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PROFESSIONAL STANDARDS

VOLUME 3

ACCOUNTING

• *Current Text*

AS OF JULY 1, 1978

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The materials in this volume have been prepared and compiled by the staff of the American Institute of Certified Public Accountants, and have not been reviewed or approved by the Financial Accounting Standards Board.

HOW TO USE THIS VOLUME

Scope of the Volume . . .

This volume, which is a reprint of volumes 3 & 4, looseleaf editions of *AICPA Professional Standards,* includes the currently effective Accounting Research Bulletins, the Opinions and Statements of the Accounting Principles Board, the Accounting Interpretations issued by the AICPA, the Statements and Interpretations of the Financial Accounting Standards Board, the successor to the Accounting Principles Board, and the Statements of the International Accounting Standards Committee.

How this Volume is arranged . . .

The contents of this volume are arranged as follows:

Preface, Introduction
Financial Accounting—General
Financial Statement Presentation
Revenue and Expense
Assets
Liabilities and Deferred Credits
Capital
Special Industry Applications
International Accounting Standards
AICPA Accounting Interpretations

How to use this Volume . . .

The arrangement of material in this volume is indicated in the general table of contents at the front of the volume. There is a detailed table of contents covering the material within each major division.

The major divisions are divided into sections, each with its own section number. Each paragraph within a section is decimally numbered. For example, AC section 2012.20 refers to the twentieth paragraph of section 2012, *Reporting the Results of Operations.* AICPA Accounting Interpretations have the same section number as the section to which they relate, but the number is always preceded by a "U". For example, AC section U1091 refers to AICPA Accounting Interpretations of section 1091, *Accounting for Business Combinations.*

FASB Statements are located in the major divisions related to their subject matter. FASB Interpretations are assigned the same section numbers as the pronouncements to which they relate except

that a hyphenated number in serial order is added. For example, section 4211-1 is the first interpretation of section 4211.

Statements of International Accounting Standards are included in section 9000 in chronological order.

Appendix A is a cross-reference index which lists the Accounting Research Bulletins, Opinions and Statements of the Accounting Principles Board, Statements and Interpretations of the Financial Accounting Standards Board, and Statements of International Accounting Standards in numerical order cross-referenced to the section numbers in this volume in which material from the pronouncements still in effect may be found.

Appendix B is a cross-reference index which is arranged by section numbers in this volume and which indicates the Accounting Research Bulletins, Opinions and Statements of the Accounting Principles Board, Statements and Interpretations of the Financial Accounting Standards Board, and Statements of International Accounting Standards from which the material in the section was derived.

Appendix C is a schedule of the major changes which have taken place in Accounting Research Bulletins 43 through 51, in the Opinions and Statements of the Accounting Principles Board, and pronouncements of the Financial Accounting Standards Board since June 1953 when ARB No. 43 was issued. The dates of change are also indicated.

Appendix D is a cross-reference index which is arranged by section numbers and which indicates the AICPA Accounting Interpretations and FASB Interpretations relating to the official pronouncements. By reference to this appendix, it is possible to determine whether an Interpretation has been issued on any official pronouncement.

Appendix E lists the American Institute of Certified Public Accountants Industry Audit/Accounting Guides and Statements of Position. Accounting principles applicable to specialized situations are discussed in these publications.

The topical index uses the key word method to facilitate reference to the pronouncements. This index is arranged alphabetically by subject, with references to section and paragraph numbers.

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AC Section 100

Preface • Introduction

FINANCIAL ACCOUNTING—GENERAL

. . . preface and introduction to current text of accounting pronouncements . . . fundamentals of financial accounting . . . nonmonetary transactions . . . changes in accounting principles and estimates . . . price-level changes . . . foreign operations . . . business combinations

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AC Section 100

Preface

(This preface represents a combination of the preface prepared by the committee on accounting procedure in 1953 for Accounting Research Bulletin Number 43, *Restatement and Revision of Accounting Research Bulletins,* and a statement of subsequent developments.)

.01 Since its organization the American Institute of Certified Public Accountants, aware of divergences in accounting procedures and of an increasing interest by the public in financial reporting, has given consideration to problems raised by these divergences. Its studies led it, in 1932, to make certain recommendations to the New York Stock Exchange which were adopted by the Institute in 1934. Further consideration developed into a program of research and the publication of opinions, beginning in 1938, in a series of Accounting Research Bulletins.

.02 Forty-two bulletins were issued during the period from 1939 to 1953. Eight of these were reports of the committee on terminology. The other 34 were the result of research by the committee on accounting procedure directed to those segments of accounting practice where problems were most demanding and with which business and the accounting profession were most concerned at the time.

.03 Some of these studies were undertaken to meet new business or economic developments. Some arose out of the war which ended in 1945 and the problems following in its wake. Certain of the bulletins were amended, superseded, or withdrawn as changing conditions affected their usefulness.

.04 Although the committee has approved the objective of finding a better term than the word *surplus* for use in published financial statements, it has used *surplus* herein as being a technical term well understood among accountants, to whom its pronouncements are primarily directed.

.05 The committee on accounting procedure and the committee on terminology of the American Institute of Certified Public Accountants were superseded on Septem-

ber 1, 1959, by the Accounting Principles Board. At its first meeting, on September 11, 1959, the Board approved the following resolution:

> The Accounting Principles Board of the American Institute of Certified Public Accountants on September 1, 1959, assumed the responsibilities of the former committees on accounting procedure and on terminology.
>
> During its existence, the committee on accounting procedure issued a series of accounting research bulletins and the committee on terminology issued a series of accounting terminology bulletins. In 1953, the first forty-two of the accounting research bulletins were revised, restated, or withdrawn and appeared as Accounting Research Bulletin No. 43 and Accounting Terminology Bulletin No. 1. Since 1953, other bulletins have been issued, the last accounting research bulletin being No. 51 and the last terminology bulletin being No. 4.
>
> The Accounting Principles Board has the authority, as did the predecessor committees, to review and revise any of these bulletins and it plans to take such action from time to time.
>
> Pending such action and in order to prevent any misunderstanding meanwhile as to the status of the existing accounting research and terminology bulletins, the Accounting Principles Board now makes public announcement that these bulletins should be considered as continuing in force with the same degree of authority as before.

.06 The Accounting Principles Board has issued a number of "Opinions" and "Statements." Certain of the Opinions modify Accounting Research Bulletins or other Opinions. With these revisions, all currently existing Bulletins, Opinions and Statements continue in full force and effect.

.07 The Institute staff has been authorized to issue Accounting Interpretations of accounting questions having general interest to the profession. The purpose of the Interpretations is to provide guidance on a timely basis

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without the formal procedures required for an Accounting Principles Board Opinion. These Interpretations, which are reviewed with informed members of the profession, are not pronouncements of the Board.

.08 This looseleaf edition has been instituted to facilitate reference to the Bulletins, Opinions, Statements and Accounting Interpretations and to provide an effective means of reflecting modifications of them on a timely basis. Due to the fact that it is a compilation of pronouncements of the predecessor committee and the Board, the composition of which has changed during the periods of their existence, it has been considered desirable to maintain the language of the pronouncements in their original form and context to the extent feasible. Accordingly, such terms as *committee* and *Board* appear unchanged from the original pronouncements.

.09 The Council of the Institute passed the following resolution[1] at its May 7, 1973 meeting:

> Whereas in 1959 the Council designated the Accounting Principles Board to establish accounting principles, and
>
> Whereas the Council is advised that the Financial Accounting Standards Board has become operational, it is
>
> Resolved, that as of April 1, 1973, all authority of the Accounting Principles Board shall terminate, except in respect of action taken on pronouncements of such Board approved prior to April 1, 1973 for exposure, and action of the APB Chairman in respect of pronouncements not issued by such Board; and that on June 30, 1973 or upon approval for final issuance for all such APB pronouncements, whichever first occurs, the Accounting Principles Board shall be dissolved.
>
> Resolved, that the Accounting Standards Executive Committee is hereby designated as the Senior Technical Committee of the Institute with respect to

[1] See section 510.08 for the Council Resolution establishing the Financial Accounting Standards Board as the body to establish accounting principles pursuant to Rule 203 of the Rules of Conduct of the American Institute of Certified Public Accountants.

financial accounting and reporting, and cost accounting, as defined in the statement of its responsibilities, authority and structure approved by the Board of Directors, except as hereinabove provided with respect to the authority of the Accounting Principles Board and its Chairman until the dissolution of such Board.

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AC Section 510

Introduction—General

(This section of the introduction was prepared, except as otherwise indicated herein, by the committee on accounting procedure and was issued in June 1953 as a part of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins.*)

ACCOUNTING AND THE CORPORATE SYSTEM

.01 Accounting is essential to the effective functioning of any business organization, particularly the corporate form. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not merely from that of any one group of interested persons.

.02 The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet changes as they occur. In the past fifty years there has been an increasing use of the corporate system for the purpose of converting into readily transferable form the ownership of large, complex, and more or less permanent business enterprises. This evolution has brought in its train certain uses of the processes of law and accounting which have led to the creation of new controls, revisions of the laws, and reconsideration of accounting procedures.

.03 As a result of this development, the problems in the field of accounting have increasingly come to be considered from the standpoint of the buyer or seller of an interest in an enterprise, with consequent increased recognition of the significance of the income statement and a tendency to restrict narrowly charges and credits to surplus. The fairest possible presentation of periodic net income, with neither material overstatement nor understatement, is important, since the results of operations are significant not only to prospective buyers of an interest in the enterprise but also to prospective sellers. With the increasing importance of the income statement there has been a tendency to regard the balance sheet as the connecting link

between successive income statements; however this concept should not obscure the fact that the balance sheet has significant uses of its own.

.04 This evolution has also led to a demand for a larger degree of uniformity in accounting. *Uniformity* has usually connoted similar treatment of the same item occurring in many cases, in which sense it runs the risk of concealing important differences among cases. Another sense of the word would require that different authorities working independently on the same case should reach the same conclusions. Although uniformity is a worthwhile goal, it should not be pursued to the exclusion of other benefits. Changes of emphasis and objective as well as changes in conditions under which business operates have led, and doubtless will continue to lead, to the adoption of new accounting procedures. Consequently, diversity of practice may continue as new practices are adopted before old ones are completely discarded.

APPLICABILITY OF COMMITTEE OPINIONS

.05 The principal objective of the committee has been to narrow areas of difference and inconsistency in accounting practices, and to further the development and recognition of generally accepted accounting principles, through the issuance of opinions and recommendations that would serve as criteria for determining the suitability of accounting practices reflected in financial statements and representations of commercial and industrial companies. In this endeavor, the committee has considered the interpretation and application of such principles as appeared to it to be pertinent to particular accounting problems. The committee has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational, and similar non-profit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

VOTING PROCEDURE IN ADOPTING OPINIONS

.06 The committee regards the representative character and general acceptability of its opinions as of the

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highest importance, and to that end has adopted the following procedures:

(a) Any opinion or recommendation before issuance is submitted in final form to all members of the committee either at a meeting or by mail.

(b) No such opinion or recommendation is issued unless it has received the approval of two-thirds of the entire committee.

(c) Any member of the committee dissenting from an opinion or recommendation issued under the preceding rule is entitled to have the fact of his dissent and his reasons therefor recorded in the document in which the opinion or recommendation is presented.

.07 Before reaching its conclusions, the committee gives careful consideration to prior opinions, to prevailing practices, and to the views of professional and other bodies concerned with accounting procedures.

AUTHORITY OF OPINIONS

.08 The Council of the American Institute passed the following resolution [1] at its May 7, 1973 meeting:

Whereas in 1959 the Council designated the Accounting Principles Board to establish accounting principles, and

Whereas the Council is advised that the Financial Accounting Standards Board has become operational, it is

Resolved, that as of the date hereof the Financial Accounting Standards Board, in respect of Statements of Financial Accounting Standards finally adopted by such Board in accordance with its Rules of Procedure and the bylaws of the Financial Accounting Foundation, be, and hereby is, designated by this Council as the body to establish accounting principles pursuant to Rule 203 of the Rules of Conduct of the American Institute of Certified Public Accountants; provided, however, any Accounting Research Bulletins, or Opinions of the Accounting Principles Board presently issued or approved for exposure by the Accounting Principles Board prior to April 1, 1973 and finally adopted by such Board on or before June 30, 1973, shall constitute statements of accounting principles promulgated by a body

[1] See section 100.09 for the Council Resolution which relates to the internal AICPA adjustment to the designation of the FASB as the body to establish accounting principles pursuant to Rule 203 of the Rules of Conduct of the American Institute of Certified Public Accountants.

designated by Council as contemplated in Rule 203 of the Rules of Conduct[2] unless and until such time as they are expressly superseded by action of the FASB.

.09 The committee contemplates that its opinions need not be applied to immaterial items. It considers that items of little or no consequence may be dealt with as expediency may suggest. However, freedom to deal expediently with immaterial items should not extend to a group of items whose cumulative effect in any one financial statement may be material and significant. [As amended, effective after August, 1970 by the revision of notes to APB Opinions starting with APB Opinion No. 16.]

OPINIONS NOT RETROACTIVE

.10 No opinion issued by the committee or by the Board is required to have a retroactive effect unless it contains a statement of such requirement. Thus an opinion will ordinarily have no application to a transaction arising prior to its publication (or stated effective date), nor to transactions in process of completion at the time of publication. But while the committee considers it inequitable to make its statements retroactive, it does not wish to discourage the revision of past accounts in an individual case if it appears to be desirable in the circumstances. [As amended to reflect Board policy—beginning with APB Opinion No. 6, October 1965—of stating the effective date of each Opinion.]

THE COMPANY AND ITS AUDITORS

.11 Underlying all committee opinions is the fact that the accounts of a company are primarily the responsibility of management. The responsibility of the auditor is to express his opinion concerning the financial statements and to state clearly such explanations, amplifications, disagreement, or disapproval as he deems appropriate. While opinions of the committee are addressed particularly to certified public accountants whose problem it is to decide what they may properly report, the committee recommends similar application of the procedures mentioned herein by those who prepare the accounts and financial statements.

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[2] See section 520, *Excerpts from the AICPA Code of Professional Ethics.*

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AC Section 520

Excerpts from the AICPA Code of Professional Ethics

Effective March 1, 1973

RULES OF CONDUCT

.01 *Rule 203—Accounting Principles.* A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by Council to establish such principles which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

Interpretations of Rules of Conduct

Interpretation under Rule 203—Accounting Principles

.02 *203-1—Departures from established accounting principles.* Rule 203 was adopted to require compliance with accounting principles promulgated by the body designated by Council to establish such principles. There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading.

.03 However, in the establishment of accounting principles it is difficult to anticipate all of the circumstances to which such principles might be applied. The rule therefore recognizes that upon occasion there may be unusual circumstances where the literal application of pronouncements on accounting principles would have the effect of rendering financial statements misleading. In such cases, the proper accounting treatment is that which will render the financial statements not misleading.

.04 The question of what constitutes unusual circumstances as referred to in Rule 203 is a matter of professional judgment involving the ability to support the position that adherence to a promulgated principle would be regarded generally by reasonable men as producing a misleading result.

.05 Examples of events which may justify departures from a principle are new legislation or the evolution of a new form of business transaction. An unusual degree of materiality or the existence of conflicting industry practices are examples of circumstances which would not ordinarily be regarded as unusual in the context of Rule 203.

.06 *203-2—Status of FASB Interpretations.* Council is authorized under Rule 203 to designate a body to establish accounting principles and has designated the Financial Accounting Standards Board as such body. Council also has resolved that FASB Statements on Financial Accounting Standards, together with those Accounting Research Bulletins and APB Opinions which are not superseded by action of the FASB, constitute accounting principles as contemplated in Rule 203.

.07 In determining the existence of a departure from an accounting principle established by a Statement of Financial Accounting Standards, Accounting Research Bulletin or APB Opinion encompassed by Rule 203, the Division of Professional Ethics will construe such Statement, Bulletin or Opinion in the light of any Interpretations thereof issued by the FASB.

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AC Section 1010

Fundamentals of Financial Accounting

[Source: APB Statement No. 1.]

Issue date, unless otherwise indicated: April 13, 1962

STATEMENT BY THE ACCOUNTING PRINCIPLES BOARD

.01 The Accounting Principles Board has received *Accounting Research Study No. 3,* "A Tentative Set of Broad Accounting Principles for Business Enterprises," by Robert T. Sprouse and Maurice Moonitz. The Board previously had received *Accounting Research Study No. 1,* "The Basic Postulates of Accounting," by Maurice Moonitz. Study No. 1 was published in September 1961 and Study No. 3 is scheduled for publication toward the end of April 1962.

.02 In the opinion of the Director of Accounting Research, these two studies comply with the instructions to the Accounting Research Division to make a study of the basic postulates and broad principles of accounting. Prior to its publication, Study No. 3 has been read and commented upon by a limited number of people in the field of accounting. Their reactions range from endorsement of the ideas set forth in the study of "Broad Principles" to misgivings that compliance with the recommendations set forth by the authors would lead to misleading financial statements. The Board is therefore treating these two studies (the one on "Postulates" and the other on "Principles") as conscientious attempts by the accounting research staff to resolve major accounting issues which, however, contain inferences and recommendations in part of a speculative and tentative nature.

.03 The Board feels that there is ample room for improvement in present generally accepted accounting principles and a need to narrow or eliminate areas of difference which now exist. It hopes the studies will stimulate constructive comment and discussion in the areas of the basic postulates and the broad principles of accounting. Ac-

counting principles and practices should be adapted to meet changing times and conditions, and, therefore, there should be experimentation with new principles and new forms of reporting to meet these conditions. The Board believes, however, that while these studies are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time.

.04 After a period of exposure and consideration, some of the specific recommendations in these studies may prove acceptable to the Board while others may not. The Board therefore will await the results of this exposure and consideration before taking further action on these studies.

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AC Section 1021

Purpose and Nature of the Statement

[Source: APB Statement No. 4, Chap. 1, as amended.]

Issue date, unless otherwise indicated: October, 1970

STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

PURPOSE OF THE STATEMENT

.01 The American Institute of Certified Public Accountants through its Accounting Principles Board is engaged in a program of advancing the written expression of financial accounting principles for the purpose of increasing the usefulness of financial statements. The Board has been directed to devote its attention to the broad fundamentals of financial accounting as well as to specific accounting problems.[1] This Statement of basic concepts[2] and accounting principles underlying financial statements of business enterprises[3] (sections 1021-1029) states the Board's views in response to that directive.[4]

.02 Sections 1021-1029 have two broad purposes, one educational and the other developmental. They are intended to provide a basis for enhanced understanding of the broad fundamentals of financial accounting. They are also intended to provide a basis for guiding the future

[1] See "Report to Council of the Special Committee on Research Program," *The Journal of Accountancy,* December 1958, pp. 62-68 and *Report of Special Committee on Opinions of Accounting Principles Board,* 1965, summarized in *The Journal of Accountancy,* June 1965, pp. 12, 14, and 16.

[2] The term *basic concepts* is used to refer to the observations concerning the environment, the objectives of financial accounting and financial statements, and the basic features and basic elements of financial accounting discussed in sections 1023-1025.

[3] See section 1023.12 for a discussion of business enterprises. Although sections 1021-1029 apply to business enterprises, some of the contents may also apply to not-for-profit organizations.

[4] Three accounting research studies were among the sources used in preparing sections 1021-1029: Accounting Research Study No. 1, *The Basic Postulates of Accounting,* by Maurice Moonitz; Accounting Research Study No. 3, *A Tentative Set of Broad Accounting Principles for Business Enterprises,* by Robert T. Sprouse and Maurice Moonitz; and Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises,* by Paul Grady. (Accounting research studies are not pronouncements of this Board or of the Institute, but are published for the purpose of stimulating discussion on important accounting issues.)

development of financial accounting. To achieve these purposes sections 1021-1029 (1) discuss the nature of financial accounting, the environmental forces that influence it, and the potential and limitations of financial accounting in providing useful information, (2) set forth the objectives of financial accounting and financial statements, and (3) present a description of present generally accepted accounting principles.

NATURE OF THE STATEMENT

.03 Sections 1021-1029 are primarily descriptive, not prescriptive. They identify and organize ideas that for the most part are already accepted. In addition to the summary in section 1022, sections 1021-1029 contain two main parts that are essentially distinct—(a) sections 1023 to 1025 on the environment, objectives, and basic features of financial accounting and (b) sections 1026 to 1028 on present generally accepted accounting principles. The description of present generally accepted accounting principles is based primarily on observation of accounting practice. Present generally accepted accounting principles have not been formally derived from the environment, objectives, and basic features of financial accounting.

.04 The aspects of the environment selected for discussion are those that appear to influence the financial accounting process directly. The objectives of financial accounting and financial statements discussed are goals toward which efforts are presently directed. The accounting principles described are those that the Board believes are generally accepted *today. The Board has not evaluated or approved present generally accepted accounting principles except to the extent that principles have been adopted in Board Opinions. Publication of sections 1021-1029 does not constitute approval by the Board of accounting principles that are not covered in its Opinions.*

.05 Section 1029 describes the dynamic nature of financial accounting and the need for continual reexamination of generally accepted accounting principles. The section describes how present generally accepted accounting principles may be evaluated on the basis of the material in sections 1023 to 1025. The section also indicates some of the proposals that have been made for improving financial

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accounting information. These proposals, which the Board has not evaluated, may also be evaluated on the basis of the material in sections 1023 to 1025.

.06 Sections 1021-1029 are a step toward development of a more consistent and comprehensive structure of financial accounting and of more useful financial information. They are intended to provide a framework within which the problems of financial accounting may be solved, although they do not propose solutions to those problems and do not attempt to indicate what generally accepted accounting principles should be. Evaluation of present accounting principles and determination of changes that may be desirable are left to future pronouncements of the Board.

.07 The status of Statements of the Board is defined in section 1029.14. Sections 1021-1029 do not change, supersede, or interpret Accounting Research Bulletins or Opinions of the Accounting Principles Board currently in effect. The normal procedures established to maintain the effectiveness of these pronouncements and to interpret them continue in effect unchanged. Sections 1021-1029 do, however, modify some of the definitions of technical accounting terms in the Accounting Terminology Bulletins.[5] The following sections are superseded:

Accounting Terminology Bulletin No. 1, paragraphs:

9—*accounting*
21—*balance sheet*
26—*assets*
27—*liabilities*

Accounting Terminology Bulletin No. 4, paragraph 2, *cost*.

The following sections are amended:

Accounting Terminology Bulletin No. 2, paragraphs:

5—*revenue*
8—*income*

Accounting Terminology Bulletin No. 4, paragraph 3, *expense*.

These changes are noted by footnotes at appropriate places in sections 1021-1029.

[5] The Accounting Terminology Bulletins do not have the same authoritative status as the Accounting Research Bulletins and the Opinions of the Accounting Principles Board but are useful guides to financial accounting terminology.

