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OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD

JULY 1971

20

Accounting Changes

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Issued by the Accounting Principles Board of the American Institute of Certified Public Accountants

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INTRODUCTION

1. A change in accounting by a reporting entity may significantly affect the presentation of both financial position and results of operations for an accounting period and the trends shown in comparative financial statements and historical summaries. The change should therefore be reported in a manner which will facilitate analysis and understanding of the financial statements.

Scope of Opinion

2. This Opinion defines various types of accounting changes and establishes guides for determining the manner of reporting each type. It also covers reporting a correction of an error in previously issued financial statements.

3. The Opinion applies to financial statements which purport to present financial position, changes in financial position, and results of operations in conformity with generally accepted accounting principles. The guides in this Opinion also may be appropriate in presenting financial information in other forms or for special purposes. Companies in regulated industries may apply generally accepted accounting principles differently from nonregulated companies because of the effect of the rate-making process. This Opinion should therefore be applied to regulated companies in accordance with the provisions of the Addendum to APB Opinion No. 2.

4. This Opinion does not change the policy of the Board that its Opinions, unless otherwise stated, are not intended to be retroactive. Each published Opinion specifies its effective date and the manner of reporting a change to conform with the conclusions of the Opinion. An industry audit guide prepared by a committee of the American Institute of Certified Public Accountants may also prescribe the manner of reporting a change in accounting principle. Accordingly, the provisions of this Opinion do not apply to changes made in conformity with such pronouncements issued in the past or in the future.

5. This Opinion reaffirms the provisions of previous Board Opinions that prescribe the manner of reporting a change in accounting principle, an accounting estimate, or reporting entity except for the following paragraphs of Accounting Research Bulletins (ARB) or Opinions of the Accounting Principles Board (APB)[1]:

a. Paragraph 3 of Chapter 2, Section A, *Comparative Financial Statements,* of ARB No. 43 is amended to insert a cross reference to this Opinion. This Opinion identifies numerous accounting changes and specifies the manner of reporting each change.

b. Paragraph 20 of APB Opinion No. 9, *Reporting the Results of Operations,* and paragraph 13 of APB Opinion No. 15, *Earnings per Share,* are amended. This Opinion specifies an additional element in the presentation of the income statement.

c. Paragraph 25 of APB Opinion No. 9 is superseded. Although the conclusion of that paragraph is not modified, this Opinion deals more completely with accounting changes.

TYPES OF ACCOUNTING CHANGES

6. The term *accounting change* in this Opinion means a change in (a) an accounting principle, (b) an accounting estimate, or (c) the reporting entity (which is a special type of change in accounting principle classified separately for purposes of this Opinion). The correction of an error in previously issued financial statements is not deemed to be an accounting change.

Change in Accounting Principle

7. A change in accounting principle results from adoption of a generally accepted accounting principle different from the

1 This Opinion amends APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* to the extent that it relates to reporting accounting changes.

one used previously for reporting purposes. The term *accounting principle* includes "not only accounting principles and practices but also the methods of applying them."[2]

8. A characteristic of a change in accounting principle is that it concerns a choice from among two or more generally accepted accounting principles. However, neither (a) initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring is a change in accounting principle.

9. Changes in accounting principle are numerous and varied. They include, for example, a change in the method of inventory pricing, such as from the last in, first out (LIFO) method to the first in, first out (FIFO) method; a change in depreciation method for previously recorded assets, such as from the double declining balance method to the straight line method;[3] a change in the method of accounting for long-term construction-type contracts, such as from the completed contract method to the percentage of completion method; and a change in accounting for research and development expenditures, such as from recording as expense when incurred to deferring and amortizing the costs. (Paragraph 11 covers a change in accounting principle to effect a change in estimate.)

Change in Accounting Estimate

10. Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements. Preparing financial statements requires estimating the effects of future events. Examples of items for which estimates are

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[2] Statement on Auditing Procedure No. 33, *Auditing Standards and Procedures,* chapter 7, paragraph 2.

[3] A change to the straight line method at a specific point in the service life of an asset may be planned at the time the accelerated depreciation method is adopted to fully depreciate the cost over the estimated life of the asset. Consistent application of such a policy does not constitute a change in accounting principle for purposes of applying this Opinion. (Paragraph 5-d of APB Opinion No. 12 covers disclosure of methods of depreciation.)

necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, warranty costs, periods benefited by a deferred cost, and recoverable mineral reserves. Future events and their effects cannot be perceived with certainty; estimating, therefore, requires the exercise of judgment. Thus accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.

