should comply with SSARS No. 1. If the client asks the accountant to type separate financial statements based on the amounts reported in the tax return SSARS No. 1 might or might not apply. Mere retyping of client financial statements as an accommodation is not considered submission and does not entail a responsibility to compile or review the statements. (However, it is rare for clients to ask accountants merely to retype client data in columnar form without adjustment or meaningful consideration of the information.) On the other hand, creating financial statements based on data in a tax return prepared by the accountant would be considered submitting the statements and would require a compilation or review report.

In situations where financial statements are prepared based on amounts in the tax return, the accountant should be aware that the assets of a taxable estate may be different from the assets of an administrable estate and, consequently, care should be exercised to identify the financial statements as being presented on the income tax basis of accounting.

COMPILATION OF MANAGEMENT-USE-ONLY FINANCIAL STATEMENTS

SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services 1, "Compilation and Review of Financial Statements,"* allows CPAs to provide management-use-only financial statements *without issuing a compilation report* in certain situations. SSARS No. 8 was not published as a stand-alone statement. Instead, the provisions of SSARS No. 8 were incorporated into SSARS No. 1. Consequently, this course generally refers to either SSARS No. 8 or the amended version of SSARS No. 1.

The following paragraphs provide a summary of certain provisions of SSARS No. 8 and discuss whether SSARS No. 8 applies to compilation engagements for estates and trusts.

Overview of SSARS No. 8

SSARS No. 8—

a. Requires accountants to follow the compilation *performance* standards in SSARS No. 1 whenever he or she submits financial statements.

b. Allows accountants to provide clients with management-use-only financial statements without issuing a compilation report if the statements are *not* reasonably expected to be used by anyone other than management personnel knowledgeable about the accounting in the financial statements. (The accountant may still issue a SSARS No. 1 compilation report when he or she submits management-use-only financial statements.)

c. Allows accountants to issue an engagement letter, *preferably* signed by management, containing specific communications to management in lieu of a compilation report.

Determining Whether SSARS No. 8 Can Be Applied

The exemption from the reporting requirements of SSARS No. 1 is available only when the financial statements are not reasonably expected to be used by a *third party*. The SSARS considers *third parties* to be all persons, including those charged with governance, who are not members of management.

Thus, all intended users must both (a) be members of management and (b) possess the requisite knowledge to understand the limitations of the financial statements. Clearly, this limits management's ability to share the financial statements with others, even within the estate or trust *management* team. Thus, SSARS No. 1 limits their use to *management-use-only* as opposed to *internal-use-only*. Determining who is considered *management* will not always be easy. The following paragraphs provide general guidance for all entities, and the authors views on who might be considered *management* and *third parties* for estates and trusts.

Who Is Management? SSARS No. 1, as amended by SSARS No. 17, (AR 100.04) defines *management* as—

> The person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

SSARS No. 1, as amended by SSARS No. 17, defines *those charged with governance* as—

> The person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases, management has this responsibility). In some entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors, a committee of management, partners, equivalent persons, or some combination thereof. Those charged with governance are specifically excluded from management, unless they perform the management functions as defined above.

The above definition clarifies that others beside the traditional *management team* may also be appropriate users of management-use-only financial statements, and provides practitioners with some flexibility when considering who is expected to use the statements. In addition, because client organizations vary extensively, the determination of who might be considered management may vary from one client to the next. In the end, the practitioner should use his or her professional judgment to determine which are the appropriate users within an organization.

Note that boards of directors who are not members of management as defined above, are considered to be *third parties*. In addition, members of management who do not meet the definition of management as defined above are also considered to be *third parties*. Management-use-only financial statements may only be issued if all intended users are members of management as defined above.

In addition, SSARS No. 1 (AR 100.25) requires that when the compiled financial statements are prepared for management-use-only, the accountant should document an understanding with the client that includes a statement that management has knowledge about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

Who Are Management and Third Parties for Estates and Trusts? In discussing the final provisions of SSARS No. 8, ARSC discussed the issues of who is management when the client is not a business enterprise. This includes entities such as estates and trusts, as well as the preparation of personal financial statements included in written financial plans. ARSC members believe the key to deciding who is management rests in determining who has the ability to make decisions for the estate or trust as well as the authority to carry out such decisions. This logic seems to follow the intent of SSARS No. 8 and the SFAS No. 57 definition of management.

An analysis of which parties to an estate or trust might be considered management is presented in Exhibit 2-5.

As illustrated in Exhibit 2-5 and discussed later in this lesson SSARS No. 8 will rarely be applied for estates and trusts since most fiduciary financial statements are prepared for distribution to third parties.

Determining Intended Use of the Financial Statements

Practitioners should consider the reasons for which the client intends to use the financial statements. For an estate or trust, this might be done based on the practitioner's knowledge of and past experience with the client, the provisions of the governing document, and applicable state or other jurisdiction requirements. In addition, practitioners should discuss with the executor or trustee how they intend to use the financial statements. SSARS No. 1 requires a client representation that the statements are not intended for third party use (as that term is defined in the standard). SSARS No. 1 provides that absent any contradictory information that comes to their attention, accountants may rely on those representations without performing any further procedures.

Accountants should not, however, ignore information that would suggest the financial statements might be used by third parties. For example, if a practitioner has previously compiled financial statements for the client to meet certain reporting requirements to the courts and/or beneficiaries, he or she might question whether such requirements are still in effect before agreeing to submit management-use-only financial statements. If obvious facts suggest that the financial statements might be used by third parties (despite management's representation to the contrary), the accountant should compile and report on the statements in accordance with SSARS No. 1.

SSARS No. 1 states that an accountant who becomes aware that management-use-only financial statements have been distributed to third parties should—

- Discuss the situation with the client and request that the financial statements be returned.
- Notify known third parties that the financial statements are not intended for third-party use, if the client does not comply with that request within a reasonable period of time. Notification is recommended only after the accountant consults with his or her attorney.

Communication Requirements

Before performing a compilation of management-use-only financial statements, the accountant is required to prepare an engagement letter, *preferably* signed by management, documenting an understanding with the entity regarding the services to be performed and the use and limitations on the use of the financial statements.

Performance Standards

SSARS No. 8 does not change the applicability of SSARS No. 1, only its reporting requirements. The accountant is required to *compile* financial statements whenever he or she submits financial statements to clients or others. Thus, an accountant is required to comply with the *performance* standards for such engagements, even when the financial statements are limited to management use only.

Exhibit 2-5

Determining Who Is Management for Estates and Trusts

Parties	Member of Management?	Comments
Executor	Yes	Member of management.[a]
Trustee	Yes	Member of management.[a]
Testator (maker of the will)	Not Applicable	Estate does not exist until after death.
Grantor (maker of the trust)	Possibly	Depends on (a) the type of trust and (b) the degree of the grantor's control (and actual involvement with trust activities).