TERMINOLOGY

.08 Technical language is used in financial accounting. Many technical terms used in financial accounting are words that have wide common usage but that are given special meanings by accountants. Many important technical terms are defined or discussed in sections 1021-1029. The meaning of these terms is best understood in the context of the discussions in which they appear. The terms and the sections in which they are defined or discussed are:

	Sections
Accounting	1023.01
Accrual	1022.27, 1025.08
Assets	1025.19
Balance sheet	1022.03, 1025.20
Basic elements	1025.17
Basic features	1025.01
Basic financial statements	1027.17
Business enterprise	1021.01 (footnote 3), 1023.12
Casualties	1023.23
Cost	1023.26, 1026.28
Current assets	1027.25
Current liabilities	1027.25
Deferred charges	1025.19 (footnote 2)
Deferred credits	1025.19 (footnote 4)
Depreciation	1026.23, 1027.10 (M-6B)
Economic obligations	1023.19
Economic resources	1023.18
Exchanges	1023.23
Expenses	1025.21, 1026.18-.19
External events	1023.23
Extraordinary items	1027.25
Fair presentation (or *presents fairly*) in conformity with generally accepted accounting principles	1027.15
Fair value	1026.09 (footnote 5), 1027.07 [M-1A(1)]
Financial accounting	1023.02
Financial position	1025.20
Financial statements	1022.02
Gains	1027.25

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	Sections
General objectives	1024.01, 1024.04
Generally accepted accounting principles	1026.01-.04
Going concern	1025.04
Income statement	1022.04, 1025.22
Internal events	1023.23
Liabilities	1025.19
Losses	1027.25
Matching	1026.11 (footnote 6)
Net income	1025.21
Net loss	1025.21
Net realizable value	1023.31 (footnote 11)
Nonreciprocal transfers	1023.23
Owners' equity	1025.19
Production	1023.10, 1023.23
Profit-directed activities	1024.06 (footnote 4)
Qualitative objectives	1024.13, 1024.14
Realization	1026.14
Residual interest	1023.20
Results of operations	1025.22
Retained earnings	1027.25
Revenue	1025.21, 1026.12
Statement of changes in financial position	1022.06
Statement of retained earnings	1022.05
Substantial authoritative support	1026.01 (footnote 1)
Transfers between the enterprise and its owners	1023.23
Working capital	1027.25

[As amended, effective for fiscal periods ending after September 30, 1971, by APB Opinion No. 19.]

The next page is 7181.

AC Section 1022

Summary of the Statement

[Source: APB Statement No. 4, Chap. 2, as amended.]

Issue date, unless otherwise indicated: October, 1970

STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

.01 Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions. Sections 1021-1029 deal with financial accounting for business enterprises, the branch of accounting that focuses on the general-purpose reports on financial position and results of operations known as financial statements.

FINANCIAL STATEMENTS

.02 Financial statements are the means by which the information accumulated and processed in financial accounting is periodically communicated to those who use it. They are designed to serve the needs of a variety of users, particularly owners and creditors. Through the financial accounting process, the myriad and complex effects of the economic activities of an enterprise are accumulated, analyzed, quantified, classified, recorded, summarized, and reported as information of two basic types: (1) financial position, which relates to a point in time, and (2) changes in financial position, which relate to a period of time. Notes to the statements, which may explain headings, captions or amounts in the statements or present information that cannot be expressed in money terms, and descriptions of accounting policies are an integral part of the statements. [As amended by APB Opinion No. 22, December 31, 1971.]

Financial Position—The Balance Sheet

.03 A balance sheet (or statement of financial position) presents three major categories: (a) assets, (b) liabilities, and (c) owners' equity, the difference between total assets and total liabilities. A balance sheet at any date

presents an indication in conformity with generally accepted accounting principles of the financial status of the enterprise at a particular point of time.

Changes in Financial Position—The Income Statement

.04 The income statement for a period presents the revenue, expenses, gains, losses, and net income (net loss) recognized during the period and thereby presents an indication in conformity with generally accepted accounting principles of the results of the enterprise's profit-directed activities during the period. The information presented in an income statement is usually considered the most important information provided by financial accounting because profitability is a paramount concern to those interested in the economic activities of the enterprise.

Changes in Financial Position—Changes in Owners' Equity

.05 An income statement is usually not sufficient to describe the total change in owners' equity during a period because changes arise from sources other than profit-directed activities. The total change in owners' equity is described by three statements: an income statement, a statement of retained earnings, and a statement of other changes in owners' equity. A statement of retained earnings presents net income (as shown in the income statement) and items such as dividends and adjustments of the net income of prior periods. A statement of other changes in owners' equity presents additional investments by owners, retirements of owners' interests (except for the part considered to be a distribution of earnings), and similar events. If these other changes are simple and few in number, they are often presented in notes to the other financial statements rather than in a separate statement.

Changes in Financial Position—Other Statements

.06 A statement of changes in financial position shows the major sources of increases in an enterprise's assets for a period in addition to net income, for example, from borrowing, owners' investments, and disposal of assets other than through normal operations. It also shows how the

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enterprise used its assets during the period, for example, in acquiring other assets, in paying debt, and in distributions to owners. [As amended, effective for fiscal periods ending after September 30, 1971 by APB Opinion No. 19.]

.07 Other statements that analyze specific changes in financial position are occasionally presented, for example, changes in plant and equipment, changes in long-term liabilities, and cash receipts and disbursements. Statements that analyze changes in each asset, each liability, and each item of owners' equity could be prepared, but statements of changes in financial position in addition to those already discussed are seldom presented. [As amended, effective for fiscal periods ending after September 30, 1971 by APB Opinion No. 19.]

The Source of Financial Statements

.08 Financial statements are the end product of the financial accounting process. This process is governed by generally accepted accounting principles, which determine the information that is included, how it is organized, measured, combined, and adjusted, and finally how it is presented in the financial statements. The principles reflect the objectives and the basic features of financial accounting (discussed below). All of financial accounting—principles, objectives, and basic features—is grounded in the environment of business enterprises.

THE ENVIRONMENT OF FINANCIAL ACCOUNTING

.09 An understanding of financial accounting and an ability to evaluate the information it produces depend not only on delineation of accounting principles and the features and objectives of accounting, but also on an understanding of the environment within which financial accounting operates and which it is intended to reflect (section 1023). The users of financial accounting information and economic activity in society and in individual business enterprises are aspects of the environment important to an analysis of the problems of financial accounting.

Users

.10 Needs and expectations of users of financial statements are a part of the environment that determines the type of information required of financial accounting. A

knowledge of important classes of users, of their common and special needs for information, and of their decision processes is helpful in improving financial accounting information.

Economic Activity

.11 Economic activity can be described in terms of (1) its general nature in highly developed economies, (2) the economic resources, obligations, and residual interest of a business enterprise and the economic activities that change them, and (3) the ways of measuring economic activity.

.12 Describing economic resources, economic obligations, and residual interest and the economic activities that change them is important because the basic elements of financial accounting—assets, liabilities, owners' equity, revenue, expenses, and net income—are related to these economic elements. A discussion of the measurement of economic activity is also relevant because measurement difficulties underlie many of the problems of financial accounting.

OBJECTIVES OF FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

.13 The basic purpose of financial accounting and financial statements is to provide financial information about individual business enterprises that is useful in making economic decisions (section 1024). General and qualitative objectives aid in fulfilling this basic purpose and provide means for evaluating present and proposed accounting principles.

.14 General objectives determine the appropriate content of financial accounting information. These objectives are to present reliable financial information about enterprise resources and obligations, economic progress and other changes in resources and obligations, to present information helpful in estimating earnings potential, and to present other financial information needed by users, particularly owners and creditors.

.15 Certain qualities or characteristics make financial information useful. Providing information that has each of these qualities is an objective of financial accounting.

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These qualitative objectives are relevance, understandability, verifiability, neutrality, timeliness, comparability, and completeness.

.16 The objectives of financial accounting and financial statements are at least partially achieved at present, although improvement is probably possible in connection with each of them. Constraints on full achievement of the objectives arise from (1) conflicts of objectives, (2) environmental influences, and (3) lack of complete understanding of the objectives.

BASIC FEATURES AND BASIC ELEMENTS OF FINANCIAL ACCOUNTING

Basic Features

.17 The basic features of financial accounting (section 1025) are determined by the characteristics of the environment in which financial accounting operates. The features are:

(1) *Accounting entity*—economic activities of individual entities are the focus of financial accounting.

(2) *Going concern*—continuation of entity operations is usually assumed in financial accounting in the absence of evidence to the contrary.

(3) *Measurement of economic resources and obligations*—financial accounting is primarily concerned with measurement of economic resources and obligations and changes in them.

(4) *Time periods*—financial accounting presents information about activities for relatively short time periods.

(5) *Measurement in terms of money*—financial accounting measures in terms of money.

(6) *Accrual*—determining periodic income and financial position depends on measurement of noncash resources and obligations.

(7) *Exchange price*—financial accounting measurements are primarily based on exchange prices.

(8) *Approximation*—approximations are inevitable in the allocations required in financial accounting.

(9) *Judgment*—financial accounting requires informed judgment.

(10) *General-purpose financial information*—financial accounting presents general-purpose financial information.

(11) *Fundamentally related financial statements*—statements of financial position and changes in financial position are fundamentally related.

(12) *Substance over form*—financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment.

(13) *Materiality*—financial reporting is only concerned with significant information.

Basic Elements

.18 The basic elements of financial accounting are assets, liabilities, owners' equity, revenue, expenses, and net income (section 1025). These elements are defined in terms of (a) economic resources, economic obligations, and residual interest and changes in resources, obligations, and residual interest and (b) generally accepted accounting principles.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

.19 Generally accepted accounting principles (sections 1026 to 1028) incorporate the consensus[1] at any time as to which economic resources and obligations should be recorded as assets and liabilities, which changes in them should be recorded, when these changes should be recorded, how the recorded assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared. In this Statement, generally accepted accounting principles are divided into three levels: pervasive principles, broad operating principles, and detailed principles.

.20 Pervasive principles (section 1026) form the basis for much of the accounting process. They include pervasive measurement principles and modifying conventions. The

[1] See section 1026.01, footnote 1.

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pervasive measurement principles—for example, realization—broadly determine the events recognized in financial accounting, the basis of measurement used in financial accounting, and the way net income is determined. The modifying conventions—for example, conservatism—affect the application of the pervasive measurement principles.

.21 Broad operating principles (section 1027) are general rules, derived from the pervasive principles, that govern the application of the detailed principles. They are described in this Statement in two groups, principles of selection and measurement and principles of financial statement presentation. The principles of selection and measurement include principles that guide selection of events to be accounted for and assignment of dollar amounts and principles that determine the effects of recorded events on assets, liabilities, owners' equity, revenue, and expenses of the enterprise.

.22 Detailed principles are the numerous rules and procedures that are based on the broad principles and specify the way data are processed and presented in specific situations. Detailed principles are discussed but not listed in section 1028.

.23 The three types of principles determine the operation of the financial accounting process. All three levels of principles are conventional. They have developed on the basis of experience, reason, and custom; they become generally accepted by agreement (often tacit agreement) and are not formally derived from a set of postulates.

DYNAMIC NATURE OF FINANCIAL ACCOUNTING

.24 Present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue (section 1029). Principles change in response to changes in economic and social conditions, to new knowledge and technology, and to demands by users for more serviceable financial information. Change is more pronounced in the detailed principles than in the broad operating principles; the pervasive principles tend to be the most stable. Nevertheless, because the principles are conventional and have been developed in relation to a specific environment and with assumptions about needed financial

information, they are all subject to review, evaluation, and possible change.

CHARACTERISTICS AND LIMITATIONS OF FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

.25 The environment, objectives, and basic features of financial accounting determine the structure of financial accounting and provide constraints and conditions on its operations. The accounting principles that are generally accepted at a particular time as the basis of reporting represent a response to these influences, constraints, and conditions as they exist at that time and determine not only the scope of financial accounting information at the time but also its relevance. These principles are the result of the historical development of financial accounting, the way in which needs of users of financial accounting information are perceived, and the way accountants interact with the environment.

.26 The complexity of the economic activity that forms the subject matter of accounting gives financial accounting some definite limits. Taking one approach in financial accounting requires rejection of other approaches and limits the scope of accounting. The approach taken is reflected in certain characteristics of the financial accounting process and its product, the financial statements. In the midst of the continuous and complex interactions found in the economic environment of enterprises, periodic measurements are made based on a relatively simple classification system. Faced with the uncertainty and joint effects that characterize economic activity, accountants adopt conventional procedures that emphasize verifiable measures and are based on assumptions that certain causal relationships exist and can be traced.

.27 Some of the more important present characteristics and limitations of financial accounting and financial statements are briefly described.

Historical Report. Financial accounting and financial statements are primarily historical in that information about events that have taken place provides the basic data of financial accounting and financial statements.

General-Purpose Financial Statements. Financial accounting presents information designed to serve the

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common needs of a variety of user groups with primary emphasis on the needs of present and potential owners and creditors.

Fundamentally Related Financial Statements. Financial statements are fundamentally related. Aspects of financial position presented in the balance sheet are related to changes in financial position presented in the income statement and the statement of changes in financial position.

Classification. Information about financial position and results of operations is classified based on the presumed needs of owners, creditors, and other users.

Summarization. Transactions and other events of a business enterprise that have similar characteristics are grouped and presented in summary form.

Measurement in Terms of Money. Financial statements in the United States are expressed in terms of numbers of U. S. dollars. Changes in the general purchasing power of the dollar are not reflected in the basic financial statements.

Measurement Bases. Several measurement bases are used in financial accounting, for example, net realizable value (receivables), lower of acquisition cost and present market price (inventories), and acquisition cost less accumulated depreciation (plant and equipment). Financial statements in general do not purport to reflect the current value of the assets of the enterprise or their potential proceeds on liquidation under present generally accepted accounting principles.

Accrual. The effects of transactions and other events on the assets and liabilities of a business enterprise are recognized and reported in the time periods to which they relate rather than only when cash is received or paid.

Estimates and Judgment. The complexity and uncertainty of economic activity seldom permit exact measurement. Estimates and informed judgment must often be used to assign dollar amounts to the effects of transactions and other events that affect a business enterprise.

Verifiability. Although estimates are unavoidable in financial accounting, an attempt is made to keep the effects of estimates to a minimum by basing financial accounting measurements primarily on enterprise transactions and requiring corroboration by outside evidence before increases in value are recognized. Estimates included in financial accounting are usually related in some way to data derived from verifiable events and the estimates are accounted for in a consistent and systematic manner.

Conservatism. The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income.

Substance Over Form. Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form.

Technical Terminology. Many of the terms used in financial statements are common words to which accountants have given technical meanings.

Audience. Financial statement users are presumed to be generally familiar with business practices, the technical language of accounting, and the nature of the information reported.

[As amended, effective for fiscal periods ending after September 30, 1971 by APB Opinion No. 19.]

USE OF FINANCIAL ACCOUNTING INFORMATION

.28 Appropriate use of financial accounting information requires a knowledge of the characteristics and limitations of financial accounting. Financial accounting information is produced for certain purposes by the use of conventional principles. Use of the information for other purposes or without a general knowledge of its characteristics and limitations may lead to misinterpretation and errors.

.29 An important characteristic of financial statements, for example, is that the information they contain de-

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scribes the past, while decision making is oriented toward the future. A record of past events and a knowledge of past position and changes in position, however, help users evaluate prior decisions and this information is also a starting point for users in predicting the future. Decision makers should not assume, however, that the conditions that produced past results will necessarily continue in the future.

.30 Financial statements are designed to provide an important part of the information that users need for many of their decisions. The information contained in the statements should not be relied on exclusively, however, and should be supplemented by other information about the specific prospects of the company, the industry in which it operates, and the economy in general.

.31 A knowledge of the characteristics and limitations of financial statements also helps users avoid putting undue reliance on single measures or the results of a single year. Net income or earnings per share of a single year, for example, should not be overemphasized since these amounts are derived from complex computations, are based on estimates and judgments, and often have their meaning modified by information in the notes to the financial statements. In reaching decisions users should consider movements in the components of net income, the effects of estimates and judgments, the possible effects of information disclosed in notes, and similar factors.

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AC Section 1023

The Environment of Financial Accounting

[Source: APB Statement No. 4, Chap. 3, as amended.]

Issue date, unless otherwise indicated: October, 1970

STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

.01 Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions—in making reasoned choices among alternative courses of action. Accounting includes several branches, for example, financial accounting, managerial accounting, and governmental accounting.

.02 Financial accounting for business enterprises is one branch of accounting. It provides, within limitations described below, a continual history quantified in money terms of economic resources and obligations of a business enterprise and of economic activities that change those resources and obligations.

.03 Financial accounting is shaped to a significant extent by the environment, especially by:

1. The many uses and users which it serves,
2. The overall organization of economic activity in society,
3. The nature of economic activity in individual business enterprises, and
4. The means of measuring economic activity.

Environmental conditions, restraints, and influences are generally beyond the direct control of businessmen, accountants, and statement users. Understanding and evaluating financial accounting requires knowledge of this environment and of its impact on the financial accounting process. Aspects of the environment are reflected in the basic features and basic elements of financial accounting (see Section 1025) and in generally accepted accounting principles (see Sections 1026 to 1028).

USES AND USERS OF FINANCIAL ACCOUNTING INFORMATION

.04 Financial accounting information[1] is used by a variety of groups and for diverse purposes. The needs and expectations of users determine the type of information required. User groups may be broadly classified into (1) those with direct interests in business enterprises and (2) those with indirect interests.

Users with Direct Interests

.05 Some users have or contemplate having a direct economic interest in business enterprises. Examples of these users and of the types of evaluations and decisions for which they use financial accounting information are:

Owners—retain, increase, or decrease proportionate ownership; evaluate the use and stewardship of resources by management.

Creditors and suppliers—extend credit; determine terms of credit; require security or restrictive covenants in terms; enter suit or force bankruptcy or receivership; increase or decrease reliance on the enterprise as a customer.

Potential owners, creditors, and suppliers—commit resources to the enterprise; determine amount of commitment; evaluate the use and stewardship of resources by management.

Management (including directors and officers)—assess nature and extent of financing needs; evaluate results of past economic decisions; set dividend policy; project future financial position and income; assess merger and acquisition possibilities; recommend reorganization or dissolution.

Taxing authorities—evaluate tax returns; assess taxes or penalties; make investigations and audits.

Employees—negotiate wages; terminate employment; or, for prospective employees, apply for employment.

Customers—anticipate price changes; seek alternative sources or broader bases of supply.

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[1] The term *information* is sometimes applied only to relevant data. Sections 1021-1029 do not distinguish between the terms *information* and *data*.

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Users with Indirect Interests

.06 Some users of financial accounting information derive an interest because their function is to assist or protect those who have or contemplate having a direct interest. Examples are:

Financial analysts and advisors—advise investors and potential investors to retain, increase, decrease, or acquire an investment in the enterprise; evaluate prospects of investment in the enterprise relative to alternative investments.[2]

Stock exchanges—accept or cancel listings; suspend trading; encourage changes in accounting practices or additional disclosure of information.

Lawyers—determine whether covenants and contractual provisions are fulfilled; advise on legality of dividends and profit sharing and deferred compensation agreements; draft pension plan terms.

Regulatory or registration authorities—assess reasonableness of rate of return; allow or require increases or decreases in prices or rates; require or recommend changes in accounting or disclosure practices; issue cease-and-desist or stock-trading-suspension orders.

Financial press and reporting agencies—prepare descriptive analyses; combine, summarize, or select information to present in descriptions; conform information to uniform presentation arrangements; compute trends and ratios.

Trade associations—compile industry statistics and make comparisons; analyze industry results.

Labor unions—formulate wage and contract demands; assess enterprise and industry prospects and strengths.

Common and Special Needs

.07 Financial accounting information may be directed toward the common needs of one or more of the user groups cited above or may be directed toward specialized needs. Examples of information directed toward common needs are the general-purpose reports on enterprise financial posi-

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[2] Investment bankers are users with derived interests when they act as analysts and advisors to issuers of securities and investors in securities. They are users with direct interests when they purchase and sell securities on their own account.

tion and progress known as the balance sheet, the income statement and the statement of changes in financial position. The emphasis in financial accounting on general-purpose information (see section 1025.12) is based on the presumption that a significant number of users need similar information. General-purpose information is not intended to satisfy specialized needs of individual users. [As amended, effective for fiscal periods ending after September 30, 1971 by APB Opinion No. 19.]

.08 Examples of information that is derived from financial accounting records and directed toward specialized needs are some financial reports submitted to regulatory authorities, special financial reports prepared to obtain credit or loans, many reports to management, tax returns, and statistical financial information given to trade and industry associations. Information prepared for a particular purpose cannot be expected to serve other needs well. Furthermore, the problem of ascertaining specialized needs of a large number of users, the cost of attempting to serve these needs on an individual basis, and the confusion that might result from disseminating more than one set of information about the financial results of an enterprise's operations militate against attempting to serve all needs of users with special-purpose reports.

.09 Improving financial accounting requires continuing research on the nature of user needs, on the decision processes of users, and on the information that most effectively serves user needs.

THE ORGANIZATION OF ECONOMIC ACTIVITY IN SOCIETY

.10 All societies engage in certain fundamental economic activities:

Production—the process of converting economic resources into outputs of goods and services that are intended to have greater utility than the required inputs. In sections 1021-1029 the term *production* is used in this broad sense and encompasses the provision of services and the movement and storage of goods as well as changes in physical form of goods. The term *production* therefore is not used in sections 1021-1029 synonymously with the term *manufacturing*.[3]

[3] See paragraph .23 for further discussion of production.

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Income distribution—the process of allocating rights to the use of output among individuals and groups in society.

Exchange—the process of trading resources or obligations for other resources or obligations.

Consumption—the process of using the final output of the production process.

Saving—the process by which individuals and groups set aside rights to present consumption in exchange for rights to future consumption.

Investment—the process of using current inputs to increase the stock of resources available for future output as opposed to immediately consumable output.

.11 In less developed economies each form of economic activity is relatively simple and many of the processes are merged into one another. Individuals or groups produce for their own consumption; the distribution of claims to output and income is direct and obvious; exchange is the exception rather than the rule; and saving and investment occur together as some individuals or groups set aside part of the product of their current effort for future rather than present consumption.

.12 In contrast, economic activity is specialized and complex in highly developed economies like the United States. Goods and services are produced by specialized units. These units may be government owned, but in the United States most productive activity is carried on through investor owned business enterprises. Business enterprises are individuals or associations of individuals that control and use resources for a variety of purposes including the purpose of yielding a return to the owners of the enterprise. They produce for sale rather than their own consumption and generally engage in market exchanges to acquire inputs for the production process and to dispose of goods and services produced.