11. *Change in estimate effected by a change in accounting principle.* Distinguishing between a change in an accounting principle and a change in an accounting estimate is sometimes difficult. For example, a company may change from deferring and amortizing a cost to recording it as an expense when incurred because future benefits of the cost have become doubtful. The new accounting method is adopted, therefore, in partial or complete recognition of the change in estimated future benefits. The effect of the change in accounting principle is inseparable from the effect of the change in accounting estimate. Changes of this type are often related to the continuing process of obtaining additional information and revising estimates and are therefore considered as changes in estimates for purposes of applying this Opinion.

Change in the Reporting Entity

12. One special type of change in accounting principle results in financial statements which, in effect, are those of a different reporting entity. This type is limited mainly to (a) presenting consolidated or combined statements in place of statements of individual companies, (b) changing specific subsidiaries comprising the group of companies for which consolidated financial statements are presented, and (c) changing the companies included in combined financial statements. A different group of companies comprise the reporting entity after each change. A business combination accounted for by the pooling of interests method also results in a different reporting entity.

Correction of an Error in Previously Issued Financial Statements

13. Reporting a correction of an error in previously issued financial statements concerns factors similar to those relating to reporting an accounting change and is therefore discussed in this Opinion.[4] Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgment. Thus, an error is distinguishable from a change in estimate. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error for purposes of applying this Opinion.

VIEWS ON REPORTING CHANGES IN ACCOUNTING PRINCIPLES

14. An essential question in reporting a change in accounting principle is whether to restate the financial statements currently presented for prior periods to show the new accounting principle applied retroactively. A summary of differing views bearing on that question is:

a. Accounting principles should be applied consistently for all periods presented in comparative financial statements. Using different accounting principles for similar items in financial statements presented for various periods may result in misinterpretations of earnings trends and other analytical data that are based on comparisons. The same accounting principle therefore should be used in presenting financial statements of current and past periods. Accordingly, financial statements presented for prior periods in current reports should be restated if a reporting entity changes an accounting principle.

[4] Statement on Auditing Procedure No. 41, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* discusses other aspects of errors in previously issued financial statements.

b. Restating financial statements of prior periods may dilute public confidence in financial statements and may confuse those who use them. Financial statements previously prepared on the basis of accounting principles generally accepted at the time the statements were issued should therefore be considered final except for changes in the reporting entity or corrections of errors.

c. Restating financial statements of prior periods for some types of changes requires considerable effort and is sometimes impossible. For example, adequate information may not be available to restate financial statements of prior periods if the method of recording revenue from long-term contracts is changed from the completed contract method to the percentage of completion method.

d. Restating financial statements of prior periods for some changes requires assumptions that may furnish results different from what they would have been had the newly adopted principle been used in prior periods. For example, if the method of pricing inventory is changed from the FIFO method to the LIFO method, it may be assumed that the ending inventory of the immediately preceding period is also the beginning inventory of the current period for the LIFO method. The retroactive effects under that assumption may be different from the effects of assuming that the LIFO method was adopted at an earlier date.

OPINION

Justification for a Change in Accounting Principle

15. The Board concludes that in the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users by facilitating analysis and understanding of comparative accounting data.

16. The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable. However, a method of accounting that was previously adopted for a type of transaction or event which is being terminated or which was a single, nonrecurring event in the past should not be changed. For example, the method of accounting should not be changed for a tax or tax credit which is being discontinued or for preoperating costs relating to a specific plant. The Board does not intend to imply, however, that a change in the estimated period to be benefited for a deferred cost (if justified by the facts) should not be recognized as a change in accounting estimate. The issuance of an Opinion of the Accounting Principles Board that creates a new accounting principle, that expresses a preference for an accounting principle, or that rejects a specific accounting principle is sufficient support for a change in accounting principle. The burden of justifying other changes rests with the entity proposing the change.[5]

General Disclosure—A Change in Accounting Principle

17. The nature of and justification for a change in accounting principle and its effect on income should be disclosed in the financial statements of the period in which the change is made. The justification for the change should explain clearly why the newly adopted accounting principle is preferable.

Reporting A Change in Accounting Principle

18. The Board believes that, although they conflict, both (a) the potential dilution of public confidence in financial statements resulting from restating financial statements of prior periods and (b) consistent application of accounting principles in comparative statements are important factors in reporting a change in accounting principles. The Board concludes that most changes in accounting should be recognized by including the cumulative effect, based on a retroactive computation, of changing to a new accounting principle in net income of the

[5] The issuance of an industry audit guide by a committee of the American Institute of Certified Public Accountants also constitutes sufficient support for a change in accounting principle (paragraph 4).

period of the change (paragraphs 19 to 26) but that a few specific changes in accounting principles should be reported by restating the financial statements of prior periods (paragraphs 27 to 30 and 34 to 35).