Beneficiaries	No	Although they are parties to the estate or trust, beneficiaries do not have the ability to make and carry out decisions relating to the estate or trust.
Courts	No	Third parties.
IRS and other taxing authorities	No	Third parties.
Business advisors (e.g., investment managers, financial advisors)	No	Executor or trustee has the final authority to make decisions. Although in certain cases, advisors may be delegated authority to make and carry out certain decisions (e.g., investment manager may buy and sell fiduciary investments according to the entity's investment plan), ultimately, the executor or trustee has the ability to approve or reject the investment plan and the employment of the advisor.
Attorneys	Possibly	Depends on whether their role is as executor or trustee (would be management) or a legal advisor to the entity (not management—see comments for business advisors).
Other interested parties	No	Third parties.

Note:

[a] Although these parties may be considered members of management, they must also be knowledgeable enough to understand the financial statements in order for management-use-only financial statements to be appropriate. Depending on (a) the size of the estate or trust and (b) whether it is administered by an attorney, professional fiduciary (such as a bank trust department), or other party, several persons might be part of the management team.

* * *

Restrictive Language

SSARS No. 1 requires each page of management-use-only financial statements to include a reference (or legend) that restricts the use of such statements to management. The terminology in the example legends in SSARS No. 1 (AR 100.24) should be adjusted to reflect the situation for estates and trusts. For example, the legend might be:

- Restricted for Trustee's Use Only
- Solely for the information and use by John Lamar and the trustee of the Lamar Family Trust and not intended to be and should not be used by any other party.

Practitioners may wish to add additional language, such as the following, to the legend to inform potential third party users of the risks inherent with the use of such statements.

> These financial statements may contain material departures from generally accepted accounting principles and the effect of those departures, if any, on the financial statements may not be

disclosed. Accordingly, the financial statements are intended solely for the information and use of the trustee of ABC Trust and should not be used by third parties or others who are not knowledgeable about such matters.

Material Misstatements

Under SSARS No. 1, the accountant should consider whether information received from the client is incorrect, incomplete, or otherwise unsatisfactory. When the financial statements are intended for management's-use-only, the accountant considers misstatements in light of the modifications or omissions to the financial statements the trustee or executor has asked him or her to make. In the end, the accountant should read the statements to determine whether they are appropriate given the modifications or omissions the fiduciary has requested and if they are free of mathematical or clerical errors. Thus, any material misstatement that the client deems unnecessary to correct need not result in either communication in a formal report, or the accountant's withdrawal from the engagement. However, SSARS No. 1 does require that the accountant include a statement in the engagement letter that material departures from GAAP may exist and the effects of those departures, if any, on the financial statements may not be disclosed.

Applicability of SSARS No. 8 to Estates and Trusts—A Final Word

As discussed throughout this course and illustrated in Exhibit 2-5, that most trust and estate financial statements seem to be prepared for distribution to third parties. Specifically, financial presentations are usually prepared for distribution to the courts, beneficiaries and other interested parties under the terms of the governing document or applicable legislation. The distribution to third parties also makes sense in that most financial presentations are prepared to show how the fiduciary discharged his responsibility.

As a practical matter, accountants generally may provide compilation services without issuing a report only if the expected user(s) of the financial statements are the (a) executor, or (b) the trustee and possibly the grantor, but only if such parties are also knowledgeable about the financial statements and the limitations of management-use-only financial statements. Examples of engagements where SSARS No. 8 might be applied if there are no external reporting requirements and other SSARS No. 8 criteria are met include:

- Interim financial statements.
- Interim financial statements that do not present all items strictly in conformity with GAAP or another basis of accounting typically used to prepare the financial statements.
- Monthly reports containing only selected financial or operational information.
- Financial statements prepared for the trustee and grantor of a trust (for example, for a grantor trust where the grantor retains certain rights or control over trust assets).

In addition to there being limited situations where SSARS No. 8 could be applied for estates or trusts, some of the principal advantages of SSARS No. 8 are not as important in the fiduciary environment. For example, in addition to not having to issue a report, one advantage often cited by practitioners is that they would not be required to detail known departures from the basis of accounting used to prepare the financial statements. However, in most fiduciary engagements, the accountant will not encounter departures from such basis since accountants and fiduciaries have latitude when selecting the basis of accounting to use for fiduciary accounting and reporting purposes.

SUBMISSION OF FINANCIAL STATEMENTS BY AN ACCOUNTANT ACTING AS TRUSTEE OR EXECUTOR

An accountant in public practice who functions as an employee, owner, or director of an entity need not issue a SSARS report when submitting financial statements. For an estate or trust, this would include accountants in public practice that serve as executors or trustees. Instead of issuing a SSARS report, the accountant may provide an informal communication (or no written communication) to accompany the statements submitted.

Interpretation No. 21 to SSARS No. 1 (AR 9100.82), *Applicability of SSARS No. 1 When Performing Controllership or Other Management Services*, says the accountant may either comply with the SSARS requirements or communicate, preferably in writing, his relationship to the entity. The following is an example of the type of communication or transmittal the accountant might use when acting as a trustee, executor, or employee of the entity:

> The accompanying summary of account of the estate of David C. Connon, Deceased, and the related schedules on pages ____ to ____ as of July 15, 20X1, and for the period December 10, 20X0, to July 15, 20X1, have been prepared by [Name of Accountant], CPA. I have prepared such financial statements in my capacity as executor of the estate of David C. Connon.

The transmittal letter should be signed and dated, although the professional standards do not require it. Because the individual accountant, not the firm, acts as the executor, trustee, or employee, the individual should sign the letter.

Alternatively, this written communication could also be documented by the CPA signing the financial statements with his or her name, title at the entity (e.g., Executor, Trustee), and the entity's name (e.g., Estate of David C. Connon)

An accountant who uses this form of communication or transmittal is not required to apply the standard compilation procedures or report any departures from GAAP or other basis of accounting used.

PRESCRIBED FORMS

According to SSARS No. 3 (AR 300), *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*, a prescribed form is any standard preprinted form designed or adopted by the body to which it is to be submitted. Such bodies include banks and governmental and regulatory bodies other than those concerned with the sale or trading of securities. An estate or trust might be asked to submit financial statements on a prescribed form that does not call for or provide space for all the matters or disclosures otherwise required by GAAP. The accountant's ability to provide financial statements in such a format depends on the level of service for which the accountant was engaged.

Compilation

Under SSARS No. 3 (AR 300), the accountant can compile financial statements on a prescribed form without disclosing the differences between the requirements of the form and GAAP. In this context, a prescribed form has both of the following characteristics:

- It is a standard preprinted form.
- The form has been designed or adopted by the body to which it is to be submitted.

A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form. For instance, a reporting package designed by a bank trust department for use in reporting financial information about trust balances and activities relating to its clients is not a prescribed form for purposes of SSARS No. 3.

Alternative Form of Standard Compilation Report. The following is an example of an alternative form of compilation report when the financial statements are included in a prescribed form that calls for a departure from GAAP:

> We have compiled the [Identification of Financial Statements, Including Period Covered and Name of Entity] included in the accompanying prescribed form in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> Our compilation was limited to presenting in the form prescribed by [Name of Body] information that is the representation of the [Executor/Trustee] We have not audited or reviewed the

financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements of [Name of Body], which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

Note that the first two paragraphs are similar to the standard compilation report of SSARS No. 1 illustrated earlier. The main differences are the references to:

a. the prescribed form, and

b. the body that prescribed the form.