.13 Within producing units, the production process itself is often specialized and complex. Modern organization permits and modern technology requires long, continuous, and intricate processes in which products and services are often the joint result of several productive re-

sources. Rapid changes in technology change patterns of inputs and of outputs and contribute to changes in their relative prices. Likewise, shifts in consumer demands and preferances affect the prices of outputs and through these the prices of inputs used in the production process.

.14 Savings and investment are also separate, specialized activities. Savings are invested through a complex set of intermediaries which offer the saver diverse types of ownership or creditor claims, most of which can be freely traded.

.15 The complexity and diversity of modern economic organization have implications for financial accounting:

(1) Since economic activity of business enterprises tends to be continuous, relationships associated with intervals of time like a year or a quarter of a year can be measured only on the basis of assumptions or conventional allocations.

(2) Because of the complexity of modern production and the joint nature of economic results, the relative effects of the various productive resources are intertwined, not only with each other but with external market events. Computing the precise effects of a particular input unit or a particular external event is therefore impossible except on an arbitrary basis.

(3) In a dynamic economy, the outcome of economic activity is uncertain at the time decisions are made and financial results often do not correspond to original expectations.

.16 On the other hand, certain elements of modern economic organization help to provide an underlying continuity and stability to some aspects of economic activity and hence to the task of measuring that activity. In particular:

(1) Several forms of enterprise, especially the corporate form, continue to exist as legal entities for extended periods of time.

(2) The framework of law, custom, and traditional patterns of action provides a significant degree of stability to many aspects of the economic environ-

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ment. In a society in which property rights are protected, contracts fulfilled, debts paid, and credit banking and transfer operations efficiently performed, the degree of uncertainty is reduced and the predicability of the outcome of many types of economic activities is correspondingly increased.

ECONOMIC ACTIVITY IN INDIVIDUAL BUSINESS ENTERPRISES

.17 The economic activities of a business enterprise increase or decrease (1) its economic resources, (2) its economic obligations, and (3) the residual interest in its resources.

Economic Resources

.18 Economic resources are the scarce means (limited in supply relative to desired uses) available for carrying on economic activities. The economic resources of a business enterprise include:

1. *Productive resources*

   These resources are the means used by the enterprise to produce its product:

   a. Productive resources of the enterprise—

      These include raw materials, plant, equipment, natural resource deposits, patents and similar intangibles, goodwill, services, and other resources used in production.

   b. Contractual rights to productive resources—

      These include contractual rights to the use of resources of other entities (including individuals) as well as rights to delivery of materials, plant, and equipment from other entities. Contractual rights to resources of other entities often arise in mutual commitments in which payment is to be made as, or shortly after, the goods or services are used or received.

2. *Products*

   These resources are outputs of the enterprise, consisting of (a) goods awaiting exchange, and (b)

partially completed goods still in the process of production.[4]

3. *Money*
4. *Claims to receive money*
5. *Ownership interests in other enterprises.*

Economic Obligations

.19 The economic obligations of an enterprise at any time are its present responsibilities to transfer economic resources or provide services to other entities in the future. Obligations usually arise because the enterprise has received resources from other entities through purchases or borrowings. Some obligations, however, arise by other means, for example, through the imposition of taxes or through legal action. Obligations are general claims against the enterprise rather than claims to specific resources of the enterprise unless the terms of the obligation or applicable legal rules provide otherwise. Economic obligations include:

1. *Obligations to pay money*
2. *Obligations to provide goods or services*

   These are normally contractual obligations calling for the transfer of resources other than money according to specified conditions. The obligations may arise because payment for the goods or services to be provided has already been received or as the result of a mutual commitment.

Residual Interest

.20 The residual or owners' interest is the interest in the economic resources of an enterprise that remains after deducting economic obligations. It is the interest of those who bear the ultimate risks and uncertainties and receive the ultimate benefits of enterprise operations. At the start of the enterprise the residual interest equals the owners' initial investment of resources. Increases or decreases in enterprise resources that are not offset by equal changes in enterprise obligations change the residual interest.

[4] The products of an enterprise also include services provided to other entities. Services provided to others cannot be inventoried, however, and therefore are not resources of the enterprise.

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Relationship Among Economic Resources, Economic Obligations, and Residual Interest

.21 The relationship among the resources of an enterprise and the claims and interests in those resources implicit in the definition of residual interest is:

Economic Resources — Economic Obligations = Residual Interest [5]

The resources, obligations, and residual interest of an enterprise are the basis for the basic elements of financial position—assets, liabilities, and owners' equity—dealt with in financial accounting (see section 1025.19-.20).

Changes in Economic Resources, Economic Obligations, and Residual Interest

.22 Resources, obligations, and residual interest of an enterprise change over time. Changes in resources and obligations include acquisitions and dispositions of resources, incurrence and discharge of obligations, and changes in the utility or prices of resources held. Because resources, obligations, and residual interest are related, changes in them are also related and a change in total resources is always accompanied by a change in obligations or residual interest. Events that change resources, obligations, and residual interest are the basis for the basic elements of results of operations—revenue, expenses, and net income (see section 1025.21-.22)—and other changes in financial position with which financial accounting is concerned.

.23 Events that change the resources, obligations, or residual interest of an enterprise may be classified in many ways. The following classification is intended to be complete, to avoid overlapping, and to highlight differences that are important to financial accounting. This classification of events is used in section 1027 as the basis for presenting the principles of selection and measurement.

I. External events: events that affect the enterprise and in which other entities participate.

  A. Transfers of resources or obligations to or from other entities.

[5] Expressing the relationship in a mathematical equation goes beyond descriptions of terms and assumes appropriate measurement. Measurement of economic activity is discussed in paragraphs .27-.33.

1. Exchanges—

   These events are reciprocal transfers of resources or obligations between the enterprise and other entities in which the enterprise either sacrifices resources or incurs obligations in order to obtain other resources or satisfy other obligations. Exchanges occur if each party to the transaction values that which he will receive more than that which he must give up and if the particular exchange is evaluated as preferable to alternative actions. Exchanges encompass many of the economic interactions of entities; they include contractual commitments as well as transfers of goods, services, money, and the exchange of one obligation for another. Some exchanges take place on a continuous basis over time instead of being consummated at a moment of time—for example, accumulations of interest and rent.

2. Nonreciprocal transfers—

   These events are transfers in one direction of resources or obligations, either from the enterprise to other entities or from other entities to the enterprise.

   a. Transfers between the enterprise and its owners—

      These are events in which the enterprise receives resources from owners and the enterprise acknowledges an increased ownership interest, or the enterprise transfers resources to owners and their interest decreases.[6] These transfers are not exchanges from the point of view of the enterprise. The enterprise sacrifices none of its resources and incurs no obligations in exchange for owners' investments, and it receives

[6] Interactions of enterprises with owners acting as customers, suppliers, employees, debtors, creditors, donors, etc., rather than as owners are excluded from this category.

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nothing of value to itself in exchange for the resources it distributes.[7] Transfers of this type also include declaration of dividends and substituting ownership interest for obligations.

b. Nonreciprocal transfers between the enterprise and entities other than owners—

In these transfers one of the two entities is often passive, a mere beneficiary or victim of the other's actions. Examples are gifts, dividends received, taxes, loss of a negligence lawsuit, imposition of fines, and theft.

B. External events other than transfers of resources or obligations to or from other entities.

Enterprise resources may be changed by actions of other entities that do not involve transfers of enterprise resources or obligations. Examples are changes in specific prices of enterprise resources, changes in interest rates, general price-level changes, technological changes caused by outside entities, and vandalism. In addition to their direct effects on the enterprise, these types of events also introduce an element of uncertainty into production and exchange activities. Unfavorable effects of these events may at best be insured or hedged against or provided for through policies that promote orderly adaptation to changed conditions.

II. Internal events: events in which only the enterprise participates.

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[7] The distinction between exchanges and transfers between an enterprise and its owners is important in financial accounting today because resources are normally recorded at the cost (see section 1026.28) in an exchange; owners' investments have no cost to the enterprise and are recorded at the fair value of the assets received (see section 1027.08, M-2). Furthermore, revenue and expenses can result from exchanges but not from transfers between an enterprise and its owners.

A. Production.

Production in a broad sense is the process by which resources are combined or transformed into products (goods or services). Production does not necessarily alter the physical form of the items produced; it may involve simply a change in location or the holding of items over a period of time. Production encompasses a broad range of activities, including manufacturing, exploration, research and development, mining, agriculture, transportation, storage, marketing and distribution, merchandising, and provision of services. Each of these activities is intended to result in a product with an exchange price greater than the cost of the resources used in its production. Production includes all the internal events of an enterprise except casualties. (The term *production* therefore is *not* used in sections 1021-1029 synonymously with the term *manufacturing*.)

B. Casualties.

Casualties are sudden,[8] substantial, unanticipated reductions in enterprise resources not caused by other entities.[9] Examples are fires, floods, and other events ordinarily termed acts of God. Some events in this category are similar to those in category IB in that they introduce an element of uncertainty and may be insured against.

.24 Net income or loss can result from each of the types of events listed except transfers between an enterprise and its owners.

.25 *Discussion of Classification of Events.* Classifying events involves problems regardless of the system of classification chosen. First, the distinctions between classes probably cannot be made clear enough to make the class

[8] Casualties also include concealed progressive changes in assets that are discovered after substantial change has taken place, for example, damage from settling of a building foundation.

[9] This definition of casualties differs from that in the Internal Revenue Code, which includes some external events as casualties.

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in which every event belongs obvious. For example, the distinctions between external and internal events and between production and casualties involve borderline situations which require judgment in assigning events to classes. Second, more than one event can occur at the same time and place. For example, when employees are at work, exchanges are taking place between the enterprise and the employees (wages and salaries are accruing) and production is taking place at the same time. Single occurrences must sometimes be analyzed into component events that fit into separate classes. Finally, the economic substance of some events may differ from their legal form. Classification of this kind of event may differ depending on whether its form or its substance is considered to govern (see section 1025.14).

.26 *Cost.* Changes in resources, obligations, and residual interest often involve economic cost to the enterprise. Economic cost is the sacrifice (that which is given up or foregone) incurred in economic activities (see section 1026.28 for treatment of cost under generally accepted accounting principles).

MEASURING ECONOMIC ACTIVITY

.27 Comparison and evaluation of diverse economic activities are facilitated by measurement[10] of enterprises' resources and obligations and the events that change them.

Measurement Problems

.28 The complexity, continuity, and joint nature of economic activity (see paragraphs .12 to .15) present problems in measuring the effects of enterprise activities and associating them with specific products and services and with relatively short time periods. The need to relate measurements to each other also presents problems because it requires selecting like quantitative attributes and ignoring others. Attributes are selected on the basis of concepts that specify the attribute to be measured and how and when measurements are to be made. Disagreements over meas-

[10] The terms *measurement* and *valuation* are often used interchangeably in accounting to mean simply the quantification of resources, obligations, and changes in them in money terms. An accounting research study on measurement and valuation in financial accounting is now in progress. The technicalities of differences between measurement and valuation, if any, will be examined in that study.

urement concepts are the source of many of the differences of opinion about how to achieve the objectives of financial accounting and financial statements. (The objectives are discussed in section 1024.)

.29 Because the resources and obligations of an enterprise and changes in them are inseparably connected, measuring the resources and obligations and measuring changes in them (including those changes that are the source of net income for a period) are two aspects of the same problem.

Exchange Prices

.30 The effects of economic activities are measured in terms of money in a monetary economy. Money measurements are used to relate economic activities that use diverse types of resources to produce diverse types of products and services. Fluctuations in the general purchasing power of money cause problems in using money as a unit of measure (see sections 1026.30 to 1026.32).

.31 Resources are measured in terms of money through money prices, which are ratios at which money and other resources are or may be exchanged. Several types of money prices can be distinguished based on types of markets (purchase prices and sales prices) and based on time (past prices, present prices, and expected future prices). Four types of money prices are used in measuring resources in financial accounting.

1. *Price in past purchase exchanges of the enterprise*
   This price is usually identified as *historical cost* or *acquisition cost* because the amount ascribed to the resource is its cost, measured by the money or other resources exchanged by the enterprise to obtain it.
2. *Price in a current purchase exchange*
   This price is usually identified as *replacement cost* because the amount ascribed to the resource is measured by the current purchase price of similar resources that would now have to be paid to acquire it if it were not already held or the price that would now have to be paid to replace assets held.
3. *Price in a current sale exchange*
   This price is usually identified as *current selling price* because the amount ascribed to the resource

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is measured by the current selling price of the resource that would be received in a current exchange.

4. *Price based on future exchanges*

   This price is used in several related concepts—*present value of future net money receipts, discounted cash flow, (discounted) net realizable value,* and *value in use.* Each indicates that the amount ascribed to the resource is measured by the expected net future money flow related to the resource in its present or expected use by the enterprise, discounted for an interest factor.[11]

.32 Each of these concepts has at least some current application in financial accounting. Their application is discussed in connection with present generally accepted accounting principles in section 1027.05.

.33 Measuring economic activities in terms of exchange prices has certain limitations because some important changes that affect these activities are not changes in monetary attributes of resources. Examples are (1) physical changes in resources during production, (2) certain external events, such as technological changes and changes in consumer tastes, and (3) certain broad forces in the economy, such as changes in governmental attitudes toward business operations. Reporting these changes in terms of exchange prices when they occur requires certain assumptions, for example, assumptions concerning the presumed effect of these changes on prices of enterprise resources. The alternative is to wait to report these changes until they affect aspects of resources that are directly related to exchange prices or until exchanges occur.

→ *The next page is 7221.* ←

[11] *Current selling price* and *net realizable value* differ conceptually, although they may give the same amount under certain conditions: (1) future sales price is expected to be the same as current sales price (or no better estimate of future sales price than current price is available), (2) no future costs are expected, and (3) discounting is ignored.

AC Section 1024

Objectives of Financial Accounting and Financial Statements

[Source: APB Statement No. 4, Chap. 4, as amended.]

Issue date, unless otherwise indicated: October, 1970

STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

.01 The basic purpose of financial accounting and financial statements is to provide quantitative financial information about a business enterprise that is useful to statement users, particularly owners and creditors, in making economic decisions. This purpose includes providing information that can be used in evaluating management's effectiveness in fulfilling its stewardship and other managerial responsibilities. Within the framework of these purposes financial accounting and financial statements have a number of objectives that (1) determine the appropriate content of financial accounting information (general objectives) and (2) indicate the qualities that make financial accounting information useful (qualitative objectives). The objectives provide means to evaluate and improve generally accepted accounting principles (see section 1029.07).

.02 The content of financial accounting information can be examined on two levels. First, the appropriate content of particular financial statements prepared at a given date may be examined. Second, the appropriate content of financial accounting information in general, without regard for the conventions at any particular date, may be examined.

OBJECTIVES OF PARTICULAR FINANCIAL STATEMENTS

.03 The objectives of particular financial statements are to present fairly in conformity with generally accepted accounting principles[1] (1) financial position, (2) results

[1] See section 1026.01-.04 for a discussion of the nature of generally accepted accounting principles. See section 1027.15 for a discussion of fair presentation in conformity with generally accepted accounting principles.

of operations, and (3) other changes in financial position. Financial position and changes in financial position of an enterprise are defined in terms of its economic resources and obligations and changes in them that are identified and measured in conformity with accounting principles that are generally accepted at the time the statements are prepared.[2]

GENERAL OBJECTIVES

.04 The objectives of particular financial statements are stated in terms of the accounting principles that are generally accepted at the time the financial statements are prepared. These principles may change in response to a variety of forces.[3] General objectives that give direction to the development of accounting principles are therefore required. These general objectives are broader or longer range than those for particular financial statements and indicate the appropriate content of financial accounting information in general. They are independent of generally accepted accounting principles at any particular time. Improving financial accounting to better achieve the general objectives involves difficulties, which are discussed in paragraphs .38 to .41.

Statement of the General Objectives

.05 A general objective of financial accounting and financial statements is to provide reliable financial information about economic resources and obligations of a business enterprise. This information is important in evaluating the enterprise's strengths and weaknesses. It indicates how enterprise resources are financed and the pattern of its holdings of resources. It aids in evaluating the enterprise's ability to meet its commitments. The information indicates the present resource base available to exploit opportunities and make future progress. In short, information about economic resources and obligations of a business enterprise is needed to form judgments about the ability of the enterprise to survive, to adapt, to grow, and to prosper amid changing economic conditions.

.06 Another general objective, of prime importance, is to provide reliable information about changes in net re-

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[2] See section 1025.17-.22.

[3] See section 1029.02-.03 for a discussion of the dynamic nature of financial accounting.

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sources (resources less obligations) of an enterprise that result from its profit-directed activities.[4] Almost all who are directly concerned with the economic activities of an enterprise are interested in its ability to operate successfully. Investors expect a dividend return or increases in the price of ownership shares or both. An enterprise that operates successfully is more likely to be able to pay creditors and suppliers, provide jobs for employees, pay taxes, and generate funds for expansion. Management of the enterprise also needs information about economic progress to plan operations and evaluate progress in comparison with previously established goals. To survive, the enterprise needs some minimum level of success in its profit-directed activities over the long run.

.07 A related general objective is to provide financial information that assists in estimating the earning potential of the enterprise. Information about the past and present may help users of the information in making predictions. Trend figures usually (though not invariably) are better aids to prediction than the results of a single year. Extrapolations of financial data, however, should be made only in conjunction with the best additional information available about the enterprise, its circumstances, and its prospects.

.08 Another general objective is to provide other needed information about changes in economic resources and obligations. Examples are information about changes in residual interest from sources other than profit-directed activities and information about financing and investing activities. [As amended, effective for fiscal periods ending after September 30, 1971 by APB Opinion No. 19.]

.09 A further general objective is to disclose, to the extent possible, other information related to the financial statements that is relevant to statement users' needs. Examples of disclosures of this type are descriptions of the accounting policies adopted by the reporting entity. [As amended by APB Opinion No. 22, December 31, 1971.]

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[4] The term *profit-directed activities* is used in sections 1021-1029 to refer to all activities of an enterprise except transfers between the enterprise and its owners.

.10 Underlying the preceding discussion is the recognition that decisions of financial statement users involve the process of choosing among alternative courses of action. Owners make choices on whether to increase, retain, or dispose of holdings in various enterprises. Creditors often must choose between enterprises in deciding whether to extend credit. Management makes choices, for example, between alternative business activities and between alternative investments. Generally, statement users compare performance both between enterprises and over two or more reporting periods for the same enterprise. (See paragraphs .21 and .23-.33 for a discussion of comparability in financial accounting.)

Discussion of General Objectives

.11 The general objectives aid in improving accounting principles by relating the content of the information to the underlying activities of business enterprises and to the interests and needs of users of the information.

.12 The general objectives do not specify which resources and obligations and changes should be measured and reported as assets, liabilities, revenue, and expenses in financial accounting. They contain no implication that assets and liabilities ideally should include *all* resources and obligations or that *all* changes in assets and liabilities ideally should be reported.[5] Furthermore, they do not specify how the resources and obligations to be recorded should be measured. A complementary set of objectives, the qualitative objectives, aids in determining which resources and obligations and changes should be measured and reported and how they should be measured and reported to make the information most useful.

QUALITATIVE OBJECTIVES

.13 Certain qualities or characteristics make financial information useful. Providing information that has each of these qualities is an objective of financial accounting.

[5] Not all resources and obligations and changes in them are presently reported. For example, rights under executory contracts, obligations whose amounts are indeterminate, and changes in market price of productive resources are generally not recorded as assets, liabilities, revenue, and expenses, although they may be disclosed. (See sections 1026-1028 on generally accepted accounting principles.)

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These qualitative objectives are at least partially achieved at present, although improvement is probably possible in connection with each of them. Constraints on full achievement of the qualitative objectives are caused by conflicts of objectives, by environmental influences, and by lack of complete understanding of the objectives (see paragraphs .38 to .41).

.14 The qualitative objectives are related to the broad ethical goals of truth, justice, and fairness that are accepted as desirable goals by society as a whole. To the extent that the objectives are met, progress is made toward achieving the broad ethical goals as well as toward making financial information more useful. The qualitative objectives are less abstract than the ethical goals of truth, justice, and fairness and can therefore be applied more directly to financial accounting. Nevertheless, they are also generalizations that require judgment in using them to evaluate and improve accounting principles.

Statement of the Qualitative Objectives

.15 The Board believes that financial accounting has seven qualitative objectives (0-1 to 0-7). The primary qualitative objective is relevance.

.16 0-1. *Relevance.* Relevant financial accounting inmation bears on the economic decisions for which it is used.

The objective of relevance helps in selecting methods of measuring and reporting in financial accounting that are most likely to aid users in making the types of economic decisions for which they use financial accounting data.[6] In judging relevance of general-purpose information attention is focused on the common needs of users and not on specific needs of particular users. A vital task is to determine these common needs and the information that is relevant to them (see sections 1023.07 and 1023.09). Relevance is the primary qualitative objective because information that does not bear on the decisions for which it is used is useless, regardless of the extent to which it satisfies the other objectives.

[6] See discussion on uses and users in section 1023.04-.09.

.17 0-2. *Understandability.* Understandable financial accounting information presents data that can be understood by users of the information and is expressed in a form and with terminology adapted to the users' range of understanding.

Understandability is important because accounting information must be intelligible if it is to be useful. Users of financial statements can understand the information only if the data presented and their method of presentation are meaningful to them. Understandability also requires that the users have some understanding of the complex economic activities of enterprises, the financial accounting process, and the technical terminology used in financial statements.

.18 0-3. *Verifiability.* Verifiable financial accounting information provides results that would be substantially duplicated by independent measurers using the same measurement methods.

Measurements cannot be completely free from subjective opinions and judgments. The process of measuring and presenting information must use human agents and human reasoning and therefore is not founded solely on an "objective reality." Nevertheless, the usefulness of information is enhanced if it is verifiable, that is, if the attribute or attributes selected for measurement and the measurement methods used provide results that can be corroborated by independent measurers.

.19 0-4. *Neutrality.* Neutral financial accounting information is directed toward the common needs of users and is independent of presumptions about particular needs and desires of specific users of the information.

Measurements not based on presumptions about the particular needs of specific users enhance the relevance of the information to common needs of users. Preparers of financial accounting information should not try to increase the helpfulness of the information to a few users to the detriment of others who may have opposing interests.

.20 0-5. *Timeliness.* Timely financial accounting information is communicated early enough to

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be used for the economic decisions which it might influence and to avoid delays in making those decisions.

.21 0-6. *Comparability.* Comparable financial accounting information presents similarities and differences that arise from basic similarities and differences in the enterprise or enterprises and their transactions and not merely from differences in financial accounting treatments.

Problems in achieving comparability are discussed in paragraphs .23 to .33.

.22 0-7. *Completeness.* Complete financial accounting information includes all financial accounting data that reasonably fulfill the requirements of the other qualitative objectives (0-1 to 0-6).