19. For all changes in accounting principle except those described in paragraphs 27 to 30 and 34 to 35, the Board therefore concludes that:

a. Financial statements for prior periods included for comparative purposes should be presented as previously reported.
b. The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of the period of the change (paragraph 20).
c. The effect of adopting the new accounting principle on income before extraordinary items and on net income (and on the related per share amounts) of the period of the change should be disclosed.
d. Income before extraordinary items and net income computed on a pro forma basis[6] should be shown on the face of the income statements for all periods presented as if the newly adopted accounting principle had been applied during all periods affected (paragraph 21).

Thus, income before extraordinary items and net income (exclusive of the cumulative adjustment) for the period of the change should be reported on the basis of the newly adopted accounting principle. The conclusions in this paragraph are modified for various special situations which are described in paragraphs 23 to 30.

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[6] The pro forma amounts include both (a) the direct effects of a change and (b) nondiscretionary adjustments in items based on income before taxes or net income, such as profit sharing expense and certain royalties, that would have been recognized if the newly adopted accounting principle had been followed in prior periods: related income tax effects should be recognized for both (a) and (b). Direct effects are limited to those adjustments that would have been recorded to restate the financial statements of prior periods to apply retroactively the change. The nondiscretionary adjustments described in (b) should not therefore be recognized in computing the adjustment for the cumulative effect of the change described in paragraph 20 unless nondiscretionary adjustments of the prior periods are actually recorded.

20. *Cumulative effect of a change in accounting principle.* The amount shown in the income statement for the cumulative effect of changing to a new accounting principle is the difference between (a) the amount of retained earnings at the beginning of the period of a change and (b) the amount of retained earnings that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods which would have been affected and by recognizing only the direct effects of the change and related income tax effect.[7] The amount of the cumulative effect should be shown in the income statement between the captions "extraordinary items" and "net income." The cumulative effect is not an extraordinary item but should be reported in a manner similar to an extraordinary item. The per share information shown on the face of the income statement should include the per share amount of the cumulative effect of the accounting change.

21. *Pro forma effects of retroactive application.* Pro forma effects of retroactive application (paragraph 19-d including footnote 6) should be shown on the face of the income statement for income before extraordinary items and net income. The earnings per share amounts (primary and fully diluted, as appropriate under APB Opinion No. 15, *Earnings per Share*) for income before extraordinary items and net income computed on a pro forma basis should be shown on the face of the income statement. If space does not permit, such per share amounts may be disclosed prominently in a separate schedule or in tabular form in the notes to the financial statements with appropriate cross reference; when this is done the actual per share amounts should be repeated for comparative purposes. Pro forma amounts should be shown in both current and future reports for all periods presented which are prior to the change and which would have been affected. Appendix A illustrates the manner of reporting a change in accounting principle. If an income statement is presented for the current period only, the actual and the pro forma amounts (and related per share data) for the immediately preceding period should be disclosed.

[7] See footnote 6.

22. The principal steps in computing and reporting the cumulative effect and the pro forma amounts of a change in accounting principle may be illustrated by a change in depreciation method for previously recorded assets as follows:

a. The class or classes of depreciable assets to which the change applies should be identified. (A "class of assets" relates to general physical characteristics.)

b. The amount of accumulated depreciation on recorded assets at the beginning of the period of the change should be recomputed on the basis of applying retroactively the new depreciation method. Accumulated depreciation should be adjusted for the difference between the recomputed amount and the recorded amount. Deferred taxes should be adjusted for the related income tax effects.

c. The cumulative effect on the amount of retained earnings at the beginning of the period of the change resulting from the adjustments referred to in (b) above should be shown in the income statement of the period of the change.

d. The pro forma amounts should give effect to the pro forma provisions for depreciation of each prior period presented and to the pro forma adjustments of nondiscretionary items,[8] computed on the assumption of retroactive application of the newly adopted method to all prior periods and adjusted for the related income tax effects.

23. *Change in method of amortization and related disclosure.* Accounting for the costs of long-lived assets requires adopting a systematic pattern of charging those costs to expense. These patterns are referred to as depreciation, depletion, or amortization methods (all of which are referred to in this Opinion as methods of amortization). Various patterns of charging costs to expenses are acceptable for depreciable assets; fewer patterns are acceptable for other long-lived assets.