The third paragraph indicates that the basis of accounting and disclosures required by the form are different from GAAP and cautions the reader about the limits of the financial statements. The cautionary language is similar to report language used for compiled financial statements that omit substantially all disclosures.

SSARS No. 3 does not require disclosure of departures from GAAP that are required by the prescribed form. However, the accountant must disclose in the compilation report any material departures from the requirements of the prescribed form that he or she becomes aware of during the compilation.

The accountant should not sign a preprinted report form that does not conform with SSARS. If the form calls for the accountant to sign a representation or report that does not conform to SSARS, he should append an appropriate report to the prescribed form.

Applicability to Fiduciary Entities. A scenario in which a prescribed form might be considered is when a probate judge gives the executor a specific set of instructions and financial illustrations to follow when preparing the accounting. This alternative is not recommended because of the following issues:

- First, SSARS No. 3 (AR 300.02) states "a prescribed form is any standard *preprinted form* designed or adopted by the body to which it is to be submitted." (Emphasis added.) A strict reading of this paragraph implies that if the financial statements prepared for the court are not submitted on a *preprinted form* designed by the court, SSARS No. 3 cannot be used. In most circumstances, the desires of the court are nothing more than typed or oral instructions. In many cases, the prescribed form is not a preprinted form but instead a photocopy of a previous accounting that the judge particularly favored. Some accountants believe that a strict interpretation of the "preprinted form" requirement of SSARS No. 3 is not practical in this situation because the failure of the court to employ a "preprinted form" is not done with the intention to mislead third parties. Instead, a preprinted form is not used because the court simply cannot afford one or does not have the time to design one. Based on this reasoning, there may be some justification for a flexible interpretation of the "preprinted form" requirement of SSARS No. 3. However, there is a more troublesome requirement of SSARS No. 3 that cannot be overlooked.

- SSARS No. 3 report language must state that the requirements of the court differ from GAAP. To some accountants, this is a contradictory statement because the requirements of the court [i.e., (1) the governing document, (2) state law, or (3) what is reasonable and equitable] are viewed by them to be the same as GAAP. In other words, they believe GAAP is generally recognized to be the accounting required by most courts. However, other accountants view the term GAAP as a generic term that stands for "accrual accounting" and not a specific body of accounting conventions widely recommended for an entity. These accountants would have less difficulty in applying the report language in SSARS No. 3.

Because the use of a SSARS No. 3 (AR 300) report can be viewed with some controversy (the statements might not be on a preprinted form, and the SSARS No. 3 disclaimer can be viewed as a contradiction), this reporting alternative is not recommended. Instead, use a SSARS report based on (a) GAAP, or (b) the terms of an agreement when the CPA does not believe GAAP for estates and trusts is identifiable.

Review

While SSARS No. 3 (AR 300) allows the accountant to provide a compilation report on financial statements on a prescribed form, it does not allow a similar report for reviews. If the form calls for departures from GAAP or an OCBOA, the accountant who reviews the financial statements in such a form should modify the review report to draw attention to the departures.

Interpretation 1 to SSARS No. 3, "Omission of Disclosures in Financial Statements Included in Certain Prescribed Forms," (AR 9300.01) notes that the accountant who has previously reviewed the financial statements may issue a compilation report on financial statements for the same period that are included in a prescribed form that calls for a departure from generally accepted accounting principles. When the only difference between the previously reviewed financial statements and the financial statements included in the prescribed form is that disclosures not requested by the form are omitted, the accountant may wish to refer to the review report in the report on the compiled financial statements included in the prescribed form. For example, the following sentence might be added to the report:

> These financial statements were compiled by us from financial statements for the same period which we previously reviewed, as indicated in our report dated _______.

If the measurement principles used in the compiled financial statements in the prescribed form cause the financial statements to be materially different from the previously reviewed financial statements, no reference should be made to the review engagement.

The accountant should not sign a preprinted report form that does not conform with SSARS. If the form calls for the accountant to sign a representation or report that does not conform to SSARS, he or she should append an appropriate report to the prescribed form.

Audit

The accountant who audits the financial statements in a prescribed form should modify the audit report to reflect any material departures from GAAP or OCBOA, even if they are called for by the form. The special rule included in SSARS No. 3 for prescribed-form engagements discussed previously does not apply to audits. If a printed report form calls on the auditor to make a statement that he is not justified in making, he should reword the form or attach a separate report.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

33. Which of the following statements is correct concerning tax return engagements?

    a. SSARS No. 1 applies to reporting on financial presentations included in income tax returns.

    b. At a minimum, a compilation report should be attached to the tax return and each page of the tax return referenced to the compilation report.

    c. The accountant's reporting responsibilities are not affected when the tax return is used for a purpose other than that for which it was prepared.

    d. A photocopy of the fiduciary tax return is considered a financial statement subject to SSARS No. 1 when supplied to a beneficiary.

34. Which of the following would be considered management related to the estate and trust?

    a. The courts.

    b. The executor.

    c. A beneficiary.

    d. An other interested party.

35. Which of the following statements is correct concerning an accountant who serves as trustee or executor and submits financial statements for the fiduciary entity?

    a. The accountant must comply with SSARS or communicate his relationship to the fiduciary entity.

    b. Communication of the accountant's relationship to the entity must be written, signed, and dated.

    c. The accountant's firm, not the accountant, must sign the transmittal letter documenting the relationship to the entity.

    d. The CPA could sign the financials and include his title and the name of the entity and any departures from GAAP or other bases must still be reported.

36. SSARS No. 3 allows the accountant to issue a report on a prescribed form without disclosing the differences between the requirements of the form and GAAP in which of the following situations?

    a. An audit.

    b. A review.

    c. A compilation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

33. Which of the following statements is correct concerning tax return engagements? **(Page 263)**

    a. SSARS No. 1 applies to reporting on financial presentations included in income tax returns. [This answer is incorrect. SSARS No. 1 does not establish any standards or procedures applicable to income tax return preparation nor does it encompass reporting on financial presentations included in the tax return.]

    b. At a minimum, a compilation report should be attached to the tax return and each page of the tax return referenced to the compilation report. [This answer is incorrect. A compilation is not required unless the client requests it per SSARS No. 1.]

    c. The accountant's reporting responsibilities are not affected when the tax return is used for a purpose other than that for which it was prepared. [This answer is correct. Interpretation No. 10 of SSARS No. 1 makes it clear that using the tax return for purposes other than filing with the tax authority does not affect the accountant's reporting responsibilities.]

    d. A photocopy of the fiduciary tax return is considered a financial statement subject to SSARS No. 1 when supplied to a beneficiary. [This answer is incorrect. Distributing a photocopy of a fiduciary tax return does not convert it into a financial statement under SSARS No. 1.]