The first six qualitative objectives specify qualities that are desirable in reported financial information. The objective of completeness specifies that all information that has the six qualities in reasonable degree should be reported.

Comparability

.23 Comparability means the ability to bring together for the purpose of noting points of likeness and difference. Comparability of financial information generally depends on like events being accounted for in the same manner. Comparable financial accounting information facilitates conclusions concerning relative financial strengths and weaknesses and relative success, both between periods for a single enterprise and between two or more enterprises.

.24 *Comparability Within a Single Enterprise.* A comparison of the financial statements of one enterprise at one date or for one period of time with those of the same enterprise at other dates or for other periods of the same length is more informative if the following conditions exist:

(1) The presentations are in the same form—that is, the arrangement within the statements is identical.

(2) The content of the statements is identical—that is, the same items from the underlying accounting records are classified under the same captions.

(3) Accounting principles are not changed or, if they are changed, the financial effects of the changes are disclosed.

(4) Changes in circumstances or in the nature of the underlying transactions are disclosed.

.25 If these four conditions are satisfied, a comparison of the financial statements furnishes useful information about differences in the results of operations for the periods involved or in the financial positions at the dates specified. To the extent, however, that any one of the conditions is not met, comparisons may be misleading.

.26 *Consistency*—Consistency is an important factor in comparability within a single enterprise. Although financial accounting practices and procedures are largely conventional, consistency in their use permits comparisons over time. If a change of practice or procedure is made, disclosure of the change and its effect permits some comparability, although users can rarely make adjustments that make the data completely comparable.

.27 *Regular reporting periods*—Regular reporting periods are also an important factor in comparability within a single enterprise. Periods of equal length facilitate comparisons between periods. Comparing the results of periods shorter than a year, even though the periods are of equal length, however, may require consideration of seasonal factors. (See section 2071, *Interim Financial Reporting*.)

.28 *Comparability Between Enterprises.* Comparability between enterprises is more difficult to attain than comparability within a single enterprise. Widespread public interest in investment opportunities in recent years has focused attention on the desirability of achieving greater comparability of financial statements.

.29 To make comparisons between enterprises as meaningful as possible, the four conditions outlined in paragraph .24 as well as other conditions should be satisfied. The most important of the other conditions is that, ideally, differences between enterprises' financial statements should arise from basic differences in the enterprises themselves or from the nature of their transactions and not merely from differences in financial accounting practices and pro-

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cedures. One of the most important unsolved problems at present, therefore, is the general acceptance of alternative accounting practices under circumstances which themselves do not appear to be sufficiently different to justify different practices.

.30 Achieving comparability between enterprises depends on accomplishing two difficult tasks: (1) identifying and describing the circumstances that justify or require the use of a particular accounting practice or method, (2) eliminating the use of alternative practices under these circumstances. If these tasks can be accomplished, basic differences under which enterprises operate can be reflected by appropriate, and possibly different, practices.

.31 Pending accomplishment of these tasks, users of financial statements should recognize that financial statements of different enterprises may not be fully comparable; that is, they may to an unknown extent reflect differences unrelated to basic differences in the enterprises and in their transactions. Evaluation of differences is not completely effective in the absence of criteria governing the applicability of various practices and methods.

.32 Supplemental disclosures are sometimes directed toward overcoming this present weakness in financial reporting, but disclosure does not necessarily make financial statements comparable. For example, a statement user may not safely assume that he has made comparable the financial statements of two enterprises which use different accounting methods even though he has been able to put them on the same inventory or depreciation method through the use of disclosed information, because the circumstances may differ to such an extent that similar methods may not be appropriate.

.33 The Accounting Principles Board and others in the accounting profession are continuing to work on problems of comparability between enterprises. The Board has, for example, developed criteria for application of practices and procedures in some problem areas and expects to deal with others in the future. The great variety of business enterprises and the large number of different circumstances in which enterprises operate, even within the same industry, make the task a difficult one. The Board ranks compara-

bility among the most important of the objectives of financial accounting, however, and is attempting to narrow areas of difference in accounting practices that are not justified by differences in circumstances.

Adequate Disclosure

.34 Financial information that meets the qualitative objectives of financial accounting also meets the reporting standard of adequate disclosure.[7] Adequate disclosure relates particularly to objectives of relevance, neutrality, completeness, and understandability. Information should be presented in a way that facilitates understanding and avoids erroneous implications. The headings, captions, and amounts must be supplemented by enough additional data so that their meaning is clear but not by so much information that important matters are buried in a mass of trivia.

Reliability of Financial Statements

.35 Achievement of the qualitative objectives of financial accounting enhances the reliability of financial statements. Reliability of information is important to users because decisions based on the information may affect their economic well-being. Reliability does not imply precision of the information in financial statements because financial accounting involves approximation and judgment (see sections 1025.10 and 1025.11).

.36 The responsibility for the reliability of an enterprise's financial statements rests with its management. This responsibility is discharged by applying generally accepted accounting principles that are appropriate to the enterprise's circumstances, by maintaining effective systems of accounts and internal control, and by preparing adequate financial statements.

.37 The users of financial statements also look to the reports of independent auditors to ascertain that the financial statements have been examined by independent experts who have expressed their opinion as to whether or not the information is presented fairly in conformity with generally accepted accounting principles consistently applied.

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[7] AU section 430 (volume 1, AICPA PROFESSIONAL STANDARDS).

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ACHIEVING THE OBJECTIVES

.38 The objectives of financial accounting and financial statements are at least partially achieved at present, although improvement is probably possible in connection with each of them. The objectives are often difficult to achieve, however, and are usually not equally capable of attainment. Constraints on full achievement of the objectives arise from (1) conflicts of objectives, (2) environmental influences, and (3) lack of complete understanding of the objectives.

.39 The pursuit of one objective or one set of objectives may conflict with the pursuit of others. It is not always possible, for example, to have financial statements that are highly relevant on the one hand and also timely on the other. Nor is it always possible to have financial accounting information that is both as verifiable and as relevant as desired. Only if all other objectives are not affected will a change in information that increases compliance with one objective be certain to be beneficial. Conflicts between qualitative objectives might be resolved by arranging the objectives in order of relative importance and determining desirable trade-offs, but, except for the primacy of relevance, neither accountants nor users now agree as to their relative importance. Determining the trade-offs that are desirable requires judgment.

.40 Constraints on achieving the objectives may stem from influences of the environment on accounting. First, the objectives, which are based largely on the needs of users of financial information, are not necessarily compatible with environmental influences. The inherent difficulties of measurement in terms of money, for example, mean that information produced by accounting will necessarily fall short to some extent of objectives of verifiability and comparability. Second, financial accounting costs money. Anticipated benefits from proposed changes in financial accounting information that are intended to better achieve the objectives must be weighed against the additional cost involved. Finally, changing financial accounting practices to better achieve the objectives involves user costs and dislocations that may tend to offset the advantages to be obtained. For example, changing practices may affect business arrangements that were initiated on the basis of

practices before the change. Also, the costs of learning how to use new types of information and the reluctance to change ways of using information may reduce the benefits otherwise obtainable from improvements.

.41 The Board believes that the objectives discussed in this section are helpful in evaluating and improving financial accounting information even though they are stated in general terms. Obtaining clearer understanding of the nature and implications of the objectives is an important prerequisite to further improvement of financial accounting and financial statements.

→ *The next page is 7241.* ←

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AC Section 1025

Basic Features and Basic Elements of Financial Accounting

[Source: APB Statement No. 4, Chap. 5.]

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STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

BASIC FEATURES OF FINANCIAL ACCOUNTING

.01 The basic features of financial accounting are a distillation of the effects of environmental characteristics (described in section 1023) on the financial accounting process. These features underlie present generally accepted accounting principles, discussed in sections 1026 to 1028, but they could also serve as a foundation for other accounting principles that are based on the same environmental characteristics.

Statement of the Basic Features of Financial Accounting

.02 The following thirteen statements (F-1 to F-13) describe the basic features of financial accounting. Each statement contains a parenthetical reference to environmental characteristics from which it is, at least in part, derived.

.03 F-1. *Accounting entity.* Accounting information pertains to entities, which are circumscribed areas of interest. In financial accounting the entity is the specific business enterprise. The enterprise is identified in its financial statements. (sections 1023.12, 1023.17)

Attention in financial accounting is focused on the economic activities of individual business enterprises. The boundaries of the accounting entity may not be the same as those of the legal entity, for example, a parent corporation and its subsidiaries treated as a single business enterprise.

.04 F-2. *Going concern.* An accounting entity is viewed as continuing in operation in the absence of evidence to the contrary.[1] (section 1023.16)

Because of the relative permanence of enterprises, financial accounting is formulated basically for going concerns. Past experience indicates that continuation of operations is highly probable for most enterprises although continuation cannot be known with certainty. An enterprise is not viewed as a *going concern* if liquidation appears imminent.

.05 F-3. *Measurement of economic resources and obligations.* Financial accounting is primarily concerned with measurement of economic resources and obligations and changes in them. (sections 1023.10, 1023.17-.19, 1023.22-.24, 1023.27)

The subject matter of financial accounting is economic activity and financial accounting therefore involves measuring and reporting on the creation, accumulation, and use of economic resources. Economic activities that can be quantified are emphasized in financial accounting. Accounting does not deal directly with subjective concepts of welfare or satisfactions; its focus is not sociological or psychological.

.06 F-4. *Time periods.* The financial accounting process provides information about the economic activities of an enterprise for specified time periods that are shorter than the life of the enterprise. Normally the time periods are of equal length to facilitate comparisons. The time period is identified in the financial statements. (sections 1023.13, 1023.15-.16, 1023.28)

Interested parties make evaluations and decisions at many points in the lives of enterprises. The continuous activities of enterprises are therefore segmented into relatively short periods of time so that information can be prepared that will be useful in decisions.

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[1] The corollary observation is that if liquidation appears imminent, financial information may be prepared on the assumption that liquidation will occur.

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.07 F-5. *Measurement in terms of money.* Financial accounting measures monetary attributes of economic resources and obligations and changes in them. The unit of measure is identified in the financial statements. (sections 1023.12, 1023.17, 1023.27, 1023.30-.31)

Measurement in terms of money focuses attention on monetary attributes of resources and obligations; other aspects, such as physical attributes, are not emphasized. Money measurement entails significant problems (see sections 1023.28, 1023.29 and 1023.33).

.08 F-6. *Accrual.* Determination of periodic income and financial position depends on measurement of economic resources and obligations and changes in them as the changes occur rather than simply on recording receipts and payments of money. (sections 1023.17, 1023.20-.22, 1023.24, 1023.27, 1023.29, 1023.31)

Enterprise economic activity in a short period seldom follows the simple form of a cycle from money to productive resources to product to money. Instead, continuous production, extensive use of credit and long-lived resources, and overlapping cycles of activity complicate the evaluation of periodic activities. As a result, noncash resources and obligations change in time periods other than those in which money is received or paid. Recording these changes is necessary to determine periodic income and to measure financial position. This is the essence of accrual accounting.

.09 F-7. *Exchange price.* Financial accounting measurements are primarily based on prices at which economic resources and obligations are exchanged. (sections 1023.12, 1023.28, 1023.30-.33)

Measurement in terms of money is based primarily on exchange prices. Changes in resources from other than exchanges (for example, production) are measured by allocating prices in prior exchanges or by reference to current prices for similar resources. The multiple concepts of exchange price (section 1023.31) require decisions about the prices relevant to the uses of financial accounting information.

.10 F-8. *Approximation.* Financial accounting measurements that involve allocations among relatively short periods of time and among complex and joint activities are necessarily made on the basis of estimates. (sections 1023.12-.13, 1023.15-.16, 1023.28, 1023.33)

The continuity, complexity, uncertainty, and joint nature of results inherent in economic activity often preclude definitive measurements and make estimates necessary.

.11 F-9. *Judgment.* Financial accounting necessarily involves informed judgment. (sections 1023.04, 1023.07-.08, 1023.15-.16, 1023.28-.29, 1023.32-.33)

The estimates necessarily used in financial accounting (F-8) involve a substantial area of informed judgment. This precludes reducing all of the financial accounting process to a set of inflexible rules.

.12 F-10. *General-purpose financial information.* Financial accounting presents general-purpose financial information that is designed to serve the common needs of owners, creditors, managers, and other users, with primary emphasis on the needs of present and potential owners and creditors. (sections 1023.05-.08, 1023.24)

General-purpose financial statements are prepared by an enterprise under the presumption that users have common needs for information (see section 1023.07). Although special-purpose information may be prepared from financial accounting records, it is not the primary product of financial accounting and is not discussed in sections 1021-1029.

.13 F-11. *Fundamentally related financial statements.* The results of the accounting process are expressed in statements of financial position and changes in financial position, which are based on the same underlying data and are fundamentally related. (sections 1023.22, 1023.24, 1023.29)

The basic interrelationships between economic resources and economic obligations and changes in them make

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measurement of periodic net income and of assets and liabilities part of the same process and require that the financial statements be fundamentally related. The measurement bases used to quantify changes in financial position are necessarily related to the measurement bases of the resources and obligations used in representations of financial position.

.14 F-12. *Substance over form.* Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment. (sections 1023.02, 1023.25, 1023.27)

Usually the economic substance of events to be accounted for agrees with the legal form. Sometimes, however, substance and form differ. Accountants emphasize the substance of events rather than their form so that the information provided better reflects the economic activities represented.

.15 F-13. *Materiality.* Financial reporting is only concerned with information that is significant enough to affect evaluations or decisions. (section 1023.04-.06)

Basic Features and the Environment

.16 The basic features of financial accounting described above are the result of environmental factors and influence the financial accounting process. The relationships between the features and the environment and among the features themselves are complex. The relationships between environmental conditions and the basic features of financial accounting can be illustrated with examples. The importance of money in a highly developed economy is the basis for the feature of measurement in terms of money (F-5). The complexity and continuity of economic activity, the joint nature of economic results, and the uncertain outcome of economic activity are important factors in the features of approximation (F-8) and judgment (F-9).

BASIC ELEMENTS OF FINANCIAL ACCOUNTING

.17 The basic elements of financial accounting—assets, liabilities, owners' equity, revenue, expenses, and net income (net loss)—are related to the economic resources, economic obligations, residual interest, and changes in them which are discussed in section 1023. Not all economic resources and obligations and changes in them are recognized and measured in financial accounting. The objectives of financial accounting (section 1024) provide broad criteria that aid in selecting economic resources, obligations, and changes in them for recognition and measurement. The basic features are additional factors in determining which economic elements and changes in them are recognized and measured. The particular economic elements and changes to be recognized and measured at any time as the basic elements of financial accounting are determined by generally accepted accounting principles in effect at that time. The basic elements of financial accounting therefore are defined in terms of both (1) economic resources and obligations of enterprises, and (2) generally accepted accounting principles.

.18 Because generally accepted accounting principles change, the concepts of assets, liabilities, owners' equity, revenue, expenses, and net income also change, subject to the constraints of the economic elements referred to in their definitions. The definitions themselves, therefore, provide criteria for determining those economic resources, economic obligations, and changes in them that *are* included in the basic elements at any particular time but do not provide criteria for determining from a broader or longer-range perspective those economic elements that *should be* included in the basic elements. Under the definitions given, determining the items that should be included in the basic elements is part of the overall problem of determining what generally accepted accounting principles should be. Criteria intended to help solve that problem are provided by the general and qualitative objectives of financial accounting and financial statements (section 1024).

Financial Position

.19 The basic elements of the financial position of an enterprise are assets, liabilities, and owners' equity:

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Assets—economic resources of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Assets also include certain deferred charges that are not resources [2] but that are recognized and measured in conformity with generally accepted accounting principles.[3]

Liabilities—economic obligations of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Liabilities also include certain deferred credits that are not obligations [4] but that are recognized and measured in conformity with generally accepted accounting principles.[5]

Owners' equity—the interest of owners in an enterprise, which is the excess of an enterprise's assets over its liabilities.[6]

Owners' equity is defined in terms of assets and liabilities, just as residual interest is defined in terms of economic resources and obligations (see section 1023.20). The relationship among assets, liabilities, and owners' equity implicit in the definition of owners' equity is:

Assets — Liabilities = Owners' Equity [7]

.20 The *financial position* of an enterprise at a particular time comprises its assets, liabilities, and owners' equity

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[2] Deferred charges from income tax allocation are an example of deferred charges that are not resources. The term *deferred charges* is also sometimes used to refer to certain resources, for example, prepaid insurance.

[3] This definition differs from that in Accounting Terminology Bulletin No. 1, paragraph 26, which defines assets as debit balances carried forward upon a closing of books of account that represent property values or rights acquired.

[4] Deferred credits from income tax allocation are an example of deferred credits that are not obligations. The term *deferred credits* is also sometimes used to refer to certain obligations, for example, subscriptions collected in advance.

[5] This definition differs from that in Accounting Terminology Bulletin No. 1, paragraph 27, in that (1) it defines liabilities primarily in terms of obligations rather than as credit balances carried forward upon closing the books, and (2) it excludes capital stock and other elements of owners' equity.

[6] This definition isolates owners' equity as a separate element. Owners' equity is included in the definition of liabilities in Accounting Terminology Bulletin No. 1, paragraph 27. Owners' equity is conventionally classified into several categories (see section 1027.24).

[7] Expressing the relationship in a mathematical equation goes beyond descriptions of terms and assumes appropriate measurement. Measurement of economic activity is discussed in section 1023.27-.33.

and the relationship among them, plus those contingencies, commitments, and other financial matters that pertain to the enterprise at that time and are required to be disclosed under generally accepted accounting principles. The financial position of an enterprise is presented in the *balance sheet*[8] and in notes to the financial statements.

Results of Operations

.21 The basic elements of the results of operations of an enterprise are revenue, expenses, and net income:

Revenue—gross increases in assets or gross decreases in liabilities recognized and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities[9] of an enterprise that can change owners' equity.[10]

Increases in assets and decreases in liabilities designated as revenue are related to changes in resources and obligations discussed in section 1023.22. Revenue does not, however, include all recognized increases in assets or decreases in liabilities. Revenue results only from those types of profit-directed activities that can change owners' equity under generally accepted accounting principles. Receipt of the proceeds of a cash sale is revenue under present generally accepted accounting principles, for example, because the net result of the sale is a change in owners' equity.[11] On the other hand, receipt of the proceeds of a loan or receipt of an asset purchased for cash, for example, is not revenue under present generally ac-

[8] The definition of balance sheet in this paragraph differs from that in Accounting Terminology Bulletin No. 1, paragraph 21, in that it defines the content in terms of assets, liabilities, and owners' equity, rather than balances carried forward after closing books kept according to principles of accounting.

[9] See section 1024.06, fn. 4, for the definition of profit-directed activities.

[10] The definition of revenue in this paragraph differs from that in Accounting Terminology Bulletin No. 2, paragraphs 5-7, in that (1) it emphasizes the nature of revenue rather than the usual point of recognition—the sale, (2) it includes the proceeds rather than only the gain from sale or exchange of assets "other than stock in trade." Gain is defined in sections 1021-1029 as a net concept, the result of deducting expenses from revenue. See section 1027.24 for a discussion of gains in financial accounting.

[11] If by coincidence the proceeds of a sale are equal to the cost and owners' equity does not change, receipt of the proceeds is nevertheless revenue because a sale is a type of event in which owners' equity can change under present generally accepted accounting principles.

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cepted accounting principles because owners' equity can not change at the time of the loan or purchase.

Expenses—gross decreases in assets or gross increases in liabilities recognized and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities of an enterprise that can change owners' equity.[12]

Decreases in assets and increases in liabilities designated as expenses are related to changes in resources and obligations discussed in section 1023.22. Expenses, like revenue, result only from those types of profit-directed activities that can change owners' equity under generally accepted accounting principles. Delivery of product in a sale is an expense under present generally accepted accounting principles, for example, because the net result of the sale is a change in owners' equity. On the other hand, incurring a liability for the purchase of an asset is not an expense under present generally accepted accounting principles because owners' equity can not change at the time of the purchase.

Net income (*net loss*)—the excess (deficit) of revenue over expenses for an accounting period, which is the net increase (net decrease) in owners' equity (assets minus liabilities) of an enterprise for an accounting period from profit-directed activities that is recognized and measured in conformity with generally accepted accounting principles.

The relationship among revenue, expenses, and net income (net loss) implicit in the definition of net income (net loss) is:

Revenue — Expenses = Net Income (Net Loss) [13]

[12] This definition of expenses differs from that given in Accounting Terminology Bulletin No. 4, paragraphs 3-4, and 6. It is similar to the "broad" definition in the Terminology Bulletin except that it includes the cost of assets "other than stock in trade" disposed of rather than only the loss (see section 1027.24 for a discussion of losses in financial accounting). The "narrow" definition of expenses recommended in the Terminology Bulletin for use in financial statements excludes "cost of goods or services sold" from expenses and is incompatible with the definition in sections 1021-1029. Expense in this "narrow" sense should always be modified by appropriate qualifying adjectives, for example, *selling and administrative expenses* or *interest expense*.

[13] Expressing the relationship in a mathematical equation goes beyond descriptions of terms and assumes appropriate measurement. Measurement of economic activity is discussed in section 1023.27-.33.

.22 The *results of operations* of an enterprise for a period of time comprises the revenue, expenses, and net income (net loss) of the enterprise for the period. The results of operations of an enterprise are presented in the *income statement.*

Interrelationship of Financial Position and Results of Operations

.23 The financial position and results of operations of an enterprise are fundamentally related. Net income (net loss) for an accounting period, adjustments of income of prior periods, and investments and withdrawals by owners during the period constitute the change during the period in owners' equity, an element of financial position. Other relationships between the income statement and the balance sheet, for example, the relationship of cost of goods sold to inventory and of depreciation to fixed assets, are further indications of the interrelatedness of the statements.

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AC Section 1026

Generally Accepted Accounting Principles—Pervasive Principles

[Source: APB Statement No. 4, Chap. 6, as amended.]

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STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

.01 Financial statements are the product of a process in which a large volume of data about aspects of the economic activities of an enterprise are accumulated, analyzed, and reported. This process should be carried out in accordance with generally accepted accounting principles. Generally accepted accounting principles incorporate the consensus[1] at a particular time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities should be recorded, when these changes should be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared.

.02 *Generally accepted accounting principles* therefore is a technical term in financial accounting. Generally accepted accounting principles encompass the conventions,

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[1] Inasmuch as generally accepted accounting principles embody a consensus, they depend on notions such as *general acceptance* and *substantial authoritative support,* which are not precisely defined. The Securities and Exchange Commission indicated in Accounting Series Release No. 4 that when financial statements are "prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate . . . ." The AICPA Special Committee on Opinions of the Accounting Principles Board defines *generally accepted accounting principles* as those "having substantial authoritative support." Problems in defining substantial authoritative support are discussed in Marshall Armstrong, "Some Thoughts on Substantial Authoritative Support," *The Journal of Accountancy,* April 1969, pp. 44-50.

rules, and procedures necessary to define accepted accounting practice at a particular time. The standard[2] of "generally accepted accounting principles" includes not only broad guidelines of general application, but also detailed practices and procedures.[3]

.03 Generally accepted accounting principles are conventional—that is, they become generally accepted by agreement (often tacit agreement) rather than by formal derivation from a set of postulates or basic concepts. The principles have developed on the basis of experience, reason, custom, usage, and, to a significant extent, practical necessity.