24. Various factors are considered in selecting an amortization method for identifiable assets, and those factors may change,

[8] See footnote 6.

even for similar assets. For example, a company may adopt a new method of amortization for newly acquired, identifiable, long-lived assets and use that method for all additional new assets of the same class but continue to use the previous method for existing balances of previously recorded assets of that class. For that type of change in accounting principle, there is no adjustment of the type outlined in paragraphs 19-22, but a description of the nature of the change in method and its effect on income before extraordinary items and net income of the period of the change, together with the related per share amounts, should be disclosed. If the new method of amortization is however applied to previously recorded assets of that class, the change in accounting principle requires an adjustment for the cumulative effect of the change and the provisions of paragraphs 15 to 22 should be applied.

25. *Pro forma amounts not determinable.* In rare situations the pro forma amounts described in paragraph 21 cannot be computed or reasonably estimated for individual prior periods, although the cumulative effect on retained earnings at the beginning of the period of change can be determined. The cumulative effect should then be reported in the income statement of the period of change in the manner described in paragraph 20. The reason for not showing the pro forma amounts by periods should be explained because disclosing those amounts is otherwise required and is expected by users of financial statements.

26. *Cumulative effect not determinable.* Computing the effect on retained earnings at the beginning of the period in which a change in accounting principle is made may sometimes be impossible. In those rare situations, disclosure will be limited to showing the effect of the change on the results of operations of the period of change (including per share data) and to explaining the reason for omitting accounting for the cumulative effect and disclosure of pro forma amounts for prior years. The principal example of this type of accounting change is a change in inventory pricing method from FIFO to LIFO for which the difficulties in computing the effects of that change are described in paragraph 14-d.

27. *Special changes in accounting principle reported by applying retroactively the new method in restatements of prior periods.* Certain changes in accounting principle are such that the advantages of retroactive treatment in prior period reports outweigh the disadvantages. Accordingly, for those few changes, the Board concludes that the financial statements of all prior periods presented should be restated. The changes that should be accorded this treatment are: (a) a change from the LIFO method of inventory pricing to another method, (b) a change in the method of accounting for long-term construction-type contracts, and (c) a change to or from the "full cost" method of accounting which is used in the extractive industries.

28. The nature of and justification for a change in accounting principle described in paragraph 27 should be disclosed in the financial statements for the period the change was adopted. In addition, the effect of the change on income before extraordinary items, net income, and the related per share amounts should be disclosed for all periods presented. This disclosure may be on the face of the income statement or in the notes. Appendix B illustrates the manner of reporting a change in accounting principle retroactively by restating the statements of those prior periods affected. Financial statements of subsequent periods need not repeat the disclosures.

29. *Special exemption for an initial public distribution.* The Board concludes that in one specific situation the application of the foregoing provisions of this Opinion may result in financial statement presentations of results of operations that are not of maximum usefulness to intended users. For example, a company owned by a few individuals may decide to change from one acceptable accounting principle to another acceptable principle in connection with a forthcoming public offering of shares of its equity securities. The potential investors may be better served by statements of income for a period of years reflecting the use of the newly adopted accounting principles because they will be the same as those expected to be used in future periods. In recognition of this situation, the Board concludes that financial statements for all prior periods presented

may be restated retroactively when a company first issues its financial statements for any one of the following purposes: (a) obtaining additional equity capital from investors, (b) effecting a business combination, or (c) registering securities. This exemption is available only once for changes made at the time a company's financial statements are first used for any of those purposes and is not available to companies whose securities currently are widely held.

30. The company should disclose in financial statements issued under the circumstances described in paragraph 29 the nature of the change in accounting principle and the justification for it (paragraph 17).

Reporting a Change in Accounting Estimate

31. The Board concludes that the effect of a change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.[9]

32. A change in accounting estimate that is recognized in whole or in part by a change in accounting principle should be reported as a change in an estimate because the cumulative effect attributable to the change in accounting principle cannot be separated from the current or future effects of the change in estimate (paragraph 11). Although that type of accounting change is somewhat similar to a change in method of amortization (paragraphs 23 and 24), the accounting effect of a change in a method of amortization can be separated from the effect of a change in the estimate of periods of benefit or service and residual values of assets. A change in method of amortization for previously recorded assets therefore should be treated as a change in accounting principle, whereas a change

[9] Financial statements of a prior period should not be restated for a change in estimate resulting from later resolution of an uncertainty which may have caused the auditor to qualify his opinion on previous financial statements unless the change meets all the conditions for a prior period adjustment (paragraph 23 of APB Opinion No. 9).

in the estimated period of benefit or residual value should be treated as a change in accounting estimate.