34. Which of the following would be considered management related to the estate and trust? **(Page 265)**

    a. The courts. [This answer is incorrect. The probate court does not have the authority to make and carry out decisions related to the fiduciary entity. They are considered a third party.]

    b. The executor. [This answer is correct. The professional fiduciary possesses the requisite knowledge concerning the limitations of management-use only financial statements, and has the authority to make and carry out decisions related to the fiduciary entity.]

    c. A beneficiary. [This answer is incorrect. Beneficiaries are parties to the trust, but cannot make decisions on behalf of the trust.]

    d. Another interested party. [This answer is incorrect. An interested party such as the holder of a mortgage related to estate assets, is unable to make decisions on behalf of the estate and would be classified as a third party.]

35. Which of the following statements is correct concerning an accountant who serves as fiduciary and submits financial statements for the fiduciary entity? **(Page 268)**

    a. The accountant must comply with SSARS or communicate his relationship to the fiduciary entity. [This answer is correct. Per Interpretation No. 21 to SSARS No. 1, written communication is preferred, but not required.]

    b. Communication of the accountant's relationship to the entity must be written, signed, and dated. [This answer is incorrect. Written communication is preferred, but not required by Interpretation No. 21 to SSARS No. 1. A signed, dated, communication is preferred, but professional standards do not require it.]

    c. The accountant's firm, not the accountant, must sign the transmittal letter documenting the relationship to the entity. [This answer is incorrect. The accountant, not the firm, is acting as fiduciary so the accountant, not the firm, should add any signature to the transmittal letter.]

    d. The CPA could sign the financials and include his title and the name of the entity, and any departures from GAAP or other bases must still be reported. [This answer is incorrect. No report of basis of accounting departures is required under such circumstances because the accountant is not required to apply the standard compilation procedures.]

36. SSARS No. 3 allows the accountant to issue a report on a prescribed form without disclosing the differences between the requirements of the form and GAAP in which of the following situations? **(Page 268)**

    a. An audit. [This answer is incorrect. Audits are not afforded this treatment under SSARS No. 3.]

    b. A review. [This answer is incorrect. SSARS No. 3 does not permit a review to be issued without such disclosures.]

    c. A compilation. [This answer is correct. Under SSARS No. 3, the exception to disclosure of differences between form and GAAP requirements applies to compilations, but not reviews or audits.]

ELEMENTS, ACCOUNTS, OR ITEMS OF A FINANCIAL STATEMENT

Authoritative guidance for reporting on specified elements, accounts, or items of a financial statement is contained in several different standards. As a practical matter, practitioners reporting on a trust or estate financial presentation will not often be asked to report on the elements, accounts, or items of a financial statement. However, any of four levels of service can be applied: audit, review, compilation, and application of agreed-upon procedures. Exhibit 2-6 describes the sources of guidance for various types of engagements on elements, accounts, or items.

PPC's Guide to Nontraditional Engagements provides detailed guidance, including sample reports and practice aids, for engagements relating to specified elements, accounts, or items of a financial statement. It also includes detailed information about SSAE No. 10. The following paragraphs provide an overview of such guidance as it relates to trusts and estates.

Elements Presented Separately

Authoritative guidance for reporting on specified elements, accounts, or items of a financial statement is contained in SAS No. 62 (AU 623), *Special Reports*, SSAE No. 10, *Attestation Standards: Revision and Recodification*, and SSARS No. 13 (AR 110), *Compilation of Specified Elements, Accounts, or Items of a Financial Statement*. According to SAS No. 62, an accountant can audit a specified element of a financial statement that is presented separately, i.e., not presented as supplementary information with financial statements. (Elements presented as supplementary information to the financial statements are discussed later.) In addition, the accountant may compile such information under SSARS, or perform a review or agreed-upon procedures engagement under the attestation standards.

Compilation. SSARS No. 13 (AR 110), *Compilation of Specified Elements, Accounts, or Items of a Financial Statement*, addresses the compilation of specified elements, accounts, or items of a financial statement within the professional standards. When the accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the report should state that:

a. The specified elements, accounts, or items identified in the report were compiled. If the compilation was performed in conjunction with a compilation of the company's financial statements, the paragraph should state this and indicate the date of the accountant's compilation report on those financial statements. In addition, any departure from the standard report on those statements should be disclosed if considered relevant to the presentation of the specified elements, accounts, or items.

b. The compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

c. The compilation is limited to presenting financial information that is the representation of management (executor trustee—see the discussion of management of estates and trusts included earlier).

d. The specified elements, accounts, or items have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.

Exhibit 2-6

Authoritative Guidance for Reports on Elements, Accounts, or Items of a Financial Statement

Assurance Level	Element Presented Separately	Element Presented as Supplement to Financial Statements
Audit	May audit under SAS No. 62 (AU 623), *Special Reports*.	May audit under SAS No. 29 (AU 551), *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (if an auditor-submitted document). Also, may report that element is fairly stated in relation to financial statements under SAS No. 8 (AU 550), *Other Information in Documents Containing Audited Financial Statements*, as amended by SAS No. 98, *Omnibus Statement on Auditing Standards—2002* (if a client-prepared document). Also, may report that element is fairly stated in relation to financial statements under SAS No. 42 (AU 552), *Reporting on Condensed Financial Statements and Selected Financial Data* (if a client-prepared document).
Review	Review under Attestation Standards	May review under SSARS No. 1 (AR 100.60).
Compilation	May compile under SSARS No. 13 (AR 110), *Compilation of Specified Elements, Accounts, or Items of a Financial Statement*.	May compile under SSARS No. 1 (AR 100.60).
Agreed-Upon Procedures	SSAE No. 10 (AT 201, *Agreed-Upon Procedures Engagements*), as amended. The report must be restricted to the users who specify the procedures.	SSAE No. 10 (AT 201, *Agreed-Upon Procedures Engagements*), as amended. The report must be restricted to the users who specify the procedures.

* * *

In addition, SSARS No. 13 requires that the report include:

a. A description of the basis on which the specified elements, accounts, or items are presented if that basis is not GAAP.

b. A signature of the accounting firm or the accountant. The signature can be manual, stamped, electronic, or typed.

c. The date of the compilation report. The date of the accountant's report should be the date of completion of the compilation procedures.

Furthermore, reference to the accountant's report should be included at the bottom of each page of the compiled specified elements, accounts, or items of a financial statement. An example of such a report follows:

> We have compiled the accompanying schedule of investments of the Hart Family Trust as of December 31, 20X1 in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of a schedule information that is the representation of the trustee of the Hart Family Trust. We have not audited or reviewed the accompanying schedule and, accordingly, do not express an opinion or any other form of assurance on it.

SSARS No. 13 allows an accountant to compile and report on specified elements, accounts, or items of a financial statement. An accountant engaged to compile one or more specified elements, accounts, or items of a financial statement is required to report on such compiled financial information. However, an accountant who has not been so engaged is not required to report, as the Standard does not preclude the accountant from preparing or assisting in the preparation of one or more specified elements, accounts, or items of a financial statement without issuance of a report. But, if the accountant prepares or assists a client in preparing a schedule of one or more specified elements, accounts, or items of a financial statement, the accountant should consider the potential of being associated with the schedule and the likelihood that the user may inappropriately infer, through association, an unintended level of assurance. An accountant could be associated with the schedule because his or her name is somehow included in a document containing the schedule or through verbal communication. In these instances, the accountant may wish to (but is not required to) issue a disclaimer indicating that such a presentation has not been audited, reviewed, or compiled by the practitioner and, accordingly, no opinion or any other form of assurance is being expressed. Exhibit 2-6 summarizes the reporting choices available when associated with (or asked to report on) a specified element, account, or item of a financial statement.