.04 In recent years Opinions of the Accounting Principles Board have received considerable emphasis as a major determinant of the composition of generally accepted accounting principles. All of the Accounting Research Bulletins and the early Opinions of the Accounting Principles Board include the statement that ". . . the authority of the bulletins [or Opinions] rests upon their general acceptability. . . ." Beginning with Opinion No. 6 (October 1965), however, Opinions of the Accounting Principles Board include a statement to reflect the adoption in October 1964 by Council of the American Institute of Certified Public Accountants of a resolution that provides in essence that accounting principles accepted in Opinions of the Accounting Principles Board constitute, per se, generally accepted accounting principles for Institute members. [Effective March 1, 1973 members are governed by Rule 203 of the AICPA Code of Professional Ethics in reporting departures from generally accepted accounting principles.] (See section 520.)

.05 In sections 1021-1029 the discussion of present generally accepted accounting principles is divided into three sections: (1) pervasive principles, which relate to financial accounting as a whole and provide a basis for the other

[2] The independent auditor's report gives the auditor's opinion as to whether the financial statements "present fairly the financial position . . . and the results of . . . operations, in conformity with generally accepted accounting principles. . . ."

[3] "The term 'principles of accounting' as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them." AU section 410.02 (volume 1, AICPA PROFESSIONAL STANDARDS).

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principles, (2) broad operating principles, which guide the recording, measuring, and communicating processes of financial accounting, and (3) detailed principles, which indicate the practical application of the pervasive and broad operating principles. This classification provides a useful framework for analysis, although the distinctions between the types of principles, especially between the broad operating and detailed principles, are somewhat arbitrary. This section discusses the pervasive principles. The broad operating and detailed principles are discussed in sections 1027 and 1028, respectively.

.06 The three types of principles form a hierarchy. The pervasive principles are few in number and fundamental in nature. The broad operating principles derived from the pervasive principles are more numerous and more specific, and guide the application of a series of detailed principles. The detailed principles are numerous and specific. Detailed principles are generally based on one or more broad operating principles and the broad operating principles are generally based on the pervasive principles. No attempt is made in sections 1021-1029 to indicate specific relationships between principles.

PERVASIVE PRINCIPLES

.07 The pervasive principles specify the general approach accountants take to recognition and measurement of events that affect the financial position and results of operations of enterprises. The pervasive principles are divided into (1) pervasive measurement principles and (2) modifying conventions.

Pervasive Measurement Principles

.08 The pervasive measurement principles (P-1 to P-6) establish the basis for implementing accrual accounting. They include the initial recording principle, the realization principle, three pervasive expense recognition principles, and the unit of measure principle. These principles broadly determine (1) the types of events to be recognized by financial accounting, (2) the bases on which to measure the events, (3) the time periods with which to identify the events, and (4) the common denominator of measurement.

.09 *Initial Recording.* The principle for initial recording of assets and liabilities is important in financial accounting because it determines (1) the data that enter the accounting process, (2) the time of entry, and (3) generally the amounts at which assets, liabilities, revenue, and expenses are recorded.

> P-1. *Initial recording of assets and liabilities.* Assets and liabilities generally are initially recorded on the basis of events in which the enterprise acquires resources from other entities or incurs obligations to other entities.[4] The assets and liabilities are measured by the exchange prices[5] at which the transfers take place.

.10 The initial recording of assets and liabilities may also reflect the elimination of other assets or liabilities, for example, the payment of cash in acquiring equipment. The amounts at which assets and liabilities are initially recorded may be carried without change, may be changed, for example, by amortization or write off, or may be shifted to other categories. The effects of transactions or other events to which the entity is not a party are usually not recognized in the accounting records until transactions of the enterprise occur, although there are significant exceptions to this general principle (see section 1027.09). The effects of executory contracts also are generally not recognized until one of the parties at least partially fulfills his commitment.

.11 *Income Determination.*[6] Income determination in accounting is the process of identifying, measuring, and relating revenue and expenses of an enterprise for an

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[4] This principle does not cover the first recording of assets produced or constructed by the enterprise from other assets that previously have been initially recorded. Accounting for produced or self-constructed assets is discussed in paragraph .23.

[5] In transfers that involve deferred payments of money, the determination of exchange prices requires a realistic rate of interest (refer to section 4111.) [As amended, effective October 1, 1971, by APB Opinion No. 21.]

In transfers that do not involve money prices, such as barter transactions or investments by owners, assets are usually measured at "fair value," that is, at the amount of money that would be involved if the assets were received in exchanges that involved money prices. For exceptions to this general rule see section 1027.08, M-2B and M-2C.

[6] The term *matching* is often used in the accounting literature to describe the entire process of income determination. The term is also often

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accounting period. Revenue for a period is generally determined independently by applying the realization principle. Expenses are determined by applying the expense recognition principles on the basis of relationships between acquisition costs[7] and either the independently determined revenue or accounting periods. Since the point in time at which revenue and expenses are recognized is also the time at which changes in amounts of net assets are recognized, income determination is interrelated with asset valuation. From the perspective of income determination, costs are divided into (1) those that have "expired" and become expenses and (2) those that are related to later periods and are carried forward as assets in the balance sheet. From the perspective of asset valuation, those costs that no longer meet the criteria of assets become expenses and are deducted from revenue in determining net income.

.12 *Revenue and Realization.* Revenue is a gross increase in assets or a gross decrease in liabilities recognized and measured in conformity with generally accepted accounting principles that results from those types of profit-directed activities of an enterprise that can change owners' equity (see section 1025.21). Revenue under present generally accepted accounting principles is derived from three general activities: (a) selling products, (b) rendering services and permitting others to use enterprise resources, which result in interest, rent, royalties, fees, and the like, and (c) disposing of resources other than products—for example, plant and equipment or investments in other entities. Revenue does not include receipt of assets purchased, proceeds of borrowing, investments by owners, or adjustments of revenue of prior periods.

.13 Most types of revenue are the joint result of many profit-directed activities of an enterprise and revenue is

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applied in accounting, however, in a more limited sense to the process of expense recognition or in an even more limited sense to the recognition of expenses by associating costs with revenue on a cause and effect basis (see paragraph .21). Because of the variety of its meanings, the term *matching* is not used in sections 1021-1029.

[7] See section 1023.26 for a general discussion of the term *cost* and paragraph .28 for a discussion of the meaning of the term *cost* under present generally accepted accounting principles.

often described as being "earned" gradually and continuously by the whole of enterprise activities. *Earning* in this sense is a technical term that refers to the activities that give rise to the revenue—purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth. All of the profit-directed activities of an enterprise that comprise the process by which revenue is earned may be called the *earning process.*

.14 Revenue is conventionally recognized at a specific point in the earning process of a business enterprise, usually when assets are sold or services are rendered. This conventional recognition is the basis of the pervasive measurement principle known as realization.

> P-2. *Realization.* Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place.

.15 The exchange required by the realization principle determines both the time at which to recognize revenue and the amount at which to record it. Revenue from sales of products is recognized under this principle at the date of sale, usually interpreted to mean the date of delivery to customers. Revenue from services rendered is recognized under this principle when services have been performed and are billable. Revenue from permitting others to use enterprise resources, such as interest, rent, and royalties is also governed by the realization principle. Revenue of this type is recognized as time passes or as the resources are used. Revenue from sales of assets other than products is recognized at the date of sale. Revenue recognized under the realization principle is recorded at the amount received or expected to be received.

.16 Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of

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periodic income results. Sometimes revenue is recognized at the completion of production and before a sale is made. Examples include certain precious metals and farm products with assured sales prices.[8] The assured price, the difficulty in some situations of determining costs of products on hand, and the characteristic of unit interchangeability are reasons given to support this exception.

.17 The realization principle requires that revenue be earned before it is recorded. This requirement usually causes no problems because the earning process is usually complete or nearly complete by the time of the required exchange. The requirement that revenue be earned becomes important, however, if money is received or amounts are billed in advance of the delivery of goods or rendering of services. For example, amounts for rent or magazine subscriptions received in advance are not treated as revenue of the period in which they are received but as revenue of the future period or periods in which they are "earned." These amounts are carried as "unearned revenue"—that is, liabilities to transfer goods or render services in the future—until the earning process is complete. The recognition of this revenue in the future period results in recording a decrease in a liability rather than an increase in an asset.

.18 *Expense Recognition.* Expenses are gross decreases in assets or gross increases in liabilities recognized and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities of an enterprise that can change owners' equity (see section 1025.21). Important classes of expenses are (1) costs of assets used to produce revenue (for example, cost of goods sold, selling and administrative expenses, and interest expense), (2) expenses from nonreciprocal transfers and casualties (for example, taxes, fires, and theft), (3) costs of assets other than products (for example, plant and equipment or investments in other companies) disposed of, (4) costs incurred in unsuccessful efforts, and (5) declines in market prices of inventories held for sale. Expenses do not include repayments of

[8] This increase in assets is often reported in the income statement as a reduction of cost of goods sold rather than as sales revenue.

borrowing, expenditures to acquire assets, distributions to owners (including acquisition of treasury stock), or adjustments of expenses of prior periods.

.19 Expenses are the costs that are associated with the revenue of the period, often directly but, frequently indirectly through association with the period to which the revenue has been assigned. Costs to be associated with future revenue or otherwise to be associated with future accounting periods are deferred to future periods as assets. Costs associated with past revenue or otherwise associated with prior periods are adjustments of the expenses of those prior periods.[9] The expenses of a period are (a) costs directly associated with the revenue of the period, (b) costs associated with the period on some basis other than a direct relationship with revenue, and (c) costs that cannot, as a practical matter, be associated with any other period.

.20 Three pervasive expense recognition principles specify the bases for recognizing the expenses that are deducted from revenue to determine the net income or loss of a period. They are "associating cause and effect," "systematic and rational allocation," and "immediate recognition."

.21 P-3. *Associating cause and effect.*[10] Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue.

Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

.22 Several assumptions regarding relationships must be made to accumulate the costs of products sold or services provided. For example, manufacturing costs

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[9] See paragraph .38.

[10] The term *matching* is often applied to this process (see paragraph .11, footnote 6).

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are considered to "attach" to products on bases of association such as labor hours, area or volume of facilities used, machine hours, or other bases presumed to indicate the relationship involved. "Attaching" costs to products often requires several allocations and reallocations of costs. Also, assumptions regarding the "flow" of costs or of physical goods (LIFO, FIFO, average) are often made to determine which costs relate to products sold and which remain in inventory as assets.

.23 P-4. *Systematic and rational allocation.* In the absence of a direct means of associating cause and effect, some costs are associated with specific accounting periods as expenses on the basis of an attempt to allocate costs in a systematic and rational manner among the periods in which benefits are provided.

If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect. The cost of an asset that provides benefits for only one period is recognized as an expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assumptions about the pattern of benefits and the relationship between costs and benefits because neither of these two factors can be conclusively demonstrated. The allocation method used should appear reasonable to an unbiased observer and should be followed systematically. Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance. Systematic and rational allocation of costs may increase assets as product costs or as other asset costs rather than increase expenses immediately, for example, depreciation charged to inventory and costs of self-constructed assets. These costs are later recognized as expenses under the expense recognition principles.

.24 P-5. *Immediate recognition.* Some costs are associated with the current accounting period as expenses because (1) costs in-

> curred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.

Application of this principle of expense recognition results in charging many costs to expense in the period in which they are paid or liabilities to pay them accrue. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts. The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense, for example, a patent that is determined to be worthless.

.25 *Application of Expense Recognition Principles.* To apply expense recognition principles, costs are analyzed to see whether they can be associated with revenue on the basis of cause and effect. If not, systematic and rational allocation is attempted. If neither cause and effect associations nor systematic and rational allocations can be made, costs are recognized as expenses in the period incurred or in which a loss is discerned. Practical measurement difficulties and consistency of treatment over time are important factors in determining the appropriate expense recognition principle.

.26 *Effect of the Initial Recording, Realization, and Expense Recognition Principles.* The essential effect of these principles as they now exist is that measurement of the assets, liabilities, revenue, and expenses of a business enterprise is based primarily on its own exchanges. Resources and obligations that result from executory contracts are generally not recorded as assets and liabilities until one of the parties at least partially fulfills his commitment. Furthermore, not all changes in the utility or price of assets are recognized. Increases in assets and the related revenue are usually not recorded if they result

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from events wholly internal to the enterprise. For example, revenue that is earned during the production process is generally not recorded until the goods and services produced are exchanged. Also, increases or decreases in assets and related revenue and expenses that result from events in which the enterprise does not participate directly are usually not recorded.[11] For example, most changes in prices of productive resources are not recognized until enterprise transactions take place.

.27 Under the initial recording, realization, and expense recognition principles assets are generally carried in the accounting records and presented in financial statements at acquisition cost or some unexpired or unamortized portion of it. When assets are sold, the difference between the proceeds realized and the unamortized portion of acquisition cost is recognized as an increase (or decrease) in the enterprise's net assets.

.28 The initial recording and realization conventions are the basis for the "cost principle" (which is more accurately described as the acquisition-price or historical-cost rule). Cost can be defined in several ways—for example, as the amount of money that would be required to acquire assets currently (replacement cost) or as the return from alternative uses of assets, such as selling them (opportunity cost). However, "cost" at which assets are carried and expenses are measured in financial accounting today usually means historical or acquisition cost because of the conventions of initially recording assets at acquisition cost and of ignoring increases in assets until they are exchanged (the realization convention).[12] The term *cost* is also commonly used in financial accounting to refer to the amount at which assets are initially recorded, regardless of how the amount is determined.

.29 *Unit of Measure.* In the United States, the U. S. dollar fulfills the functions of medium of exchange, unit of account, and store of value. It provides the unit of meas-

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[11] Exceptions include the cost or market rule for inventories (see section 1027.09).

[12] See section 1023.26 for a general discussion of the term *cost.* The discussions of cost in section 1023.26 and paragraph .28 are broader than that in Accounting Terminology Bulletin No. 4, paragraph 2, which defines only historical or acquisition cost.

ure for financial accounting. Stating assets and liabilities and changes in them in terms of a common financial denominator is prerequisite to performing the operations—for example, addition and subtraction—necessary to measure financial position and periodic net income.

.30 Defining the unit of measure in terms of money presents problems because of decreases (inflation) or increases (deflation) in the general purchasing power of money over time. The effects of inflation in the United States are not considered sufficiently important at this time to require recognition in financial accounting measurements.

> P-6. *Unit of measure.* The U. S. dollar is the unit of measure in financial accounting in the United States. Changes in its general purchasing power are not recognized in the basic financial statements.

.31 *Effect of the Unit of Measure Principle.* The basic effect of this principle is that financial accounting measures are in terms of numbers of dollars, without regard to changes in the general purchasing power of those dollars.

.32 The unit of measure principle is applied together with the other pervasive measurement principles. Costs are therefore measured in terms of the number of dollars initially invested in assets. If moderate inflation or deflation persists for several years or if substantial inflation or deflation occurs over short periods, the general purchasing power of the dollars in which expenses are measured may differ significantly from the general purchasing power of the dollars in which revenue is measured. Methods of accounting which tend to minimize this effect in the determination of periodic income—most notably the last-in, first-out method of inventory pricing and accelerated depreciation of plant and equipment—have become generally accepted and widely used in the United States. Methods of restating financial statements for general price-level changes have been used in some countries that have experi-

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enced extreme inflation but are not now used in the basic financial statements in the United States.[13]

Modifying Conventions

.33 The pervasive measurement principles are largely practical responses to problems of measurement in financial accounting and do not provide results that are considered satisfactory in all circumstances. Certain widely adopted conventions modify the application of the pervasive measurement principles. These modifying conventions, discussed in the following paragraphs, have evolved to deal with some of the most difficult and controversial problem areas in financial accounting. They are applied because rigid adherence to the pervasive measurement principles (1) sometimes produces results that are not considered to be desirable, (2) may exclude from financial statements some events that are considered to be important, or (3) may be impractical in certain circumstances.

.34 The modifying conventions are applied through generally accepted rules that are expressed either in the broad operating principles or in the detailed principles. The modifying conventions are a means of substituting the collective judgment of the profession for that of the individual accountant.

.35 *Conservatism.* Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost and market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles.

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[13] Section 1071, *Financial Statements Restated for General Price-Level Changes,* issued in June 1969, recommends supplementary disclosure of general price-level information.

.36 *Emphasis on Income.* Over the past century businessmen, financial statement users, and accountants have increasingly tended to emphasize the importance of net income and that trend has affected the emphasis in financial accounting. Although balance sheets formerly were presented without income statements, the income statement has in recent years come to be regarded as the most important of the financial statements. Accounting principles that are deemed to increase the usefulness of the income statement are therefore sometimes adopted by the profession as a whole regardless of their effect on the balance sheet or other financial statements. For example, the last-in, first-out (LIFO) method of inventory pricing may result in balance sheet amounts for inventories that become further removed from current prices with the passage of time. LIFO, however, is often supported on the grounds that it usually produces an amount for cost of goods sold in determining net income that more closely reflects current prices. This result is believed to compensate for the effect under the LIFO method of presenting inventories in the balance sheet at prices substantially different from current prices.

.37 *Application of Judgment by the Accounting Profession as a Whole.* Sometimes strict adherence to the pervasive measurement principles produces results that are considered by the accounting profession as a whole to be unreasonable in the circumstances or possibly misleading. Accountants approach their task with a background of knowledge and experience. The perspective provided by this background is used as the basis for modifying accounting treatments when strict application of the pervasive measurement principles yields results that do not appear reasonable to the profession as a whole.

.38 The exception to the usual revenue realization rule for long-term construction-type contracts, for example, is justified in part because strict adherence to realization at the time of sale would produce results that are considered to be unreasonable. The judgment of the profession is that revenue should be recognized in this situation as construction progresses. Similarly, the most meaningful concept of net income in the judgment of the pro-

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fession is one that includes all items of revenue and expense recorded during the period except for certain items that can be clearly identified with prior periods under carefully specified conditions. Extraordinary items are segregated in the current income statement so that their effects can be distinguished. Also, avoiding undue effects on the net income of a single period is judged by the profession to be important in certain circumstances. For example, actuarial gains and losses recognized in accounting for pension cost may be spread over the current year and future years.

The next page is 7281.

AC Section 1027

Generally Accepted Accounting Principles— Broad Operating Principles

[Source: APB Statement No. 4, Chap. 7, as amended.]

Issue date, unless otherwise indicated: October, 1970

STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

.01 The broad operating principles guide in selecting, measuring, and reporting events in financial accounting. They are grounded in the pervasive principles discussed in section 1026 and are applied to specific situations through the detailed principles discussed in section 1028. The broad operating principles are broader and less specific than the detailed principles. For example, the detailed principle of first-in, first-out inventory pricing is one application of the broad operating principles of product cost determination and asset measurement, and straight-line depreciation is one of the detailed principles through which the broad operating principles that deal with systematic and rational expense allocation are applied. Although the broad operating principles are more specific than the pervasive principles, they are also generalizations. Consequently, exceptions to the broad operating principles may exist in the detailed principles through which they are applied.

.02 The financial accounting process consists of a series of operations that are carried out systematically in each accounting period. The broad operating principles guide these operations. The operations are listed separately although they overlap conceptually and some of them may be performed simultaneously:

(1) *Selecting* the events. Events to be accounted for are identified. Not all events that affect the economic resources and obligations of an enterprise are, or can be, accounted for when they occur.

(2) *Analyzing* the events. Events are analyzed to determine their effects on the financial position of an enterprise.

(3) *Measuring* the effects. Effects of the events on the financial position of the enterprise are measured and represented by money amounts.

(4) *Classifying* the measured effects. The effects are classified according to the individual assets, liabilities, owners' equity items, revenue, or expenses affected.

(5) *Recording* the measured effects. The effects are recorded according to the assets, liabilities, owners' equity items, revenue, and expenses affected.

(6) *Summarizing* the recorded effects. The amounts of changes recorded for each asset, liability, owners' equity item, revenue, and expense are summed and related data are grouped.

(7) *Adjusting* the records. Remeasurements, new data, corrections, or other adjustments are often required after the events have been initially recorded, classified, and summarized.

(8) *Communicating* the processed information. The information is communicated to users in the form of financial statements.

The broad operating principles, which guide these eight operations, are divided into (1) principles of selection and measurement and (2) principles of financial statement presentation.

PRINCIPLES OF SELECTION AND MEASUREMENT

.03 The principles of selection and measurement are conventions that (1) guide selection of events to be accounted for by an enterprise, (2) determine how selected events affect the assets, liabilities, owners' equity, revenue, and expenses of the enterprise, and (3) guide assignment of dollar amounts to the effects of these events. They are classified in this section according to the types of economic events that affect the economic resources, economic obligations, and residual interests of enterprises, as discussed in section 1023 (see section 1023.23). The types of events are

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I. External Events
  A. Transfers of resources or obligations to or from other entities:
    1. Exchanges (reciprocal transfers)
    2. Nonreciprocal transfers
      a. Transfers between an enterprise and its owners
      b. Nonreciprocal transfers between an enterprise and entities other than owners
  B. External events other than transfers

II. Internal Events
  A. Production
  B. Casualties

Each type of event is explained briefly in the list of principles in paragraphs .07 to .11 and more fully in section 1023.23.

.04 Additional principles other than those that guide recognition of events govern accounting for those assets and liabilities that are not resources and obligations (see section 1025.19) and the related revenue and expenses and govern reporting of accounting changes and corrections of errors in previously issued financial statements (See section 1051). [As amended, effective for fiscal periods beginning after July 31, 1971, by APB Opinion No. 20.]

Measurement Bases

.05 Four measurement bases are currently used in financial accounting: (1) price in a past exchange of the enterprise (historical cost), which is the primary basis of measurement in financial accounting and is usually used in measuring inventory, plant and equipment, and many other assets, (2) price in a current purchase exchange, used, for example, in applying the lower of cost and market rule to inventories, (3) price in a current sale exchange, which may be used, for example, in measuring precious metals that have a fixed monetary price with no substantial cost of marketing, and (4) price based on future exchanges, used, for example, to estimate future costs when revenue is recognized on the percentage-of-completion basis. The

measurement bases are described more fully in section 1023.31.