33. *Disclosure.* The effect on income before extraordinary items, net income and related per share amounts of the current period should be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, disclosure is recommended if the effect of a change in the estimate is material.

Reporting a Change in the Entity

34. The Board concludes that accounting changes which result in financial statements that are in effect the statements of a different reporting entity (paragraph 12) should be reported by restating the financial statements of all prior periods presented in order to show financial information for the new reporting entity for all periods.

35. *Disclosure.* The financial statements of the period of a change in the reporting entity should describe the nature of the change and the reason for it. In addition, the effect of the change on income before extraordinary items, net income, and related per share amounts should be disclosed for all periods presented. Financial statements of subsequent periods need not repeat the disclosures. (Paragraphs 56 to 65 and 93 to 96 of APB Opinion No. 16, *Business Combinations,* describe the manner of reporting and the disclosures required for a change in reporting entity that occurs because of a business combination.)

Reporting a Correction of an Error in Previously Issued Financial Statements

36. The Board concludes that correction of an error in the financial statements of a prior period discovered subsequent to their issuance (paragraph 13) should be reported as a prior

period adjustment. (Paragraph 18 of APB Opinion No. 9 covers the manner of reporting prior period adjustments.)

37. *Disclosure.* The nature of an error in previously issued financial statements and the effect of its correction on income before extraordinary items, net income, and the related per share amounts should be disclosed in the period in which the error was discovered and corrected. Financial statements of subsequent periods need not repeat the disclosures.

Materiality

38. The Board concludes that a number of factors are relevant to the materiality of (a) accounting changes contemplated in this Opinion and (b) corrections of errors, in determining both the accounting treatment of these items and the necessity for disclosure. Materiality should be considered in relation to both the effects of each change separately and the combined effect of all changes. If a change or correction has a material effect on income before extraordinary items or on net income of the current period before the effect of the change, the treatments and disclosures described in this Opinion should be followed. Furthermore, if a change or correction has a material effect on the trend of earnings, the same treatments and disclosures are required. A change which does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods should be disclosed whenever the financial statements of the period of change are presented.

Historical Summaries of Financial Information

39. Summaries of financial information for a number of periods are commonly included in financial reports. The summaries often show condensed income statements, including related earnings per share amounts, for five years or more. In many annual reports to stockholders, the financial highlights present similar information in capsule form. The Board concludes that all such information should be prepared in the same manner (including the presentation of pro forma amounts) as that prescribed in this Opinion for primary

financial statements (paragraphs 15 to 38) because the summaries include financial data based on the primary financial statements. In a summary of financial information that includes an accounting period in which a change in accounting principle was made, the amount of the cumulative effect of the change that was included in net income of the period of the change should be shown separately along with the net income and related per share amounts of that period and should not be disclosed only by a note or parenthetical notation.

EFFECTIVE DATE

40. The provisions of this Opinion are effective for fiscal years beginning after July 31, 1971. However, the Board encourages application of the provisions of this Opinion in reporting any accounting changes included in fiscal years beginning before August 1, 1971 but not yet reported in financial statements issued for the year of the change.

The Opinion entitled "Accounting Changes" was adopted by the assenting votes of twelve members of the Board. Messrs. Catlett, Halvorson, Harrington, Kessler, Luper, and Watt dissented.

Messrs. Catlett, Kessler and Luper dissent to this Opinion because they believe that when a change in accounting principles is made the financial statements for prior periods should be restated on the same basis as those for the current period. The Board has reached a similar conclusion in most previous Opinions, since such Opinions have encouraged or required retroactive treatment for recommended changes in accounting principles. They also believe that the cumulative adjustments applicable to prior periods arising from changes in accounting principles have no bearing upon the current results of operations and should not be included in the determination of net income for the current period. This Opinion recognizes that consistent use of accounting principles "enhances the utility of financial statements to users by facilitating analysis and understanding of comparative accounting data" and that changes in accounting principles should not be made unless the principle adopted is "preferable." Yet, when such changes

are made, this Opinion places severe constraints on restatement and thus not only precludes "preferable" accounting for prior periods in many areas but also impairs the comparability of the financial statements.