Review. Because SSARS No. 13 applies only to compilation of specified elements, accounts, or items of a financial statement, accountants that are engaged to perform a review of an element, account, or item should look to the attestation standards [SSAE No. 10 (AT 101), as amended] for guidance. The following is an example of such a report:

> We have reviewed the accompanying schedule of investments of the Hart Family Trust as of December 31, 20X1. The trustee is responsible for this schedule.
>
> Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the schedule of investments. Accordingly, we do not express such an opinion.
>
> Based on our review, nothing came to our attention that caused us to believe that the accompanying schedule of investments is not presented in conformity with the measurement and disclosure criteria set forth in Note 1.

Audit. The auditor can audit individual elements the same way that he audits a full set of financial statements. However, he should keep the following matters in mind:

- Because the auditor expresses an opinion on each of the specified elements, accounts, or items encompassed by the auditor's report, the measurement of materiality must be related to each individual element, account, or item reported on rather than to the aggregate thereof or to the financial statements taken as a whole.

- Since many financial statement elements are interrelated, for example, dividend income and investments, the auditor should be satisfied that elements, accounts, or items that are interrelated with those on which he has been engaged to express an opinion have been considered in expressing an opinion.

The auditor should be cautious when reporting on elements if he has already expressed an adverse opinion or disclaimed an opinion on the financial statements based on an audit. The auditor can express an opinion on elements of a financial statement provided that the elements do not constitute a major portion of the financial statements. Otherwise, the report might be construed as a piecemeal opinion, which is prohibited under SAS No. 58 (AU 508).

The following is an example of a report on the audit of an element.

> We have audited the accompanying schedule of investments of the Hart Family Trust as of December 31, 20X2. This schedule is the responsibility of the trustee. Our responsibility is to express an opinion on this schedule based on our audit.
>
> We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of investments is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of investments. An audit also includes assessing the accounting principles used and significant estimates made by the trustee, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.
>
> In our opinion, the schedule of investments referred to above presents fairly, in all material respects, the investments of the Hart Family Trust as of December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

Agreed-upon Procedures. In an agreed-upon procedures engagement, the accountant issues a report of findings based on specific procedures applied to specified elements, accounts, or items of a financial statement. The specified parties and the accountant agree upon the procedures to be performed based on the procedures that the users believe are appropriate for their purposes. The nature, timing, and extent of the agreed-upon procedures vary based on the specified parties' perceptions of their needs.

Under SSAE No. 10 (AT 201), as amended, agreed-upon procedures may be applied to individual elements, accounts, or items of a financial statement. The standard does not limit the number of elements, accounts, or items to which such procedures are applied; agreed-upon procedures may be applied to all, or substantially all, of the elements, accounts, or items of a financial statement. For example, practitioners may be engaged to perform a compilation of estate or trust financial statements and apply agreed-upon procedures to specific accounts (such as agreeing cash disbursements back to cancelled checks and supporting documentation).

The accountant's report on applying agreed-upon procedures to specified elements, accounts, or items of a financial statement should be in the form of procedures and findings. The accountant's report should contain the following elements:

a. A title that includes the word *independent*.

b. Identification of the specified parties.

c. Identification of the subject matter (i.e., specified elements, accounts, or items of a financial statement) and the character of the engagement.

d. Identification of the responsible party (i.e., the trustee or executor who takes responsibility for the elements, accounts, or items).

e. A statement that the responsible party (i.e., the executor or trustee) takes responsibility for the elements, accounts, or items.

f. A statement that the procedures performed were those agreed to by the specified parties identified in the report.

g. A statement that the agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants.

h. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties, and a disclaimer of responsibility for the sufficiency of the procedures.

i. A list of the procedures performed (or a reference to such a listing) and related findings. Note that the accountant should not provide negative assurance.

j. Where applicable, a description of any agreed-upon materiality limits.

k. A statement that the accountant was not engaged to, and did not, conduct an audit of the specified elements, accounts, or items, the objective of which would be the expression of an opinion; a disclaimer of opinion on the specified elements, accounts, or items; and a statement that if the accountant had performed additional procedures, other matters might have come to his attention that would have been reported.

l. A statement restricting the use of the report to the specified parties.

m. Where applicable, reservations or restrictions concerning procedures or findings.

n. Where applicable, a description of the nature of the assistance provided by a specialist.

o. The manual or printed signature of the practitioner's firm.

p. The date of the report.

The following is an illustration of a report on applying agreed-upon procedures to specified elements, accounts, or items of a financial statement:

INDEPENDENT ACCOUNTANT'S REPORT ON
APPLYING AGREED-UPON PROCEDURES

We have performed the procedures enumerated below, which were agreed to by [List specified parties.], solely to assist you in evaluating [Identify the specified elements, accounts, or items of a financial statement for the identified fiduciary entity and the character of the engagement.]. [Name of Executor or Trustee] is responsible for the [Refer to presentation.]. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of the procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

[Include paragraphs to enumerate procedures and findings.]

We were not engaged to, and did not, conduct an audit, the objective of which would be the expression of an opinion on the [Identify the specified elements, accounts, or items.]. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of [List or refer to the specified parties.] and is not intended to be and should not be used by anyone other than these specified parties.

Elements Presented as Supplementary Information to the Financial Statements

Compilation. When the accountant has compiled both the basic financial statements and other data presented only for supplementary analysis purposes, the compilation report should also include the other data. The report might begin:

> We have compiled the accompanying [Name of Fiduciary Financial Statements] of [Name of Fiduciary Entity] and the related [List supplementary information.] as of [Date] and for the [Period], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

Review. When the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the degree of responsibility, if any, he is taking with respect to that information. The accountant who has reviewed the basic financial statements should report on the supplementary data either by including an explanation in the review report or in a separate report on the other data. The report on the supplementary data should state that:

- The review has been made primarily for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, and
- Either:

  a. The other data accompanying the financial statements are presented only for supplementary analysis purposes and have been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and the accountant did not become aware of any material modifications that should be made to such data, or

  b. The other data accompanying the financial statements are presented only for supplementary analysis purposes and have not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but were compiled from information that is the representation of the [Executor or Trustee], without audit or review, and the accountant does not express an opinion or any other form of assurance on such data.

The following is an example of the additional paragraph of a review report when the supplementary data have been subjected to the inquiry and analytical procedures as part of the review engagement:

> Our review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The information included in the accompanying Schedules I and II is presented only for supplementary analysis purposes. Such information has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and we are not aware of any material modifications that should be made thereto.