STATEMENT OF THE PRINCIPLES OF SELECTION AND MEASUREMENT

.06 The principles of selection and measurement are presented in three sections:

1. The principles of selection of events and the principles of measurement (assignment of dollar amounts) are presented together for each type of event in paragraphs .07 to .11. Principles of selection (S-1 to S-7) and measurement (M-1 to M-7) that deal with the same items are identified by the same number (e. g., S-4 and M-4). Other important principles that constitute amplifications of or exceptions to the general rule are listed under it and identified with the general principle (e. g., S-4A). The statement of a principle is followed by a short discussion if further clarification is needed.
2. Principles that govern accounting for those assets and liabilities that are *not* resources or obligations are discussed in paragraph .12.
3. The principles (E-1 to E-10) of determination of the effects of events on the basic elements are presented in paragraph .13.

Principles That Guide Selection of Events and Assignment of Dollar Amounts

I. *External Events*

A. *Transfers of Resources or Obligations to or from Other Entities*

.07 1. *Exchanges* are reciprocal transfers between the enterprise and other entities that involve obtaining resources or satisfying obligations by giving up other resources or incurring other obligations. Exchanges may take place over time rather than at points of time (for example, accumulations of interest and rent).

S-1. *Exchanges recorded.* Exchanges between the enterprise and other entities (enterprises or indi-

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viduals) are generally recorded in financial accounting when the transfer of resources or obligations takes place or services are provided.

M-1. *Exchange prices.* The effects of exchanges on assets, liabilities, revenue, and expenses are measured at the prices established in the exchanges.

S-1A. *Acquisitions of assets.* Resources acquired in exchanges are recorded as assets of the enterprise. Some assets that are not carried forward to future periods are immediately charged to expense (see S-6C).

M-1A. *Acquisition cost of assets.* Assets acquired in exchanges are measured at the exchange price, that is, at acquisition cost. Money and money claims acquired are measured at their face amount or sometimes at their discounted amount.

Discussion. Cash, accounts receivable, and other short-term money claims are usually measured at their face amount. Long-term notes receivable are measured at their discounted amounts when the notes nominally bear no interest or an interest rate clearly below a reasonable rate. (See section 4111.) [As amended, effective October 1, 1971, by APB Opinion No. 21.]

M-1A(1). *Fair value.* In exchanges in which neither money nor promises to pay money are exchanged, the assets acquired are generally measured at the fair value of the assets given up. However, if the fair value of the assets received is more clearly evident, the assets acquired are measured at that amount.

Discussion. Fair value is the approximation of exchange price in transfers in which money or money claims are not

involved. Similar exchanges are used to approximate what the exchange price would have been if an exchange for money had taken place. The recorded amount (as distinguished from the fair value) of assets given up in a trade is generally not used to measure assets acquired.

M-1A(2). *Acquisition of a group of assets in one exchange.* A group of assets acquired in a single ex-exchange is measured at the exchange price. The total price is allocated to the individual assets based on their relative fair values.

Discussion. Fair value of assets acquired is used primarily as a device for allocating total cost, not as the measurement basis of the assets acquired.

M-1A(3). *Acquisition of a business in an exchange.* A business acquired in an exchange is measured at the exchange price. Each individual asset acquired (other than goodwill) is measured at its fair value. If the total exchange price exceeds the amounts assigned to the individual assets, the excess is recorded as goodwill. If the total amount assigned to individual assets exceeds the exchange price, the difference is recorded as a reduction of the amounts assigned to the assets (also see S-2A and S-2B).

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S-1B. *Dispositions of assets.* Decreases in assets are recorded when assets are disposed of in exchanges.

M-1B. *Asset dispositions measured.* Decreases in assets are measured by the recorded amounts that relate to the assets. The amounts are usually the historical or acquisition costs of the assets (as adjusted for amortization and other changes).

Discussion. In partial dispositions, measurement of the amount removed is governed by detailed principles (e. g., first-in, first-out; last-in, first-out; and average cost for inventories) that are based on the presumed "flow" of goods or the presumed "flow" of costs.

S-1C. *Liabilities recorded.* Liabilities are recorded when obligations to transfer assets or provide services in the future are incurred in exchanges.

M-1C. *Amount of liabilities.* Liabilities are measured at amounts established in the exchanges, usually the amounts to be paid, sometimes discounted.

Discussion. Conceptually, a liability is measured at the amount of cash to be paid discounted to the time the liability is incurred. Most short-term liabilities are simply measured at the amount to be paid. Discounted present values are often used if the obligations require payments at dates that are relatively far in the future. Pension obligations and liabilities under capitalized long-term leases are measured at discounted amounts. Bonds and other long-term liabilities are in effect measured at the discounted amount of the future cash payments for interest and principal. Long-term liabilities are discounted when the notes nominally bear no interest or an interest rate clearly below a

reasonable rate. (See section 4111.) [As amended, effective October 1, 1971, by APB Opinion No. 21.] The difference between the recorded amount of a liability and the amounts to be paid is amortized over the periods to maturity.

S-1D. *Liability decreases.* Decreases in liabilities are recorded when they are discharged through payments, through substitution of other liabilities, or otherwise.

M-1D. *Liability decrease measured.* Decreases in liabilities are measured by the recorded amounts that relate to the liabilities. A partial discharge of liabilities is measured at a proportionate part of the recorded amount of the liabilities.

S-1E. *Commitments.* Agreements for the exchange of resources in the future that at present are unfulfilled commitments on both sides are not recorded until one of the parties at least partially fulfills its commitment, except that (1) some leases and (2) losses on firm commitments are recorded.

Discussion. An exception to the general rule for recording exchanges is made for most executory contracts. An exchange of promises between the contracting parties is an exchange of something of value, but the usual view in accounting is that the promises are off-setting and nothing need be recorded until one or both parties at least partially perform(s) under the contract. The effects of some executory contracts, however, are recorded, for example, long-term leases that are recorded as assets by the lessee with a corresponding liability (see discussion after M-1C).

S-1F. *Revenue from exchanges.* Revenue is recorded when products are sold, services

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are provided, or enterprise resources are used by others. Revenue is also recorded when an enterprise sells assets other than products (usually presented as part of a gain or loss—see paragraph .24).

M-1F. *Revenue measurement.* Revenue from exchanges is initially measured at prices established in the exchanges. The revenue amounts are reduced (or expenses recorded) for discounts, returns, and allowances.

Discussion. Revenue is usually recognized at the time of exchanges in which cash is received or new claims arise against other entities. However, exceptions are made, for example, for certain products that have an assured selling price (see S-6D) and long-term construction-type contracts (see S-6E). Revenue is not recognized on purchases.

S-1F(1). *Recognizing revenue and expenses if proceeds are collectible over a long period without reasonable assurance of collection.* The terms of an exchange transaction or other conditions related to receivables collectible over a long period may preclude a reasonable estimate of the collectibility of the receivables. Either an installment method or a cost recovery method of recognizing revenue and expenses may be used as long as collectibility is not reasonably assured.

M-1F(1). *Measuring revenue and expenses on installment or cost recovery methods.* Under both installment and cost recovery methods the proceeds collected

measure revenue. Under an installment method expenses are measured at an amount determined by multiplying the cost of the asset sold by the ratio of the proceeds collected to the total selling price. Under a cost recovery method, expenses are measured at the amounts of the proceeds collected until all costs have been recovered.

S-1G. *Expenses directly associated with revenue from exchanges.* Costs of assets sold or services provided are recognized as expenses when the related revenue is recognized (see S-1F).

M-1G. *Expense measurement.* Measurement of expenses directly associated with revenue recognized in exchanges is based on the recorded amount (usually acquisition cost) of the assets that leave the enterprise or the costs of the services provided (see S-6A(1) for a discussion of product and service costs).

Discussion. Revenue is usually accompanied by related expenses. For example, sale of a product leads to recording of revenue from the sale and an expense for the cost of the product sold. If an asset other than normal product, such as a building, is sold, the undepreciated cost of the asset is an expense to be subtracted from the revenue on the sale.

.08 2. *Nonreciprocal transfers* are transfers in one direction of resources or obligations, either from the enterprise to other entities or from other entities to the enterprise.

a. *Transfers between an enterprise and its owners.* Examples are investments of resources by owners, declaration of cash or property dividends, acqui-

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sition of treasury stock, and conversion of convertible debt.

S-2. *Owners' investments and withdrawals recorded.* Transfers of assets or liabilities between an enterprise and its owners are recorded when they occur.

M-2. *Owners' investments and withdrawals measured.* Increases in owners' equity are usually measured by (a) the amount of cash received, (b) the discounted present value of money claims received or liabilities cancelled, or (c) the fair value of noncash assets received.[1] Decreases in owners' equity are usually measured by (a) the amount of cash paid, (b) the recorded amount of noncash assets transferred, or (c) the discounted present value of liabilities incurred.

Discussion. Measurement of owners' investments is generally based on the fair value of the assets or the discounted present value of liabilities that are transferred. The market value of stock issued may be used to establish an amount at which to record owners' investments but this amount is only an approximation when the fair value of the assets transferred cannot be measured directly.

S-2A. *Acquisition of a business as a whole through issuance of stock.* The acquisition of a business as a whole by an enterprise through the issuance of stock is recorded when it occurs. (See S-2B for a discussion of poolings of interests.)

M-2A. *Acquisition of a business through issuance of stock measured.* A business acquired through issuance of stock is measured at the fair value of the business acquired. Each individual asset acquired (other than goodwill) is measured at its fair value. If the fair value of the whole business exceeds the amounts assigned to the

[1] The fair value of assets received is often measured by the fair value of the shares of stock issued.

individual assets, the excess is recorded as goodwill. If the total assigned to individual assets exceeds the fair value of the whole business, the difference is recorded as a reduction of the amounts assigned to the assets.

S-2B. *Poolings of interests.* Business combinations effected by issuance of voting common stock that also meet other specified criteria are accounted for as poolings of interests and not as acquisitions of one business by another. A business combination accounted for as a pooling of interests is accounted for when it occurs.

M-2B. *Poolings of interests measured.* The assets, liabilities, and elements of owners' equity of the separate companies generally become the assets, liabilities, and elements of owners' equity of the combined corporation. They generally are measured at the time of combination by the combined corporation at the amounts at which they were then carried by the separate companies. The revenue and expenses of the combined corporation for the period in which the companies are combined include the revenue and expenses of the separate companies from the beginning of the period to the date of combination. Financial statements for prior periods presented in reports of the combined corporation combine the financial statements of the separate companies.

S-2C. *Investments of noncash assets by founders or principal stockholders of a corporation.* Transfers of noncash assets to a corporation by its founders or principal stockholders are recorded when they occur.

M-2C. *Founders' or principal stockholders' investments of noncash assets measured.*

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Transfers of noncash assets to a corporation by its founders or principal stockholders are sometimes measured at their costs to the founders or principal stockholders rather than at their fair value at the date of transfer.

b. *Nonreciprocal transfers between an enterprise and entities other than owners.* Examples are gifts and donations, taxes, loss of a negligence lawsuit, imposition of fines, and theft.

S-3. *Nonreciprocal transfers recorded.* Nonreciprocal transfers with other than owners are recorded when assets are acquired, when assets are disposed of or their loss is discovered, or when liabilities come into existence or are discovered. [As amended, effective for transactions entered into after September 30, 1973, by APB Opinion No. 29.] (See section 1041.)

M-3. *Nonreciprocal transfers measured.* Those noncash assets received in nonreciprocal transfers with other than owners that are recorded are measured at their fair value on the date received. Noncash assets given are usually accounted for at fair value. Liabilities imposed are measured at the amount to be paid, sometimes discounted. [As amended, effective for transactions entered into after September 30, 1973, by APB Opinion No. 29.] (See section 1041.)

.09 B. *External events other than transfers of resources or obligations to or from other entities.* Examples are changes in specific prices of enterprise assets, changes in interest rates, general price-level changes, technological changes caused by outside entities, and damage to enterprise assets caused by others.

S-4. *Favorable external events other than transfers generally not recorded.* External events other than transfers that increase market prices or utility of assets or decrease amounts required to discharge liabilities are generally not recorded when they occur. Instead their effects are usually reflected at the time of later exchanges.

M-4. *Retention of recorded amounts.* Assets whose prices or utility are increased by external events other than transfers are normally retained in the accounting records at their recorded amounts until they are exchanged. Liabilities that can be satisfied for less than their recorded amounts because of external events generally are retained in the records at their recorded amounts until they are satisfied.

S-4A. *Some favorable events recorded.* Examples of the few exceptions to principle S-4 are (1) earnings of companies whose voting stock is owned by minority or 50% shareholders who have the ability to exercise significant influence over investees, (2) increases in market prices of marketable securities held by investment companies and (3) decreases in the amounts required currently to satisfy liabilities to provide services or deliver resources other than U. S. dollars, for example, foreign currency obligations and obligations under warranties. [As amended, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 18.]

M-4A. *Measuring favorable events.* Recorded increases in market prices are measured by the difference between the recorded amount of the securities and the higher market price. Recorded decreases in liabilities are measured by the difference between the recorded amounts of the liabilities and the lower amounts estimated to be required to satisfy them.

S-5. *Unfavorable external events other than transfers recorded.* Certain unfavorable external events, other than transfers, that decrease market prices or utility of assets or increase liabilities are recorded.

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M-5. *Measuring unfavorable events.* The amounts of those assets whose decreased market price or utility is recorded are adjusted to the lower market price or recoverable cost resulting from the external event.

Discussion. Recording unfavorable external events other than transfers varies depending on the type of asset or liability and is governed by specific rules. The major rules are described below.

S-5A. *Cost or market rule for inventories.* A loss is recognized by application of the rule of lower of cost and market to inventories when their utility is no longer as great as their cost.

M-5A. *Measuring inventory losses under the cost or market rule.* Replacement price is used in measuring the decline in price of inventory except that the recorded decline should not result in carrying the inventory at an amount that (1) exceeds net realizable value or (2) is lower than net realizable value reduced by an allowance for an approximately normal profit margin.

S-5B. *Decline in market price of certain marketable securities.* If market price of marketable securities classified as current assets is less than cost and it is evident that the decline is not due to a temporary condition a loss is recorded when the price declines.*

M-5B. *Measuring losses from decline in price of marketable securities.* The loss on a price decline of marketable securities is measured by the difference between the recorded amount and the lower market price.*

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* Modified by section 5132, *Accounting for Certain Marketable Securities.*

S-5C. *Obsolescence.* Reductions in the utility of productive facilities caused by obsolescence due to technological, economic, or other change are usually recognized over the remaining productive lives of the assets. If the productive facilities have become worthless the entire loss is then recognized.

M-5C. *Measuring obsolescence.* Obsolescence of productive facilities is usually measured by adjusting rates of depreciation, depletion, or amortization for the remaining life (if any) of the assets. If productive facilities have become worthless, unamortized cost is recognized as a current loss.

Discussion. In unusual circumstances persuasive evidence may exist of impairment of the utility of productive facilities indicative of an inability to recover cost although the facilities have not become worthless. The amount at which those facilities are carried is sometimes reduced to recoverable cost and a loss recorded prior to disposition or expiration of the useful life of the facilities.

S-5D. *Damage caused by others.* The effects of damage to enterprise assets caused by others are recorded when they occur or are discovered.

M-5D. *Measuring damage caused by others.* When enterprise assets are damaged by others, asset amounts are written down to recoverable costs and a loss is recorded.

S-5E. ***Decline in market prices of noncurrent assets generally not recorded.*** Reductions in the market prices of noncurrent assets

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are generally not recorded until the assets are disposed of or are determined to be worthless.

M-5E. *Retention of recorded amount.* Noncurrent assets whose market prices have declined are generally retained in accounting records at their recorded amounts until they are disposed of or have become worthless.

Discussion. In unusual circumstances a reduction in the market price of securities classified as noncurrent assets may provide persuasive evidence of an inability to recover cost although the securities have not become worthless. The amount at which those securities are carried is sometimes reduced and a loss recognized prior to disposition of the securities.

S-5F. *Increases in amounts required to liquidate liabilities other than those payable in U. S. dollars recorded.* Increases in the amounts required currently to satisfy liabilities to provide services or deliver resources other than U. S. dollars, for example, foreign currency obligations and obligations under warranties, are often recorded. Increases in amounts required currently to liquidate liabilities payable in U. S. dollars because of changes in interest rates or other external factors are generally not recorded until the liabilities are liquidated, converted, or otherwise disposed of.

M-5F. *Liability increases measured.* Recorded increases in liabilities from external events other than transfers are measured at the difference between the recorded amount of the liabilities and the higher amounts estimated to be required to satisfy them.

II. *Internal Events*

.10 A. *Production.* Production in a broad sense is the economic process by which inputs of goods and services are combined to produce an output of product which may be either goods or services. Production in this sense is therefore *not* restricted to manufacturing operations, but includes activities such as merchandising, transporting, and holding goods.

S-6. *Production recorded.* Utility added to assets by the internal profit-directed activities of the enterprise is generally not recorded at the time of production. Instead, historical or acquisition costs, including costs of the production process, are shifted to different categories of assets or to expenses as events in the enterprise indicate that goods and services have been used (either partially or completely) in production operations of the period. The costs that continue to appear in asset categories are deducted from revenue when the products or services to which they have been related are sold at a later date (see S-1G).

M-6. *Production measurement.* Utility created by production is generally not measured at the time of production. Instead, previously recorded amounts (usually acquisition costs) are shifted or allocated between asset categories or between activities or periods in a systematic and rational manner.

Discussion. Accounting for production encompasses much of the internal accounting for the enterprise. Accounting to determine costs of manufacturing products and providing services (cost accounting) is a part of production accounting in general. The purpose of production accounting is to relate costs to revenue when the product is sold or services provided or to relate costs to particular accounting periods.

S-6A. *Costs of manufacturing products and providing services.* Costs of manufacturing

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products and providing services during a period include (1) costs of assets that are completely used during the period in manufacturing products and providing services and (2) allocated portions of the costs of assets that are partially used during the period in manufacturing products and providing services, assigned in a systematic and rational manner to those activities.

M-6A. *Measuring costs of manufacturing products and providing services.* Costs of manufacturing products and providing services are measured at the recorded amounts (usually acquisition costs) of assets used directly and by allocations in a systematic and rational manner of recorded amounts of assets used indirectly.

Discussion. Cost accounting often involves shifts and allocations of acquisition costs. The shifts and allocations are based on observed or assumed relationships between the assets used and the activities of manufacturing products or providing services. An example of a shift to a different category is the shift of costs from raw materials inventory to work in process inventory. Examples of allocated costs are overhead costs such as power, indirect labor, repair costs, and depreciation of plant and equipment.

S-6A(1). *Product and service costs.* Costs assigned to products and services provided are those costs of manufacturing products and providing services that are considered productive, including direct costs and indirect costs (absorbed overhead). Costs of manufacturing products and providing services for a period that are not

assigned to product or service costs are charged to expense during the period, for example, unabsorbed overhead.

M-6A(1). *Measuring product and service costs.* Product and service costs are measured by the sum of productive costs of manufacturing products and providing services assigned to units of product or service in a rational and systematic manner.

S-6B. *Expenses from systematic and rational allocation.* Some expenses are associated with accounting periods by allocating costs of assets over their useful lives.

M-6B. *Determination of expenses by systematic and rational allocation.* These expenses are allocations of the recorded amount of assets in a systematic and rational manner to the period or periods of the assets' lives.

Discussion. If all the benefits of an asset are related to one period, the recorded amount of the asset is charged as expense in that period. If the asset will benefit several periods, the recorded amount is charged to expense in a systematic and rational manner over the periods involved. Depreciation, depletion, and amortization of long-lived assets are examples of amounts allocated to periods as expenses (excluding amounts allocated to costs of manufacturing products and providing services, see S-6A).

S-6C. *Expenses recognized immediately.* The costs of some assets are charged to expense immediately on acquisition.

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M-6C. *Measurement of expenses recognized immediately.* Expenses from immediate recognition are measured at the acquisition prices of the assets acquired.

Discussion. Enterprises never acquire expenses per se; they always acquire assets. Costs may be charged to expenses in the period goods or services are acquired either under this principle of immediate recognition or, if they only benefit the period in which they are acquired, under the principle of systematic and rational allocation (see S-6B). Examples of costs that often are charged to expense immediately are salaries paid to officers and payments for advertising.

S-6D. *Revenue at completion of production.* Revenue may be recorded at the completion of production of precious metals that have a fixed selling price and insignificant marketing costs. Similar treatment may also be accorded certain agricultural, mineral, and other products characterized by inability to determine unit acquisition costs, immediate marketability at quoted prices that cannot be influenced by the producer, and unit interchangeability.

M-6D. *Revenue measured by net realizable value of product.* Revenue recorded at completion of production is measured by the net realizable value of the product.

Discussion. Recognition of revenue at completion of production is an exception to principles S-1F and S-6. The net realizable value of product is its selling price less expected costs to sell.[2]

S-6E. *Revenue as production progresses.* Revenue from cost-plus-fixed-fee and long-term

[2] See section 1026.16, footnote 8, for a discussion of income statement treatment of revenue recognized at completion of production.

construction-type contracts is recognized as production progresses using the percentage-of-completion method if the total cost and the ratio of performance to date to full performance can be reasonably estimated and collection of the contract price is reasonably assured. When the current estimate of total contract costs indicates a loss on long-term construction-type contracts, in most circumstances provision is made for the loss on the entire contract.

M-6E. *Measuring revenue as production progresses.* Under cost-plus-fixed-fee contracts, revenue recognized as production progresses includes either reimbursable costs and an allocated portion of the fee or an allocated portion of the fee alone. Under long-term construction-type contracts, revenue recognized as production progresses is measured at an allocated portion of the predetermined selling price. Product or service cost is subtracted from revenue as an expense as production progresses for long-term construction-type contracts and for those cost-plus-fixed-fee contracts for which recorded revenue includes reimbursable costs.

Discussion. Recognition of revenue as production progresses is another exception to principles S-1F and S-6.

.11 B. *Casualties.* Casualties are sudden, substantial, unanticipated reductions in enterprise assets not caused by other entities. Examples are fires, floods, and abnormal spoilage.

S-7. *Casualties.* Effects of casualties are recorded when they occur or when they are discovered.

M-7. *Measuring casualties.* When casualties occur or are discovered, asset amounts are written down to recoverable costs and a loss is recorded.

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Accounting for Those Assets and Liabilities That Are Not Resources or Obligations

.12 Accounting for those assets and liabilities that are not resources or obligations (see section 1025.19) and the related revenue and expenses is governed by detailed principles, for example, principles for accounting for deferred federal income taxes in section 4091. The principles are generally related to the modifying conventions, especially emphasis on income (see sections 1026.33 to 1026.38).

Principles That Determine Effects on Assets, Liabilities, Owners' Equity, Revenue, and Expenses of an Enterprise

.13 Principles (E-1 to E-10) that summarize the effects of selection and measurement on the basic elements of financial accounting are related to changes in assets, liabilities, owners' equity, revenue, and expenses rather than to types of events. The first of these principles recognizes the interrelated effects of events.