Mr. Harrington and Messrs. Catlett, Kessler and Luper dissent to this Opinion because in their view the great divergence between the selective requirements for restatement in paragraphs 27, 29 and 34 and the general requirements for cumulative adjustments in paragraphs 19 and 24 is not based on any supportable rationale; and such general requirements will be confusing and will contribute far more to the dilution of public confidence in financial reporting than would the restatement of prior periods for all changes in accounting principles. Furthermore, Messrs. Catlett, Harrington and Luper are particularly concerned with the continuing tendency of the Board to attempt to eliminate alleged "abuses" by means of arbitrary rules and to use accounting requirements as a disciplinary tool rather than to establish standards for the most meaningful financial reports for investors and other users of financial statements. They believe that the cumbersome requirements of this Opinion will discourage improvements in accounting in numerous areas on which the Board will not issue Opinions for many years.

Mr. Halvorson dissents because he believes that all income and expense should be included in the income statement once and neither more nor less than once, and that this can really be achieved only if newly-adopted principles are applied prospectively. The cumulative adjustment required by the Opinion for most accounting changes ignores this cardinal tenet of reporting by effectively obscuring the result if the one-time inclusion is accommodated in the cumulative adjustment and completely negating the desired result when the cumulative adjustment requires duplication in the future of items already accounted for and reported in earlier periods. He believes that restatement ("actual" or pro forma) of information previously published in good faith will endanger the credibility of financial reporting and that availability of the cumulative-adjustment device will minimize the disciplinary effect that accounting has on the issuers of financial statements. It should be sufficient to report the dollar effect of a change (the "inconsistency") in the

year of change, and in a multi-period statement including the year of change to disclose the principle applied in each of the several included periods. It is the further view of Mr. Halvorson that the required pro forma presentation for past years cannot properly report the operating results for such years as they would have been if the newly-adopted principle had then been used, because reported operating results themselves have a compelling influence on non-accounting operating decisions in such areas as pricing and methods of financing, and the effect of such decisions cannot be arithmetically reconstructed to reflect the effect of what might have been.

Mr. Watt dissents to this Opinion because its conclusions are not in accord with his view that the best presentation is one that does not require excessive interpretation by the financial statement user. He believes that, with respect to accounting changes, it is more important for statements presented in comparative form to be comparable in detail than for historical continuity to be retained there; such continuity is important and changes to amounts previously reported can be adequately reconciled in the notes to financial statements. Thus, the presumption should be that, with respect to accounting changes, retroactive restatement is most desirable wherever statements are presented in comparative form. The exception to this would be where the change relates to items whose carrying amount involves a substantial valuation judgment. Mr. Watt is in agreement with the conclusion in the Opinion that depreciation lives of assets are an element of the estimation process and changes therein should be applied prospectively. He believes, however, that depreciation method changes, although conceptually accounting changes, are inextricably tied to subjective judgment of the periods of exhaustion of the useful lives of assets and therefore the selection of a method is usually the result of a composite decision involving both methods and estimated useful lives. Thus, it is his view that all changes in depreciation methods should be reflected prospectively. Similarly, accounting changes relating to the amortization of depletable costs, goodwill, preoperating and research and development cost, etc. should be reflected prospectively. This view as it relates to pension accruals is also consistent with that expressed in paragraph 47

of APB Opinion No. 8, *Accounting for the Cost of Pension Plans,* that a change in accounting method should be applied prospectively.

NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

Accounting Principles Board (1971)

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APPENDIX A

An Illustration of Reporting a Change in Accounting Principle (Pursuant to Paragraphs 19 to 22)

41. ABC Company decides in 1971 to adopt the straight line method of depreciation for plant equipment. The straight line method will be used for new acquisitions as well as for previously acquired plant equipment for which depreciation had been provided on an accelerated method.

42. This illustration assumes that the direct effects are limited to the effect on depreciation and related income tax provisions and that the direct effect on inventories is not material. The pro forma amounts have been adjusted for the hypothetical effects of the change in the provisions for incentive compensation. The per share amounts are computed assuming that 1,000,000 shares of common stock are issued and outstanding, that 100,000 additional shares would be issued if all outstanding bonds (which are not common stock equivalents) are converted, and that the annual interest expense, less taxes, for the convertible bonds is $25,000. Other data assumed for this illustration are —

Year	*Excess of Accelerated Depreciation Over Straight Line Depreciation*	*Effects of Change*	
		Direct, Less Tax Effect	*Pro forma (Note A)*
Prior to 1967	$ 20,000	$ 10,000	$ 9,000
1967	80,000	40,000	36,000
1968	70,000	35,000	31,500
1969	50,000	25,000	22,500
1970	30,000	15,000	13,500
Total at beginning of 1971	$250,000	$125,000	$112,500