The following is an example of the additional paragraph of a review report when the supplementary data have *not* been subjected to the inquiry and analytical procedures as part of the review engagement:

> Our review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The information included in the accompanying Schedules I and II is presented only for supplementary analysis purposes. Such information has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but was compiled from information that is the representation of the [Executor or Trustee], without audit or review. Accordingly, we do not express an opinion or any other form of assurance on the supplementary information.

Audit. The auditor is required to report on all information contained in an auditor-submitted document (this requirement does not apply to client-prepared documents). If there are supplementary schedules, the auditor should also report on such schedules. Ordinarily, the auditor does not audit the information separately from the financial statements taken as a whole, but only as part of the overall audit. Accordingly, a separate opinion is not usually given on that information.

The report, which can be added to the audit report or appear separately in the auditor-submitted document should, according to SAS 29 (AU 551.06):

- State that the audit has been performed for the purpose of forming an opinion on the basic financial statements taken as a whole.
- Identify the accompanying information. (Identification may be by descriptive title or page number of the document.)
- State that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements.
- Include either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the audit of the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.

An example of reporting on information accompanying the basic financial statements in an auditor-submitted document follows:

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The [Identify the accompanying information.] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

When the auditor disclaims an opinion on all or part of the accompanying information in a document submitted to the client or to others, the information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. An example of a report in which the auditor disclaims an opinion on all of the information follows:

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The [Identify the accompanying information.] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

An example of a report in which the auditor disclaims on only part of the information follows:

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX–YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

If the information is in a client-prepared document, the auditor may report on it under SAS Nos. 8 or 42 depending on the circumstances. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, applies to "other information" in client-prepared documents that contain financial statements on which the auditor has reported. SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, amends SAS No. 8 to specifically allow auditors to report on other information based on the procedures they applied as part of their audit of basic financial statements. According to SAS No. 8 (AU 550), as amended, the auditor can report on the information in a client-prepared document.

SAS No. 42 (AU 552), *Reporting on Condensed Financial Statements And Selected Financial Data*, provides guidance on reporting in client-prepared documents of nonpublic companies on selected financial data that are derived from audited financial statements and are presented in a document that includes the financial statements. *Derived* from audited financial statements means that the data is presented in or can be calculated from amounts presented in the financial statements.

According to SAS No. 42 (AU 552.09), such report should indicate:

- That the auditor has audited and expressed an opinion on the complete financial statements.
- The type of opinion expressed.
- Whether, in the auditor's opinion, the information set forth in the selected financial data is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.

The following is an example of an additional paragraph of the auditor's report providing assurance on the additional information:

> In our opinion, the information set forth in the Schedule of Distributions, appearing on page 5, is fairly stated, in all material respects, in relation to the summary of account from which it has been derived.

Agreed-upon Procedures. The guidance included earlier also applies to elements, accounts, or items presented as supplementary to the financial statements. However, if the report on agreed-upon procedures is combined with the report on the financial statements, the combined report must be restricted to the parties who specified the agreed-upon procedures.

RESTRICTING THE USE OF A REPORT IN COMPILATION AND REVIEW ENGAGEMENTS

SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005*, amends SSARS No. 1 by describing the circumstances in which accountants should restrict their reports, defining the terms *general use* and *restricted use*, and specifying the language that should be used in accountant's reports that are restricted as to use.

Restricted-use reports are intended only for one or more specified third parties. All other reports are considered to be *general-use* reports. SSARS No. 12 indicates that the use of the accountant's report should be restricted when the subject matter of the report or presentation being reported on is based on measurement or disclosure criteria in a contractual agreement or regulatory provisions that are not GAAP or an other comprehensive basis of accounting (OCBOA) because the basis, assumptions, or purpose of such presentations are developed for and directed only to the parties to the agreement and may be misunderstood by others.

Some CPAs have asked, however, if it is permissible to restrict the use of compilation and review reports that are not otherwise required by professional standards to be restricted. The answer is yes, such restriction is permissible. Although there are circumstances when the report is required to carry a use restriction, the accountant is not prohibited from restricting the use of any report. A practitioner who believes that restriction may be desirable should consider the following issues:

- Will the proposed restriction mitigate the practitioner's risk of lawsuits?
- Will the client accept the proposed restriction?

If the accountant issues a combined report that covers subject matter required to be restricted, as well as subject matter not required to be restricted, the accountant should restrict the use of all of the subject matter. However, when required by law to issue a separate restricted-use report in a document that also contains a general-use report, the restricted-use report remains restricted as to use, and the general-use report continues for general use. The restricted-use subject matter, however, should be clearly labeled.

Accountants may be asked to add other specified parties after the completion of the compilation or review engagement. If the accountant agrees to such a request, the accountant should obtain affirmative acknowledgment, preferably in writing, from the other parties of their understanding of the nature of the engagement, the measurement or disclosure criteria used in the engagement, and the related report. If the other parties are added after the accountant has issued his or her report, the report may be reissued or the affirmative acknowledgment obtained. If the report is reissued, the report date should not be changed. If the affirmative acknowledgment is obtained, it should state that no procedures have been performed subsequent to the date of the report.

According to SSARS No. 12, the restricted-use accountant's report should (a) indicate that the report is intended solely for the information and use of the specified parties, (b) identify the specified parties, and (c) state that the report is not intended to be and should not be used by anyone other than the specified parties. The SSARS provides the following sample report language, which should be used as the last paragraph in the restricted use accountant's report:

> This report is intended solely for the information and use of [specified parties] and is not intended to be and should not be used by anyone other than these specified parties.

Note that the report language restricts the use, not the distribution, of the report. Because of the reasons discussed earlier, the accountant should consider informing his or her client that restricted-use reports are not intended for distribution to nonspecified parties. The accountant, however, is not responsible for controlling a client's distribution of restricted-use reports.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. SSARS No. 13 applies to which of the following?

    a. Agreed-upon procedures.

    b. Compilation.

    c. Review.

    d. Audit.

38. An accountant can prepare one or more specified elements of a financial statement without issuing a compilation report.

    a. True.

    b. False.

39. Which of the following statements is correct concerning restricted-use reports issued by an accountant?

    a. Reports may be restricted-use or general-use, but not both.

    b. The accountant may restrict reports even when not required.

    c. Reports may be restricted even without specifying intended users.

    d. The report, once issued, may not be reissued.

40. Which of the following is correct concerning restricted-use reports?

    a. SSARS No. 12 includes sample report language to be used as the second paragraph.

    b. The accountant can restrict the use, not the distribution, of the report.

    c. The accountant is responsible for the distribution of the report.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

37. SSARS No. 13 applies to which of the following? **(Page 275)**

    a. Agreed-upon procedures. [This answer is incorrect. Agreed upon procedures applied to specified elements, accounts, or items of a financial statement are covered under SSAE No. 10.]

    b. Compilation. [This answer is correct. SSARS No. 13 sets forth the requirements necessary for the accountant to issue a compilation report on one or more elements, accounts, or items of the financial statements.]

    c. Review. [This answer is incorrect. Reviews of an element, account, or item are covered under the attestation standards, SSAE NO. 10, as amended by SSAE No. 11 and 12.]

    d. Audit. [This answer is incorrect. Audits of individual elements of a financial statement when the elements are presented separately are covered under SAS No. 62.]