E-1. *Dual effects.* Each recorded event affects at least two items in the financial accounting records. The double entry system of recording is based on this principle.

In the following principles, the changes in assets, liabilities, owners' equity, revenue, and expenses that are recognized in conformity with generally accepted accounting principles are listed, together with some indication of the dual effect. Recognized changes are derived from the preceding principles of selection of events and assignment of dollar amounts.

E-2. *Increases in assets* arise from (1) exchanges in which assets are acquired, (2) investments of assets in the enterprise by owners, (3) nonreciprocal transfers of assets to an enterprise by other than owners, (4) shifts of costs to different asset categories in production, and, occasionally, (5) increases in amounts ascribed to produced assets. Increases in assets sometimes arise from external events other than transfers.

In exchanges, asset increases may be accompanied by decreases in other assets (e. g., a purchase for cash), increases

in liabilities (e. g., a purchase on account), or recognition of revenue (e. g., a sale for cash). In production, costs may be shifted from one asset classification to another with no change in total assets. If production increases are recorded (e. g., at the completion of production of precious metals), the increase is recognized as revenue or reduction of expenses. Earnings of companies whose voting stock is owned by minority or 50% shareholders who have the ability to exercise significant influence over investees, and increases in the market prices of securities held by investment companies are examples of asset increases recognized on external events other than transfers. [As amended, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 18.]

E-3. *Decreases in assets* arise from (1) exchanges in which assets are disposed of, (2) withdrawals of assets from the enterprise by owners, (3) nonreciprocal transfers of assets from the enterprise other than to owners, (4) certain external events other than transfers that reduce the market price or utility of assets, (5) shifts or allocations of costs to different asset categories or to expense in production, and (6) casualties.

In exchanges, asset decreases may be accompanied by increases in other assets (e. g., a purchase for cash or a sale for cash or on account), decreases in liabilities (e. g., payment of a debt), or increases in expenses. An increase of expenses in an exchange may result if an asset acquired is used up almost immediately or if future benefits of an expenditure cannot be determined and it is therefore written off to expense immediately. The sale of products results in a decrease in product held by the enterprise and reduces an asset and increases an expense.

E-4. *Increases in liabilities* arise from (1) exchanges in which liabilities are incurred, (2) transfers between an enterprise and its owners (dividend declaration), and (3) nonreciprocal transfers with other than owners in which liabilities arise.

In exchanges, liability increases may be accompanied by decreases in other liabilities (e. g., a note given on an account payable), increases in assets (e. g., a purchase on

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account), or an expense (e. g., office salaries incurred but unpaid).

E-5. *Decreases in liabilities* arise from (1) exchanges in which liabilities are reduced, (2) transfers between an enterprise and its owners (debt converted into capital stock), and (3) nonreciprocal transfers with other than owners in which liabilities are reduced (forgiveness of indebtedness).

In exchanges, liability decreases may be accompanied by increases in other liabilities (e. g., a note given on an account payable), decreases in assets (e. g., payment of an account), or revenue (e. g., goods delivered or services rendered to satisfy a customer prepayment).

E-6. *Increases in owners' equity* arise from (1) investments in an enterprise by its owners, (2) the net result of all revenue and expenses recognized during a period (net income), and (3) nonreciprocal transfers to an enterprise from other than owners (gifts and donations). Owners' equity may also be increased by prior period adjustments.

E-7. *Decreases in owners' equity* arise from (1) transfers from an enterprise to its owners (dividends, treasury stock acquisitions), and (2) net losses for a period. Owners' equity may also be decreased by prior period adjustments.

E-8. *Revenue* arises primarily from exchanges. Occasionally revenue arises from production, and rarely from nonreciprocal transfers and from external events other than transfers.

Revenue from exchanges is usually accompanied by asset increases but may be accompanied by decreases in liabilities ("unearned revenue").

E-9. *Expenses* arise from (1) exchanges, (2) nonreciprocal transfers with other than owners, (3) external events other than transfers, (4) production, and (5) casualties.

Expenses that arise in exchanges are costs associated directly with revenue recognized when assets are sold or

services are provided [including product and service costs, see S-6A(1)]. Expenses that arise in production are (1) costs of manufacturing products and providing services not included in product or service costs (for example, unabsorbed overhead), (2) expenses from systematic and rational allocation of the cost of assets over their useful lives (excluding amounts allocated to costs of manufacturing products and providing services, see S-6A), (3) expenses recognized immediately on the acquisition of goods and services, and (4) costs of products for which revenue is recognized at the completion of production or as production progresses (see S-6D and S-6E).

E-10. *Effects of accounting for assets and liabilities that are not resources or obligations* (see section 1025.19 and paragraph .12). Accounting for these assets and liabilities results in increases and decreases in assets and increases and decreases in liabilities. The income statement effects are usually confined to increases and decreases in expenses.

PRINCIPLES OF FINANCIAL STATEMENT PRESENTATION

.14 The principles of financial statement presentation guide the communication of the information provided by the financial accounting process. They are related to the principles of selection and measurement and the pervasive principles but are not derived directly from them. The presentation principles are more closely related to the objectives of financial accounting and financial statements. The general objectives that deal with the type of information to be provided (for example, reliable information about economic resources and obligations and economic progress) and the qualitative objectives based on characteristics of useful information (such as comparability, completeness, and understandability) directly influence the content of some of the presentation principles. The basic features of financial accounting, particularly accounting entity, approximation, and fundamentally related financial statements, also influence these principles.

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Fair Presentation in Conformity with Generally Accepted Accounting Principles

.15 The qualitative standard of *fair presentation in conformity with generally accepted accounting principles* of financial position and results of operations is particularly important in evaluating financial presentations. This standard guides preparers of financial statements and is the subjective benchmark against which independent public accountants judge the propriety of the financial accounting information communicated. Financial statements "present fairly in conformity with generally accepted accounting principles" if a number of conditions are met: (1) generally accepted accounting principles applicable in the circumstances have been applied in accumulating and processing the financial accounting information, (2) changes from period to period in generally accepted accounting principles have been appropriately disclosed, (3) the information in the underlying records is properly reflected and described in the financial statements in conformity with generally accepted accounting principles, and (4) a proper balance has been achieved between the conflicting needs to disclose important aspects of financial position and results of operations in accordance with conventional concepts and to summarize the voluminous underlying data into a limited number of financial statement captions and supporting notes.

STATEMENT OF THE PRINCIPLES OF FINANCIAL STATEMENT PRESENTATION

.16 The principles of financial statement presentation guide reporting of financial accounting information. They are conventional and subject to change in the same manner as the principles of selection and measurement. Twelve principles (R-1 to R-12) of financial statement presentation are stated; two are amplified by related principles; several are followed by explanations of their characteristics or applications. [As amended, effective for fiscal periods ending after September 30, 1971 by APB Opinion No. 19.]

.17 R-1. *Basic financial statements.* A balance sheet, a statement of income, a statement of changes in retained earnings, a statement of changes in financial position, disclosure of

changes in other categories of stockholders' equity, descriptions of accounting policies, and related notes is the minimum presentation required to present fairly the financial position and results of operations of an enterprise in conformity with generally accepted accounting principles. [As amended, effective for fiscal years beginning after December 31, 1971, by APB Opinion No. 22.]

The basic financial statements are usually presented for two or more periods to enhance their usefulness. Historical summaries are also often presented. Other information may be provided as supplementary to the basic statements, for example, data as to revenue and net income by lines of business, information regarding physical output, and financial statements restated for changes in the general price level. These kinds of information, however, are not now considered necessary for a fair presentation of financial position and results of operations in conformity with generally accepted accounting principles. [As amended, effective for fiscal periods ending after September 30, 1971 by APB Opinion No. 19.]

.18 R-2. *Complete balance sheet.* The balance sheet or statement of financial position should include and properly describe all assets, liabilities, and classes of owners' equity as defined by generally accepted accounting principles.

.19 R-3. *Complete income statement.* The income statement of a period should include and properly describe all revenue and expenses as defined by generally accepted accounting principles.

Under narrowly specified conditions an income statement should exclude a few items that represent adjustments of prior periods' net income.

.20 R-4. *Complete statement of changes in financial position.* The statement of changes in financial position of a period should include and properly describe all important aspects of

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the company's financing and investing activities. [As amended, effective for fiscal periods ending after September 30, 1971 by APB Opinion No. 19.]

.21 R-5. *Accounting period.* The basic time period for which financial statements are presented is one year; "interim" financial statements are commonly presented for periods of less than a year. (See section 2071, *Interim Financial Reporting.*)

.22 R-6. *Consolidated financial statements.* Consolidated financial statements are presumed to be more meaningful than the separate statements of the component legal entities. Consolidated statements are usually necessary for fair presentation in conformity with generally accepted accounting principles if one of the enterprises in a group directly or indirectly owns over 50% of the outstanding voting stock of the other enterprises.

Consolidated financial statements present the financial position and results of operations of a parent company and its subsidiaries essentially as if the group were a single enterprise comprised of branches or divisions. The resulting accounting entity is an economic rather than a legal unit, and its financial statements are considered to reflect the substance of the combined economic relationships to an extent not possible by merely providing the separate financial statements of the corporate entities comprising the group.

.23 R-7. *Equity basis.* Unconsolidated subsidiaries and investments in 50% or less of the voting stock of companies in which the investors have the ability to exercise significant influence over investees should be presented on the equity basis.

Under the equity basis, net income during a period includes the investor company's proportionate share of the net income reported by the investee for the period (subsequent to acquisition in the period of acquisition). The effect is that

net income for the period and owners' equity at the end of the period are the same as if the companies presented on the equity basis had been consolidated. Dividends received are treated as adjustments of the amount of the investment under the equity basis. [As amended, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 18.]

.24 R-8. *Translation of foreign balances.* Financial information about the foreign operations of U. S. enterprises should be "translated" into U. S. dollars by the use of conventional translation procedures that involve foreign exchange rates.

.25 R-9. *Classification and segregation.* Separate disclosure of the important components of the financial statements is presumed to make the information more useful. Examples in the income statement are sales or other source of revenue, cost of sales, depreciation, selling and administrative expenses, interest expense, and income taxes. Examples in the balance sheet are cash, receivables, inventories, plant and equipment, payables, and categories of owners' equity.

Owners' equity of corporations is conventionally classified into categories including par or stated amount of capital stock, additional paid-in capital, and retained earnings. Net income or net loss, prior period adjustments, dividends, and certain transfers to other categories of owners' equity are among the changes in owners' equity that affect retained earnings.

R-9A. *Working capital.* Disclosure of components of working capital (current assets less current liabilities)[3] is presumed to be useful in manufacturing, trading, and some service enterprises. Current assets and current liabilities are distinguished from other assets and liabilities.

[3] Because the term *working capital* is sometimes used to describe current assets alone, the difference between current assets and current liabilities is sometimes described as *net working capital.*

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Disclosure of working capital is normally accomplished by classifying current assets and liabilities separately. Current assets include cash and other assets that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business or within one year if the operating cycle is shorter than one year. Current liabilities include those expected to be satisfied by either the use of assets classified as current in the same balance sheet or the creation of other current liabilities, or those expected to be satisfied within a relatively short period of time, usually one year. (See section 2031.)

R-9B. *Offsetting.* Assets and liabilities in the balance sheet should not be offset unless a legal right of setoff exists.

R-9C. *Gains and losses.* Revenue and expenses from other than sales of products, merchandise, or services may be separated from other revenue and expenses and the net effects disclosed as gains or losses.[4]

Revenue and expense result from dispositions of assets other than products of the enterprise as well as from sales of products or services. For disclosure purposes, revenue (proceeds received) and expenses (cost of assets relinquished) on dispositions of assets other than products are separated from other revenue and expenses and the net amounts (revenue less expense) are shown as gains or losses. If these gains or losses are not material in amount they may be combined with other income statement amounts. Other examples of gains and losses are sizable write-downs of inventories and receivables, sizable gains and losses on sale of temporary investments, gains and losses recognized in nonmonetary transactions, and gains and losses on foreign currency devaluations. Gains and losses include items that are of a character typical of the customary business activities of the entity, which may be disclosed separately if their effects are material, and extraordinary gains and losses, which should be presented separately (see the following principle). [As amended, effective for

[4] Losses are sometimes defined in the accounting literature as expired costs that produce no revenue. "Losses" of that type are a subclassification of expenses in sections 1021-1029.

transactions entered into after September 30, 1973, by APB Opinion No. 29 (See section 1041); as modified, effective for fiscal years beginning on or after January 1, 1975, pursuant to FASB Statement No. 2. (See section 4211.)]

R-9D. *Extraordinary items.* Extraordinary gains and losses should be presented separately from other revenue and expenses in the income statement.

Extraordinary items are events and transactions that are distinguished by their unusual nature *and* by the infrequency of their occurrence. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

R-9E. *Net income.* The net income of an enterprise for a period should be separately disclosed and clearly identified in the income statement.

Identifying the amount of the net income is considered necessary for fair presentation in conformity with generally accepted accounting principles.

.26 R-10. *Other disclosures.* In addition to informative classifications and segregation of data, financial statements should disclose all additional information that is necessary for fair presentation in conformity with generally accepted accounting principles. Descriptions of accounting policies and notes that are necessary for adequate disclosure are an integral part of the financial statements.

Financial statements cannot provide all of the information available about an enterprise. They are essentially summaries of a large quantity of detailed information. Furthermore, the information given on the face of the statements is largely restricted to that which can be represented by a number described by a very few words. Normally information of that type needs amplification to make it most useful, and the financial statements, descriptions of accounting policies, and notes are necessary for adequate disclosure. In addition to the four types of disclosure specified below that are considered necessary, additional disclosures are commonly made, for example, disclosure of nonarm's-length

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and nonmonetary transactions. [As amended, effective for transactions entered into after September 30, 1973, by APB Opinion No. 29.] (See section 1041.)

In general, information that might affect the conclusions formed by a reasonably informed reader of the financial statements should be disclosed. Disclosure principles carry an implied responsibility to present information so that its significance is apparent to a reasonably informed reader. A mass of detailed information, overly compressed information, and language that may be a barrier to communication are unsatisfactory. Financial statements should inform the reader of matters that may affect his interpretation of them, and may provide additional information that will facilitate his understanding and use of the statements. [As amended by APB Opinion No. 22, December 31, 1971.]

R-10A. *Customary or routine disclosure.* Information about measurement bases of important assets, restrictions on assets and of owners' equity, contingent liabilities, contingent assets, important long-term commitments not recognized in the body of the statements, information on terms of owners' equity and long-term debt, and certain other disclosures required by pronouncements of the Accounting Principles Board and the Committee on Auditing Procedure of the American Institute of Certified Public Accountants and regulatory bodies that have jurisdiction are necessary for full disclosure.

R-10B. *Disclosure of changes in accounting principles.* Disclosure of changes in accounting principles, practices, or the methods of applying them, together with the financial effect, is required in accordance with section 1051, *Accounting Changes.* [As amended, effective for fiscal periods

beginning after July 31, 1971 by APB Opinion No. 20.]

R-10C. *Disclosure of subsequent events.* Disclosure of events that affect the enterprise directly and that occur between the date of, or end of the period covered by, the financial statements and the date of completion of the statements is necessary if knowledge of the events might affect the interpretation of the statements, even though the events do not affect the propriety of the statements themselves.

R-10D. *Disclosure of accounting policies.* Description of the accounting policies adopted by the reporting entity is required as an integral part of the financial statements. [As amended, effective for fiscal years beginning after December 31, 1971, by APB Opinion No. 22.] (See section 2045.)

.27 R-11. *Form of financial statement presentation.* No particular form of financial statements is presumed better than all others for all purposes, and several forms are used.

.28 R-12. *Earnings per share.* Earnings per share information is most useful when furnished in conjunction with net income and its components and should be disclosed on the face of the income statement.

A single figure for earnings per share involves the same limitations of usefulness as does a single figure for net income. Unless earnings per share statistics are presented in conjunction with financial statements and with other historical information, their usefulness in evaluating past performance of an enterprise and attempting to formulate an opinion as to its future potential is limited. Furthermore, earnings per share should be disclosed for (a) income before extraordinary items, and (b) net income. Earnings

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per share disclosure should take into consideration matters such as changes in the number of shares outstanding, contingent changes, and possible dilution from potential conversions of convertible debentures, preferred stock, options, or warrants.

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AC Section 1028

Generally Accepted Accounting Principles— Detailed Operating Principles

[Source: APB Statement No. 4, Chap. 8, as amended.]

Issue date, unless otherwise indicated: October, 1970

STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

.01 The detailed principles of accounting are the large body of practices and procedures that prescribe definitively how transactions and other events should be recorded, classified, summarized, and presented. They are the means of implementing the pervasive and broad operating principles discussed in sections 1026 and 1027.

.02 The detailed accounting principles are not enumerated in sections 1021-1029 for several reasons:

1. Many detailed accounting principles are already found in Opinions of the Accounting Principles Board and in the Accounting Research Bulletins.
2. The pervasive principles and the broad operating principles that underlie the detailed accounting principles tend to evolve slowly. The detailed principles, on the other hand, change relatively frequently. A comprehensive statement of detailed principles therefore would need continual revision to avoid becoming obsolete.
3. A comprehensive statement of detailed accounting principles would include material that the Board cannot, as practical matter, consider at this time.

.03 Opinions of the Accounting Principles Board and Accounting Research Bulletins are the most authoritative sources of generally accepted accounting principles for members of the American Institute of Certified Public Accountants.[1] Opinions of the Accounting Principles Board and Accounting Research Bulletins deal with specific subjects

[1] See sections 100.09 and 520.

but do not constitute a comprehensive list of detailed accounting principles. No comprehensive authoritative list of detailed accounting principles is presently available.[2] [As amended, effective May 7, 1973 by Council Resolution.] (See section 510.08.)

.04 Securities and Exchange Commission pronouncements are an important source of detailed principles in some areas. These pronouncements specify requirements for Securities and Exchange Commission reports and influence financial accounting and reporting practices. Actual accounting and reporting practices are another important source of detailed accounting principles in areas not covered by Accounting Principles Board Opinions or the Accounting Research Bulletins. Publications of professional organizations, for example Industry Audit Guides published by the American Institute of CPAs, and surveys that disclose predominant or preferred accounting practices may also provide evidence of authoritative support. On the other hand, isolated instances of actual practice cannot be regarded as authoritative.

.05 Accounting textbooks and other accounting writings may also be referred to as sources of detailed accounting principles in areas that are not covered by Accounting Principles Board Opinions or the Accounting Research Bulletins. The information from these sources must be regarded as tentative. No one textbook or other writing may be regarded as authoritative in itself. The consensus of a number of writers, however, may be a good indication of existing detailed principles not covered by Accounting Principles Board pronouncements.

The next page is 7331.

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[2] Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*, by Paul Grady, is a valuable source of those detailed accounting principles that existed at the time of its publication in 1965. This is an "unofficial" source, however, because Accounting Research Studies are not pronouncements of the Accounting Principles Board or of the Institute, and the fact that the study quotes extensively from the Board Opinions and the Accounting Research Bulletins in no way changes the status of either the pronouncements or the study.

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AC Section 1029

Financial Accounting in the Future

[Source: APB Statement No. 4, Chap. 9, as amended.]

Issue date, unless otherwise indicated: October, 1970

STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

.01 Description of the environment, objectives, and basic features of financial accounting and financial statements and of broad generally accepted accounting principles has been an important objective of the Accounting Principles Board since its inception. Issuance of sections 1021-1029 is a basic step in the Board's program of determining appropriate practice and narrowing areas of difference and inconsistency.

DYNAMIC NATURE OF FINANCIAL ACCOUNTING

.02 Present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue in the future. Changes may occur at any level of generally accepted accounting principles. The pervasive and broad operating principles are relatively stable but may change over time. Changes occur more frequently in the detailed principles used to apply broad principles to specific situations.

.03 Generally accepted accounting principles change in response to changes in economic and social conditions, to new knowledge and technology, and to demands of users for more serviceable financial information. The dynamic nature of financial accounting—its ability to change in response to changed conditions—enables it to maintain and increase the usefulness of the information it provides.

BASIS FOR EVALUATION

.04 Although sections 1021-1029 do not specify what generally accepted accounting principles should be in the future, they are intended to provide a basis for evaluating principles and guiding changes in financial accounting.

Orderly change in financial accounting is promoted by evaluation of present and proposed principles in terms of their internal consistency and practical operation and in the light of observations concerning the environment and objectives of financial accounting and financial statements.

Practical Operation and Internal Consistency of Generally Accepted Accounting Principles

.05 Present generally accepted accounting principles can be analyzed to determine if they are operational and internally consistent.[1] Analysis can focus on individual principles and on their implications for and consistency with other principles. Evaluations of this type can aid in narrowing areas of difference and promoting the usefulness of financial accounting information.

The Environment

.06 Generally accepted accounting principles can also be evaluated by relating the financial accounting information they produce to the economic activities that the information attempts to represent. The significant constraints placed on accounting measurement by the complexity, continuity, and joint nature of economic activities are important in this evaluation.

Objectives of Financial Accounting and Financial Statements

.07 Understanding the objectives of financial accounting and financial statements (section 1024) is vital in evaluating and improving generally accepted accounting principles. The general objectives relate the content of financial accounting information to the interests and needs of users. The content of financial accounting information can therefore be appraised by determining the extent to which it serves these interests and needs. The qualitative objectives indicate the characteristics of useful information and thus provide criteria for appraising the usefulness of financial accounting information. The objectives are now achieved with varying degrees of success but improvement is probably possible in achieving each of them. Some objectives may conflict, however, so that improvement in one

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[1] Although consistency of principles is desirable, improving financial accounting may require changes that temporarily increase inconsistency among principles.

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area may be at the expense of another area. Generally accepted accounting principles should therefore be evaluated to determine the degree to which the objectives are met and the extent to which present principles represent an optimum practical solution to the problem of resolving conflicts between objectives.

PROPOSALS FOR CHANGE

.08 Suggestions have been made that present generally accepted accounting principles be changed (1) to eliminate differences in accounting practices that are not justified by differences in circumstances, (2) to make them more internally consistent, (3) to improve their effectiveness in accomplishing the objectives of financial accounting, and (4) to reflect more adequately the economic activities represented. These suggestions have resulted in a number of proposals in recent years which have not been fully evaluated but which, if accepted, would result in significant changes in generally accepted accounting principles and the resulting financial statements. Brief mention of some of these proposals in the following paragraphs does not, of course, imply a degree of present acceptance nor constitute a forecast of future acceptance. Reference to them in sections 1021-1029 does not give them substantial authoritative support.