43. The manner of reporting the change in two-year comparative statements is —

	1971	*1970*
Income before extraordinary item and cumulative effect of a change in accounting principle	$1,200,000	$1,100,000
Extraordinary item (description)	(35,000)	100,000
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method (Note A)	125,000	
Net Income	$1,290,000	$1,200,000
Per share amounts —		
Earnings per common share — assuming no dilution:		
Income before extraordinary item and cumulative effect of a change in accounting principle	$1.20	$1.10
Extraordinary item	(0.04)	0.10
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method	0.13	
Net income	$1.29	$1.20
Earnings per common share — assuming full dilution:		
Income before extraordinary item and cumulative effect of a change in accounting principle	$1.11	$1.02
Extraordinary item	(0.03)	0.09
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method	0.11	
Net income	$1.19	$1.11
Pro forma amounts assuming the new depreciation method is applied retroactively—		
Income before extraordinary item	$1,200,000	$1,113,500
Earnings per common share— assuming no dilution	$1.20	$1.11
Earnings per common share— assuming full dilution	$1.11	$1.04
Net income	$1,165,000	$1,213,500
Earnings per common share— assuming no dilution	$1.17	$1.21
Earnings per common share— assuming full dilution	$1.08	$1.13

(See accompanying note to the financial statements)

NOTE A:

Change in Depreciation Method for Plant Equipment

Depreciation of plant equipment has been computed by the straight line method in 1971. Depreciation of plant equipment in prior years, beginning in 1954, was computed by the sum of the years digits method. The new method of depreciation was adopted to recognize . . . (state justification for change of depreciation method) . . . and has been applied retroactively to equipment acquisitions of prior years. The effect of the change in 1971 was to increase income before extraordinary item by approximately $10,000 (or one cent per share). The adjustment of $125,000 (after reduction for income taxes of $125,000) to apply retroactively the new method is included in income of 1971. The pro forma amounts shown on the income statement have been adjusted for the effect of retroactive application on depreciation, the change in provisions for incentive compensation which would have been made had the new method been in effect, and related income taxes.

44. The manner of reporting the change in five-year comparative statements is –

	1971	*1970*	*1969*	*1968*	*1967*
Income before extraordinary item and cumulative effect of a change in accounting principle	$1,200,000	$1,100,000	$1,300,000	$1,000,000	$800,000
Extraordinary item	(35,000)	100,000		40,000	
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method (Note A)	125,000				
Net income	$1,290,000	$1,200,000	$1,300,000	$1,040,000	$800,000
Earnings per common share—assuming no dilution:					
Income before extraordinary item and cumulative effect of change in accounting principle	$1.20	$1.10	$1.30	$1.00	$0.80
Extraordinary item	(0.04)	0.10		0.04	
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method	0.13				
Net income	$1.29	$1.20	$1.30	$1.04	$0.80

Earnings per common share—assuming full dilution:					
Income before extraordinary item and cumulative effect of change in accounting principle	$1.11	$1.02	$1.20	$0.93	$0.75
Extraordinary item	(0.03)	0.09		0.04	
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method	0.11				
Net income	$1.19	$1.11	$1.20	$0.97	$0.75
Pro forma amounts assuming the new depreciation method is applied retroactively:					
Income before extraordinary item	$1,200,000	$1,113,500	$1,322,500	$1,031,500	$836,000
Earnings per common share — assuming no dilution	$1.20	$1.11	$1.32	$1.03	$0.84
Earnings per common share — assuming full dilution	$1.11	$1.04	$1.23	$0.96	$0.78
Net income	$1,165,000	$1,213,500	$1,322,500	$1,071,500	$836,000
Earnings per common share — assuming no dilution	$1.17	$1.21	$1.32	$1.07	$0.84
Earnings per common share — assuming full dilution	$1.08	$1.13	$1.23	$1.00	$0.78

A note similar to Note A of this Appendix should accompany the five-year comparative income statement.

APPENDIX B

An Illustration of Reporting a Special Change in Accounting Principle By Restating Prior Period Financial Statements (Pursuant to Paragraphs 27 and 28)

45. XYZ Company decides in 1971 to adopt the percentage of completion method in accounting for all of its long-term construction contracts. The company had used in prior years the completed contract method and had maintained records which are adequate to apply retroactively the percentage of completion method. The change in accounting principle is to be reported in the manner described in paragraphs 27 and 28 of this Opinion.