38. An accountant can prepare one or more specified elements of a financial statement without issuing a compilation report. **(Page 276)**

    a. True. [This answer is correct. SSARS No. 13 allows accountants to prepare one or more specified elements, accounts, or items of a financial statement without issuing a report.]

    b. False. [This answer is incorrect. A compilation report is not required per SSARS No. 13; however, the accountant might consider issuing a disclaimer in this situation indicating that such a presentation has not been audited, reviewed, or compiled by the practitioner, and accordingly, no opinion or any other form of assurance is being expressed.]

39. Which of the following statements is correct concerning restricted-use reports issued by an accountant? **(Page 281)**

    a. Reports may be restricted-use or general-use, but not both. [This answer is incorrect. When required by law to issue a separate restricted-use report in a document that also contains a general-use report, the practitioner should clearly label the restricted subject matter.]

    b. The accountant may restrict reports even when not required. [This answer is correct. The decision to restrict a report when not required is based on the accountant's professional judgment and the particular circumstances surrounding the decision.]

    c. Reports may be restricted even without specifying intended users. [This answer is incorrect. Intended users must be separately identified in the restriction per SSARS No. 12.]

    d. The report, once issued, may not be reissued. [This answer is incorrect. If the list of intended users is increased, the report may be reissued or an affirmative acknowledgement may be obtained per SSARS No. 12.]

40. Which of the following is correct concerning restricted-use reports? **(Page 282)**

    a. SSARS No. 12 includes sample report language to be used as the second paragraph. [This answer is incorrect. The sample report language should be included as the final paragraph in the restricted-use accountant's report per SSARS No. 12.]

    b. The accountant can restrict the use, not the distribution, of the report. [This answer is correct. SSARS No. 12 allows the accountant to restrict the use, but the accountant can not restrict the distribution of a restricted-use report.]

    c. The accountant is responsible for the distribution of the report. [This answer is incorrect. Per SSARS No. 12, the accountant is not responsible for the client's distribution of a restricted-use report.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (AETTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

20. CPAs need to use their judgment to determine whether a listing of accounts represent a financial statement or merely something analogous to a trial balance. Which of the following attributes are of a financial statement rather than a trial balance?

    i. Combination of similar account groupings.

    ii. Accounts are arranged according to their relationship to net income.

    iii. Accounts are in account number order.

    iv. Net income is closed to trust or estate equity.

    v. Statement is titled Statement of Revenue and Expenses.

    a. i, ii, iii, iv, v.

    b. ii, iv, v.

    c. i, ii, v.

    d. i, ii, iv, v.

21. Interpretation No. 21 to SSARS No. 1 made it more difficult to determine when the accountant, who is also an executor of the estate, is acting as a public accountant for the estate.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

22. Lynn is a CPA who performed several services for her clients this week. SSARS No. 1 applies to which of the following services?

    a. Lynn prepared and presented financials to the estate of Judy Why.

    b. Lynn retypes unmodified client-prepared financials as an accommodation to the Jill Elaine Trust.

    c. Lynn prepares standard monthly journal entries for the Estate of Grant Thomas.

    d. Lynn recommends, but does not prepare disclosures to the financials of the Angel Cubby Trust.

23. SAS No. 114 provides guidance for the auditor concerning communication from those charged with governance, as well as the auditor's communication to those charged with governance. Which of the following statements is correct concerning SAS No. 114 communications?

    a. Auditors are required to communicate the auditor's responsibilities under GAAS, the exact details concerning scope and timing of the audit, and significant and relevant findings.

    b. Auditors are required to summarize, in writing, all significant matters discussed with individual members of those charged with governance and to distribute the written summary to all persons charged with governance.

    c. Auditors are required to evaluate the adequacy of communication between themselves and those charged with governance, and if found to be inadequate with no resolution, the auditor may modify the opinion to reflect a scope limitation.

    d. Do not select this answer choice.

24. SAS No. 115 defines three terms of importance when communicating internal control related matters identified during an audit of the financial statements of the estate or trust. What is the term that matches the following definition: Exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

    a. Control deficiency.

    b. Significant deficiency.

    c. Material weakness.

    d. Do not select this answer choice.

25. In order for Stacy, CPA to compile the financial statements for Lacie Trust, she must obtain a sufficient level of knowledge about the accounting principles and practices of trusts to enable her to compile the financial statements in appropriate form. When does she need to have this knowledge?

    a. Before she accepts the engagement.

    b. Before beginning the engagement.

    c. Before completing the engagement.

    d. Do not select this answer choice.

26. Stacy, CPA also needs to acquire an understanding of Lacie Trust, in addition to trusts in general. She should be able to acquire this knowledge through observation and inquiry of trust personnel. What specifically does she need to understand?

    a. The client's growth potential.

    b. Predecessor accountants' names and numbers.

    c. Lacie Trust's financial strength.

    d. Qualifications of Lacie's accounting personnel.

27. Sammie, CPA is preparing the compilation report for her client, The Whitney Trust. Which term would be best for Sammie to use to complete the following sentence of the second paragraph? A compilation is limited to presenting in the form of financial statements information that is the representation of the ________.

    a. Executor.

    b. Trustee.

    c. Administrator.

    d. Personal representative.

28. Kelly, CPA is working on a review engagement for The Estate of Michael Keith. Of the items listed below, which one would not be appropriate to include with the report?

    a. A description of additional procedures performed during the compilation engagement.

    b. Additional supporting schedules.

    c. A reference to the review report on every page of the financial statements.

    d. The review report addressed to the executor of The Estate of Michael Keith.

29. Which of the following statements is correct concerning a review of financial statements containing a material departure from GAAP?

    a. The second paragraph of the review report should be modified to indicate the departure.

    b. If the client refuses to revise the financial statements the auditor may consider issuing an adverse opinion in the review report.

    c. The auditor may optionally include a separate explanatory paragraph in addition to the separate paragraph describing the departure.

    d. Do not select this answer choice.

30. If an accountant is unable to perform all the necessary procedures in a compilation, he should not issue a report or produce financial statements.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

31. An audit report on modified cash basis financial statements does **not** require which of the following?

    a. A separate schedule reconciling the basis used to GAAP reporting.

    b. A statement indicating the basis of presentation used.

    c. A statement indicating that the basis of presentation used is an OCBOA.

    d. The opinion referring to the basis of accounting used.

32. Sally Ann, CPA has been engaged by Davis Morrill Trust. The trust uses a basis of accounting specified only in their governing documents. Which of the following statements is most correct?

    a. Sally Ann will find that the basis of accounting is an OCBOA required for governing documents by SAS No. 62.

    b. Sally Ann is allowed to audit the financial statements per Interpretation No. 28 of SSARS No. 1.

    c. If Sally Ann compiles the financial statements, she is not required to disclose the basis in the report.

    d. Sally Ann should restrict distribution of her compilation report and so state in the second paragraph.

33. Cindy Lou, CPA has been engaged to prepare The Pauline Trust tax return. If Cindy Lou were asked to perform these other procedures, which one would require application of SSARS No. 1?

    a. Cindy Lou prints a prior year tax return and gives it to the trustee at his request.

    b. Cindy Lou faxes the tax return to the beneficiary before filing the original with the IRS.

    c. Cindy Lou prepares financial statements from the information contained in the tax return.

    d. Cindy Lou prepares a spreadsheet using the tax return information to accommodate the trustee.

34. SSARS No. 8 allows CPAs to provide management-use-only financial statements without issuing a compilation report in certain situations. How likely is it that SSARS No. 8 will be applied to estates and trusts?

    a. Rarely.

    b. Somewhat unlikely.

    c. Somewhat likely.

    d. Very likely.

35. When an accountant, acting as executor for an estate, submits financial statements for the estate, who signs the transmittal letter?

    a. The testator.

    b. The executor.

    c. A probate court officer.

    d. Each beneficiary.

36. Which of the following is **not** a prescribed form under SSARS No. 3, *Compilation Reports on Financial Statements Including In Certain Prescribed Forms*?

    a. A preprinted form designed and adopted by the probate court.

    b. A preprinted form designed and adopted by the trust.

    c. A preprinted form designed by the state and adopted by the probate court.

    d. Do not select this answer choice.

37. Which of the following statements concerning elements of the financial statements is correct?

    a. Compilations of an element of the financials is covered under SSAE No. 10.

    b. SSARS No. 13 covers agreed upon procedures performed on items of the financials.

    c. SAS No. 62 covers audits of elements of the financials.

    d. SSARS No. 13 covers reviews of elements of the financials.

38. Lori, CPA is auditing individual financial statement elements of the Leslie Family Trust. Lori is required to:

    a. Express an opinion on each specified element.

    b. Express a piecemeal opinion.

    c. Report in the aggregate rather than individually.

    d. Report on the financial statements taken as a whole.

39. Which of the following provides guidance on the issuance of restricted-use reports by the accountant?

    a. SSARS No. 8.

    b. SSARS No. 12.

    c. SSARS No. 13.

    d. SAS No. 58.

40. Which of the following statements is correct concerning a restricted-use report?

    a. Reports based on measurement criteria in regulatory provisions that are not GAAP or OCBOA should be considered general-use reports.

    b. When asked to add other specified parties after completing the engagement, the accountant should obtain affirmative acknowledgement from the other parties.

    c. If a report is reissued after added other specified parties, the due date should be updated.

    d. Do not select this answer choice.

GLOSSARY

ATI: Adjusted total income. ATI is the net taxable income to be taxed to the fiduciary entity or beneficiary.

Carrying value: The value of the asset at the time the fiduciary acquired the asset.

DOD: Date of death of the testator.

DNI: Distributable net income. Taxable income recomputed with certain modifications to limit the size of the fiduciary distribution deduction and the amount included in beneficiary gross income.

FAI: Fiduciary accounting income. Accounting income as defined by the governing document and state law, FAI reflects the amount of income available for current distribution to income beneficiaries.

Fiduciary Accounting: The actual reporting or accounting that fiduciaries prepare for courts and other interested parties.

Fiduciary acquisition value: The value assets are reported at in the Summary of Account. The value is generally market value on the date assets are transferred to the fiduciary (date of death or date of transfer to trust).

Governing Document: Also known as the governing instrument or trust instrument, this document expresses the will of the fiduciary entity's creator or, in the case of an intestate death, applicable state laws. The governing document contains the terms and conditions of the fiduciary entity, and is the resource of first resort for guidance related to classifying income and expense. The 1997 UPIA replaces the term "governing document" with the phrase "terms of the trust" in recognition of the fact that an estate is essentially a trust created by statute.

Income beneficiary: Beneficiary to an estate or trust who is primarily interested in a maximizing income.

OCBOA: Other comprehensive basis of accounting, normally relevant when GAAP is not followed.

Prescribed form: Any standard preprinted form designed or adopted by the body to which it is to be submitted. An estate or trust might be asked to submit financial statements on a prescribed form that does not call for or provide space for all the matters or disclosures otherwise required by GAAP.

Remainder beneficiary: Beneficiary to an estate or trust who is primarily interested in safety and growth.

Remaindermen: Beneficiaries of the principal, or corpus, of the estate or trust.

Summary of Account: The one principal financial statement that is supported by subsidiary schedules an notes explaining items on the statement. It begins with assets on hand at the beginning of the period, shows receipts and disbursements during the period, and ends with assets on hand at the end of the period.

Tenants: Beneficiaries of trust or estate income.

TI: Taxable income. This is a tax accounting concept defined in IRC Section 641. TI is the base amount for calculating the fiduciary entity's annual income tax liability.

Those charged with governance: The persons with responsibility for overseeing the strategic direction of the entity and its obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For an estate or trust, those charged with governance will likely be the executor or trustee, or those individual appointed by the executor or trustee. SAS No. 114 further states that those charged with governance encompasses a board of directors or audit committee referred to in other auditing standards.

Undistributed Income: The balance of fiduciary income less distributions of income.

UFAP: Uniform Fiduciary Accounting Principles and Model Account Formats. A report issued May 1980 by the Committee on National Fiduciary Accounting Standards to improve clarity and consistency in fiduciary accounting.

UPIA: Uniform Principal and Income Acts. Three different acts (1931, 1962, and 1997) designed to achieve fair allocation between fiduciary principal and income. Most states have adopted the 1997 Act.

INDEX

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Accounting and Reporting for Estates and Trusts—Course 1—Fiduciary Accounting for Estates & Trusts (AETTG091)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   AETTG091 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Accounting and Reporting for Estates and Trusts—Course 1—Fiduciary Accounting for Estates & Trusts (AETTG091)

Price $79

First Name: ______________________

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Birth Month: ______________________ Licensing State: ______________________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this not like this .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: December 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Accounting and Reporting for Estates and Trusts—Course 1—Fiduciary Accounting for Estates & Trusts

Course Acronym: AETTG091

Your Name (optional): ____________________ Date: ____________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
	Low (1) . . . to . . . High (10)									
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _________

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Accounting and Reporting for Estates and Trusts—Course 2—Fiduciary Reporting for Estates & Trusts (AETTG092)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   AETTG092 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Accounting and Reporting for Estates and Trusts—Course 2—Fiduciary Reporting for Estates & Trusts (AETTG092)

Price $79

First Name: ______________________

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Firm Name: ______________________

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Express Grading Requested: ☐ Add $24.95

Signature: ______________________

Credit Card Number: ______________________ Expiration Date: ______________

Birth Month: ______________________ Licensing State: ______________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this not like this .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: December 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Accounting and Reporting for Estates and Trusts—Course 2—Fiduciary Reporting for Estates & Trusts

Course Acronym: AETTG092

Your Name (optional): ______________________ Date: ______________

Email: ______________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	1	2	3	4	5	6	7	8	9	10
	Low (1) . . . to . . . High (10)									
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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(Please print legibly):

Additional Comments:

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2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________