46. The direct effect of the change in accounting principle and other data assumed for this illustration are —

	Pre-tax Income Reported by		*Difference in Income*	
Year	*Percentage of Completion Method*	*Completed Contract Method*	*Direct*	*Less Tax Effect*
Prior to 1967 . . .	$1,800,000	$1,300,000	$500,000	$250,000
1967	900,000	800,000	100,000	50,000
1968	700,000	1,000,000	(300,000)	(150,000)
1969	800,000	600,000	200,000	100,000
1970	1,000,000	1,100,000	(100,000)	(50,000)
Total at beginning of 1971 .	5,200,000	4,800,000	400,000	200,000
1971	1,100,000	900,000	200,000	100,000
Total	$6,300,000	$5,700,000	$600,000	$300,000

The per share amounts are computed assuming that 1,000,000 shares of common stock are issued and outstanding, that 100,000 additional shares would be issued if all outstanding bonds (which are not common stock equivalents) are converted, and that the annual interest expense, less taxes, for the convertible bonds is $25,000.

47. The manner of reporting the change in two-year comparative statements is —

Income Statement:

	1971	1970 as adjusted (Note A)
Income before extraordinary item	$ 550,000	$ 500,000
Extraordinary item (description) .		(80,000)
Net Income	$ 550,000	$ 420,000
Per share amounts:		
Earnings per common share—assuming no dilution:		
Income before extraordinary item	$0.55	$0.50
Extraordinary item		(.08)
Net Income	$0.55	$0.42
Earnings per common share—assuming full dilution:		
Income before extraordinary item	$0.52	$0.47
Extraordinary item		(.07)
Net Income	$0.52	$0.40

Statement of Retained Earnings:

	1971	1970 as adjusted (Note A)
Balance at beginning of year, as previously reported	$17,800,000	$17,330,000
Add adjustment for the cumulative effect on prior years of applying retroactively the new method of accounting for long-term contracts (Note A)	200,000	250,000
Balance at beginning of year, as adjusted	$18,000,000	$17,580,000
Net income	550,000	420,000
Balance at end of year	$18,550,000	$18,000,000

(See accompanying note to the financial statements)

NOTE A:

Change in Method of Accounting for Long-Term Contracts

The company has accounted for revenue and costs for long-term construction contracts by the percentage of completion method in 1971, whereas in all prior years revenue and costs were determined by the completed contract method. The new method of accounting for long-term contracts was adopted to recognize . . . (state justification for change in accounting principle) . . . and financial statements of prior years have been restated to apply the new method retroactively. For income tax purposes, the completed contract method has been continued. The effect of the accounting change on income of 1971 and on income as previously reported for 1970 is —

	Increase (Decrease)	
Effect on —	*1971*	*1970*
Income before extraordinary item and net income	$100,000	$(50,000)
Earnings per common share — assuming no dilution	$0.10	($0.05)
Earnings per common share — assuming full dilution	$0.09	($0.05)

The balances of retained earnings for 1970 and 1971 have been adjusted for the effect (net of income taxes) of applying retroactively the new method of accounting.

48. A note to a five-year summary of financial statements should disclose the effect of the change on net income and related per share amounts for the periods affected in the following manner:

NOTE A:

Change in Method of Accounting for Long-Term Contracts

The company has accounted for revenue and costs for long-term construction contracts by the percentage of completion method in 1971, whereas in all prior years revenue and costs were determined by the completed contract method. The new method of accounting for long-term contracts was adopted to recognize . . . (state justification for change in accounting principle) . . . and financial statements of prior years have been restated to apply the new method retroactively. For income tax purposes, the completed contract method has been continued. The effect of the accounting change on net income as previously reported for 1970 and prior years is —

	1970	*1969*	*1968*	*1967*
Net income as previously reported	$470,000	$300,000	$500,000	$400,000
Adjustment for effect of a change in accounting principle that is applied retroactively	(50,000)	100,000	(150,000)	50,000
Net income as adjusted	$420,000	$400,000	$350,000	$450,000
Per share amounts:				
Earnings per common share — assuming no dilution:				
Net income as previously reported	$0.47	$0.30	$0.50	$0.40
Adjustment for effect of a change in accounting principle that is applied retroactively	(0.05)	0.10	(0.15)	0.05
Net income as adjusted	$0.42	$0.40	$0.35	$0.45
Earnings per common share — assuming full dilution:				
Net income as previously reported	$0.45	$0.30	$0.47	$0.38
Adjustment for effect of a change in accounting principle that is applied retroactively	(0.05)	0.09	(0.13)	0.05
Net income as adjusted	$0.40	$0.39	$0.34	$0.43