.09 Some proposals contemplate change within the basic historical-cost-based accounting described in sections 1021-1029 in connection with present generally accepted accounting principles. The proposed changes, for example, would broaden the measurement and recognition criteria so that some items, such as contracts, commitments, and leases, that are not now recorded as assets and liabilities would be included in financial statements; also, criteria would be established for associating inventory costs and the costs of long-lived productive assets (plant and equipment) with the related revenue, both to narrow the range of acceptable procedures and to reduce the necessity of making essentially arbitrary choices among procedures. Although adopting these kinds of proposals would introduce significant changes, financial accounting for the most part would still rely on relating acquisition costs with revenue

to determine income and on acquisition prices as the basic recorded amount of assets.

.10 Other proposals contemplate more sweeping changes in the financial accounting structure or the content of financial statements. For example, they would revise the realization principle to permit accrual of increases in value of resources during production, substitute current replacement prices, current selling prices, estimated future selling prices, or discounted present-value concepts for acquisition prices as the basis of measurement, recognize changes in the general level of prices, and incorporate budgets as part of the basic financial statements.

.11 Still other proposals would change the presentation of financial accounting information rather than its accumulation and processing. New financial statements and new forms of existing financial statements have been proposed. The use of ratios instead of money amounts has been suggested, pointing to an emphasis on information such as trends, relationships, rates of return, and statements expressed in terms of percentages, rather than on absolute dollar amounts. Development of ways of disclosing information more effectively than in narrative notes has been proposed, including more use of graphs, charts, and other visual aids.

.12 Considerable interest has been shown in international accounting standards or "international generally accepted accounting principles." Prerequisite to the development of accounting standards on an international scale is not only knowledge of accounting practices and principles in various countries but also some attempts on the part of the accounting profession of each country to formalize and codify the accounting practices used in the country.*

.13 These proposals are mentioned in sections 1021-1029 not to give them recognition or support but to indicate the general nature of potential changes in ideas and conditions in the future. Financial accounting promises to be as dynamic in the future as it has been in the past. The Accounting Principles Board will be involved in guiding future changes in generally accepted accounting principles.

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* See section 9000, International Accounting Standards.

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It invites all those interested in continued improvement in financial accounting to participate actively.

NOTE

.14 *Statements 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. This Statement is not an "Opinion of the Accounting Principles Board" covered by action of the Council of the Institute in its May 7, 1973 Resolution designating the Financial Accounting Standards Board as the body to establish accounting principles pursuant to Rule 203 of the Rules of Conduct of the American Institute of Certified Public Accountants.* [*As amended, effective May 7, 1973 by Council Resolution.*] *(See section 510.08.)*

The next page is 7401.

AC Section 1041

Accounting For Nonmonetary Transactions

[Source: APB Opinion No. 29.]

Effective for transactions entered into after September 30, 1973, unless otherwise indicated

INTRODUCTION

.01 Most business transactions involve exchanges of cash or other monetary assets or liabilities[1] for goods or services. The amount of monetary assets or liabilities exchanged generally provides an objective basis for measuring the cost of nonmonetary assets or services received by an enterprise as well as for measuring gain or loss on nonmonetary assets transferred from an enterprise. Some transactions, however, involve either (a) an exchange with another entity (reciprocal transfer[1]) that involves principally nonmonetary assets or liabilities[1] or (b) a transfer of nonmonetary assets for which no assets are received or relinquished in exchange (nonreciprocal transfer[1]). Both exchanges and nonreciprocal transfers that involve little or no monetary assets or liabilities are referred to in this section as nonmonetary transactions.

.02 Questions have been raised concerning the determination of the amount to assign to a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction and also concerning the recognition of a gain or loss on a nonmonetary asset transferred from an enterprise in a nonmonetary transaction. Practice has varied; some nonmonetary transactions have been accounted for at the estimated fair value of the assets transferred and some at the amounts at which the assets transferred were previously recorded. This section sets forth the views of the Board on accounting for nonmonetary transactions.

Definitions

.03 The meanings of certain terms used in this section are:

[1] See paragraph .03 of this section for definitions of these terms.

a. *Monetary assets and liabilities* are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash, short- or long-term accounts and notes receivable in cash, and short- or long-term accounts and notes payable in cash.[2]

b. *Nonmonetary assets and liabilities* are assets and liabilities other than monetary ones. Examples are inventories; investments in common stocks; property, plant and equipment; and liabilities for rent collected in advance.[2]

c. *Exchange* (*or exchange transaction*) is a reciprocal transfer between an enterprise and another entity that results in the enterprise's acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.[3]

d. *Nonreciprocal transfer*[3] is a transfer of assets or services in one direction, either from an enterprise to its owners (whether or not in exchange for their ownership interests) or another entity or from owners or another entity to the enterprise. An entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

e. *Productive assets* are assets held for or used in the production of goods or services by the enterprise. Productive assets include an investment in another entity if the investment is accounted for by the equity method but exclude an investment not accounted for by that method. *Similar productive assets* are productive assets that are of the same general type, that perform the same function or that are employed in the same line of business.

Applicability

.04 This section does not apply to the following transactions:

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[2] Section 1071.17-.19, *Financial Statements Restated for General Price-Level Changes,* and section 1071B, contains a more complete explanation of monetary and nonmonetary items.

[3] Section 1027.06-.09, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* contains a more complete explanation of exchanges and nonreciprocal transfers.

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a. A business combination accounted for by an enterprise according to the provisions of section 1091, *Business Combinations,*

b. A transfer of nonmonetary assets solely between companies or persons under common control, such as between a parent company and its subsidiaries or between two subsidiary corporations of the same parent, or between a corporate joint venture and its owners,

c. Acquisition of nonmonetary assets or services on issuance of the capital stock of an enterprise,[4] and

d. Stock issued or received in stock dividends and stock splits which are accounted for in accordance with section 5561.

This section applies to regulated companies in accordance with section 6011, *Accounting Principles for Regulated Industries,* and it amends section 1027, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* to the extent it relates to measuring transfers of certain nonmonetary assets. Some exchanges of nonmonetary assets involve a small monetary consideration, referred to as "boot," even though the exchange is essentially nonmonetary. This section also applies to those transactions. For purposes of applying this section, events and transactions in which nonmonetary assets are involuntarily converted (for example, as a result of total or partial destruction, theft, seizure, or condemnation) to monetary assets that are then reinvested in other nonmonetary assets —are monetary transactions since the recipient is not obligated to reinvest the monetary consideration in other nonmonetary assets.

DISCUSSION

Present Accounting for Nonmonetary Transactions

.05 *Nonreciprocal Transfers with Owners.* Some nonmonetary transactions are nonreciprocal transfers between an enterprise and its owners. Examples include (a) distribution of nonmonetary assets, such as marketable equity

[4] The Board has deferred consideration of accounting for those transactions pending completion and consideration of Accounting Research Studies on intercorporate investments and stockholders' equity except to the extent they are covered in section 4062, *Accounting for Stock Issued to Employees.*

securities, to stockholders as dividends, (b) distribution of nonmonetary assets, such as marketable equity securities, to stockholders to redeem or acquire outstanding capital stock of the enterprise, (c) distribution of nonmonetary assets, such as capital stock of subsidiaries, to stockholders in corporate liquidations or plans of reorganization that involve disposing of all or a significant segment of the business (the plans are variously referred to as spin-offs, split-ups, and split-offs), and (d) distribution of nonmonetary assets to groups of stockholders, pursuant to plans of rescission or other settlements relating to a prior business combination, to redeem or acquire shares of capital stock previously issued in a business combination. Accounting for decreases in owners' equity that result from nonreciprocal nonmonetary transactions with owners has usually been based on the recorded amount of the nonmonetary assets distributed.

.06 *Nonreciprocal Transfers with Other Than Owners.* Other nonmonetary transactions are nonreciprocal transfers between an enterprise and entities other than its owners. Examples are the contribution of nonmonetary assets by an enterprise to a charitable organization and the contribution of land by a governmental unit for construction of productive facilities by an enterprise. Accounting for nonmonetary assets received in a nonreciprocal transfer from an entity other than an owner has usually been based on fair value of the assets received while accounting for nonmonetary assets transferred to another entity has usually been based on the recorded amount of the assets relinquished.

.07 *Nonmonetary Exchanges.* Many nonmonetary transactions are exchanges of nonmonetary assets or services with another entity. Examples include (a) exchange of product held for sale in the ordinary course of business (inventory) for dissimilar property as a means of selling the product to a customer, (b) exchange of product held for sale in the ordinary course of business (inventory) for similar product as an accommodation—that is, at least one party to the exchange reduces transportation costs, meets immediate inventory needs, or otherwise reduces costs or facilitates ultimate sale of the product—and not as a means of selling the product to a customer, and (c) exchange of

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productive assets—assets employed in production rather than held for sale in the ordinary course of business—for similar productive assets or for an equivalent interest in similar productive assets. Examples of exchanges in category (c) include the trade of player contracts by professional sports organizations, exchange of leases on mineral properties, exchange of one form of interest in an oil producing property for another form of interest, exchange of real estate for real estate. Accounting for nonmonetary assets acquired in a nonmonetary exchange has sometimes been based on the fair value of the assets relinquished and sometimes on the recorded amount of the assets relinquished.

Differing Views

.08 Views of accountants differ as to appropriate accounting for all of the types of nonmonetary transactions described in paragraphs .05 to .07.

.09 *Nonreciprocal Transfers of Nonmonetary Assets to Owners.* Some believe that accounting for nonreciprocal transfers of nonmonetary assets to owners should be based on the carrying amount of the nonmonetary assets transferred because only that method is consistent with the historical cost basis of accounting.

.10 Others believe that accounting for transfers of nonmonetary assets to reduce certain owners' interests other than through a reorganization, liquidation, or rescission of a prior business combination should be based on the fair value of the nonmonetary assets distributed or the fair value of the stock representing the owners' equity eliminated, whichever is more clearly evident. In their view, disposing of the value represented by a nonmonetary asset is a significant economic event, and the unrecorded increase or decrease that has resulted in the value of the nonmonetary asset since its acquisition should be recognized.

.11 Many who agree with accounting based on fair value for a nonreciprocal transfer of a nonmonetary asset that reduces certain owners' interests also believe that distributing a nonmonetary asset as an ordinary dividend (but not distributing a nonmonetary asset as a liquidating dividend or in a spin-off, reorganization or similar distributions)

may be regarded as equivalent to an exchange with owners and therefore recorded at the fair value of the nonmonetary asset distributed, particularly if the dividend is distributable as either cash or the nonmonetary asset at the election of the owner. They believe that failure to recognize the fair value of nonmonetary assets transferred may both misstate the dividend and fail to recognize gains and losses on nonmonetary assets that have already been earned or incurred by the enterprise and should be recognized on distributing the assets for dividend purposes.

.12 Others generally agree with the view that nonreciprocal transfers of nonmonetary assets to certain owners should be accounted for at fair value but believe that dividends and other prorata distributions to owners are essentially similar to liquidating dividends or distributions in spin-offs and reorganizations and should be accounted for at the recorded amount of the asset transferred.

.13 *Nonreciprocal Receipts of Nonmonetary Assets.* Many believe that a nonmonetary asset received in a nonreciprocal transfer from other than owners should be recorded at fair value because fair value is the only value revelant to the recipient enterprise. Others believe that such nonmonetary assets should be recorded at a nominal value since fair value cannot be reasonably determined in view of performance obligations usually agreed to by the recipient as a consideration for the transfer.

.14 *Nonreciprocal Transfers of Nonmonetary Assets to Other Than Owners.* Some believe that accounting for a nonreciprocal transfer of a nonmonetary asset to an entity other than an owner should be based on the carrying amount of the asset transferred because only that method is consistent with the historical cost basis of accounting. Others believe that failure to recognize the fair value of a nonmonetary asset transferred may both understate (or overstate) expenses incurred and fail to recognize gains or losses on nonmonetary assets that have already been earned or incurred by the enterprise and should be recognized when the transfer of the asset is recognized as an expense.

.15 *Exchange Transactions.* Some believe that accounting for an exchange of nonmonetary assets between an enterprise and another entity (an enterprise or indi-

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vidual acting in a capacity other than a stockholder of the enterprise) should be based on the fair values of the assets involved, while others believe that accounting for the exchange should be based on the carrying amount of the asset transferred from the enterprise. Those who advocate the former view believe it to be the only method consistent with the accounting principle that an asset acquired should be recorded at its cost as measured by the fair value of the asset relinquished to acquire it. Those advocating the latter view believe that revenue should be recognized only if an exchange involves monetary assets; therefore recognizing fair value is inappropriate unless a monetary asset is received in an exchange.

.16 Many accountants who accept the concept that accounting for an exchange of nonmonetary assets should be based on fair value believe that problems of measurement and questions about the conditions for recognizing revenue require modification of the concept in two types of exchanges. They therefore conclude that:

a. Fair values should not be recognized if an enterprise exchanges product or property held for sale in the ordinary course of business for product or property to be sold in the same line of business. The emphasis in that exchange, in their view, is on developing economical ways to acquire inventory for resale to customers rather than on marketing inventory to obtain revenue from customers. Therefore, "swapping" inventories between enterprises that are essentially competitors and not customers of each other is merely an incidental early stage of an earning process, and revenue should not be recognized until the time of sale of the exchanged products (in the same or another form) to a customer of the enterprise.

b. Fair value should not be recognized if an enterprise exchanges a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset. Therefore, revenue should not be recognized merely because one productive asset is substituted for a similar productive asset but rather should be considered to flow from the

production and sale of the goods or services to which the substituted productive asset is committed.

.17 *Fair Value Not Determinable.* General agreement exists that a nonmonetary transaction, regardless of form, should not be recorded at fair value if fair value is not determinable within reasonable limits. Major uncertainties concerning realizability of the fair value proposed to be assigned to a nonmonetary asset received in a nonmonetary transaction are indicative of an inability to determine fair value within reasonable limits. Some believe that only an exchange transaction between parties with essentially opposing interests provides an independent test of fair value to be used in measuring the transaction; therefore fair value is determinable within reasonable limits only in a negotiated exchange transaction. Others believe that fair value in a nonreciprocal transfer is also often determinable within reasonable limits and should be recognized in certain types of transactions.

OPINION

Basic Principle

.18 The Board concludes that in general accounting for nonmonetary transactions should be based on the fair values [5] of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset

[5] See paragraph .25 for determination of fair value.

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to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement).

.19 The Board believes that certain modifications of the basic principle are required to accommodate problems of measurement and questions about the conditions for recognizing revenue. These modifications are specified in paragraphs .20 to .23.

Modifications of the Basic Principle

.20 *Fair Value Not Determinable.* Accounting for a nonmonetary transaction should not be based on the fair values of the assets transferred unless those fair values are determinable within reasonable limits (paragraph .25).

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

a. An exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange, and

b. An exchange of a productive asset not held for sale in the ordinary course of business for a similar productive asset or an equivalent interest in the same or similar productive asset (similar productive asset is defined in paragraph .03 and examples are given in paragraph .07).[6]

.22 The exchanges of nonmonetary assets that would otherwise be based on recorded amounts (paragraph .21) may include an amount of monetary consideration. The Board believes that the recipient of the monetary consideration has realized gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate

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[6] The fact that an exchange of productive assets is not a taxable transaction for tax purposes may be evidence that the assets exchanged are similar for purposes of applying this section.

share of the recorded amount of the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. The Board further believes that the entity paying the monetary consideration should not recognize any gain on a transaction covered in paragraph .21 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraph .21, the entire indicated loss on the exchange should be recognized.

.23 *Nonreciprocal Transfers to Owners.* Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary assets distributed. A prorata distribution to owners of an enterprise of shares of a subsidiary or other investee company that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spin-off. Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

Applying the Basic Principle

.24 The Board's conclusions modify to some extent existing practices as described in paragraphs .05 to .07. The conclusions are based on supporting reasons given in paragraphs .08 to .17.

.25 Fair value of a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted

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market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

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

.27 A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a timing difference to be accounted for according to section 4091, *Income Taxes.*

Disclosure

.28 An enterprise that engages in one or more nonmonetary transactions during a period should disclose in financial statements for the period the nature of the transactions, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.[7]

EFFECTIVE DATE

.29 This section shall be effective for transactions entered into after September 30, 1973. Transactions recorded previously for a fiscal year ending before October 1, 1973 should not be adjusted. However, transactions re-

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[7] Section 2051.11, *Consolidated Financial Statements,* includes additional disclosures that are preferred if a parent company disposes of a subsidiary during the year.

corded previously for a fiscal year that includes October 1, 1973 may be adjusted to comply with the provisions of this section.

→ *The next page is 7431.* ←

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AC Section 1051

Accounting Changes

[Source: APB Opinion No. 20, as amended.]

Effective for fiscal years beginning after July 31, 1971, unless otherwise indicated

INTRODUCTION

.01 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 Section

.02 This section 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.

.03 This section 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 section 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 section should therefore be applied to regulated companies in accordance with the provisions of section 6011.

.04 This section does not change the policy of the Board that its Opinions, unless otherwise stated, are not intended to be retroactive. Each published section specifies its effective date and the manner of reporting a change to conform with the conclusions of each section. 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.[1] Accordingly, the provisions of this section do not apply to changes made in conformity with such pronouncements issued in the past or in the future.

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[1] See AC section 6000 Appendix for a list of AICPA Industry Audit/Accounting Guides.

.05 This section 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 sections: [2]

a. Section 2041.03, *Comparative Financial Statements,* has been amended to insert a cross reference to this section. This section identifies numerous accounting changes and specifies the manner of reporting each change.

b. Section 2010.19, *Reporting the Results of Operations,* has been superseded, and section 2011.13, *Earnings per Share,* amended by APB Opinion No. 30. This section specifies an additional element in the presentation of the income statement. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

c. Section 2010.24 has been superseded. Although the conclusion of that paragraph is not modified, this section deals more completely with accounting changes.

TYPES OF ACCOUNTING CHANGES

.06 The term *accounting change* in this section 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 section). The correction of an error in previously issued financial statements is not deemed to be an accounting change.

Change in Accounting Principle

.07 A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes "not only accounting principles and practices but also the methods of applying them." [3]

.08 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

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[2] Sections 1021-1029, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* have been amended to the extent that they relate to reporting accounting changes.

[3] AU section 410.02 (volume 1, AICPA PROFESSIONAL STANDARDS).

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(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.

.09 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;[4] 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 from recording costs as expense when incurred to deferring and amortizing them. (Paragraph .11 covers a change in accounting principle to effect a change in estimate.) [As modified, effective for fiscal years beginning on or after January 1, 1975, pursuant to FASB Statement No. 2.] (See section 4211.)

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 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

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[4] 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 section. (Section 2043.02d covers disclosure of methods of depreciation.)

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 section.

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 section.[5] 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 section.

[5] AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* discusses other aspects of errors in previously issued financial statements.

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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.

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.[6]

[6] 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 .04).

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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 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[7] should be shown

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[7] The pro forma amounts include both (a) the direct effects of a change

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.

.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.[8] 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 7) 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 section 2011, *Earnings per Share*) for income before extraordinary items and

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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.

[8] See footnote 7.

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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. Section 1051A 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.

.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,[9] computed on the assumption of retroactive application of the newly adopted method

[9] See footnote 7.

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 section 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, 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

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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. Section 1051B 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 section 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.[10]

.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

[10] [Superseded, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.] (See section 2014.)

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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 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. (Sections 1091.56-.65 and 1091.93-.96, *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. (Section 2010.17 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 section 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 section 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 pre-

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pared in the same manner (including the presentation of pro forma amounts) as that prescribed in this section 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 section are effective for fiscal years beginning after July 31, 1971. However, the Board encourages application of the provisions of this section 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.

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AC Section 1051A

Accounting Changes—Appendix A

An Illustration of Reporting a Change in Accounting Principle (Pursuant to Sections 1051.19-.22)

.01 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.

.02 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—

		Effects of Change	
Year	*Excess of Accelerated Depreciation Over Straight Line Depreciation*	*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

.03 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

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	1971	*1970*
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.

.04 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

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	1971	*1970*	*1969*	*1968*	*1967*
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.

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AC Section 1051B

Accounting Changes—Appendix B

An Illustration of Reporting a Special Change in Accounting Principle By Restating Prior Period Financial Statements (Pursuant to Sections 1051.27 and 1051.28)

.01 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 sections 1051.27 and 1051.28.

.02 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.

.03 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

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	1971	1970
Add adjustment for the cumulative effect on prior years of applying retroactively the new method of accounting or 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.

.04 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

→ *The next page is 7471.* ←

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AC Section 1051-1

Accounting Changes Related to the Cost of Inventory: An Interpretation of Section 1051

[Source: FASB Interpretation No. 1.]

June 1974

INTRODUCTION

.01 *Accounting Principles Board (APB) Opinion No. 20* [section 1051] specifies how changes in accounting principles should be reported in financial statements and what is required to justify such changes. Under that Opinion, the term *accounting principle* includes "not only accounting principles and practices but also the methods of applying them."

.02 Paragraph 5 of Chapter 4 of *Accounting Research Bulletin No. 43* [section 5121.05] states "there is a presumption that inventories should be stated at cost," which is "understood to mean acquisition and production cost." It further states that "the exclusion of all overheads from inventory cost does not constitute an accepted accounting procedure."

.03 Internal Revenue Service (IRS) Regulation 1.471—11, adopted in September 1973, specifies how certain costs should be treated in determining inventory costs for income tax reporting. Under IRS Reg. 1.471—11, some costs must be included in inventory or excluded from inventory for income tax reporting *regardless* of their treatment for financial reporting. Other costs must be included in inventory or excluded from inventory for income tax reporting *depending upon* their treatment for financial reporting, "but only if such treatment is not inconsistent with generally accepted accounting principles." Among the costs listed in IRS Reg. 1.471—11 in this last category are taxes other than income taxes, depreciation, cost depletion, factory administrative expenses, and certain insurance costs.

.04 Taxable income and accounting income are based on common information about transactions of an enterprise. However, the objectives of income determination for Federal income taxation and the objectives of income determination for financial statements of business enterprises are not always the same.

INTERPRETATION

.05 A change in composition of the elements of cost included in inventory is an accounting change. A company which makes such a change for financial reporting shall conform to the requirements of *APB Opinion No. 20* [section 1051], including justifying the change on the basis of preferability as specified by paragraph 16 of *APB Opinion No. 20* [section 1051.16]. In applying *APB Opinion No. 20* [section 1051], preferability among accounting principles shall be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone.

EFFECTIVE DATE

.06 This Interpretation shall be effective on July 1, 1974.

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AC Section 1051-2

Reporting Accounting Changes under AICPA Statements of Position: An Interpretation of Section 1051

[Source: FASB Interpretation No. 20.]

November 1977

INTRODUCTION AND BACKGROUND INFORMATION

.01 The Accounting Standards Division of the AICPA has asked the FASB to either reconsider certain provisions of *APB Opinion No. 20* [section 1051], "Accounting Changes," or to clarify whether statements of position issued by the AICPA may specify how to report a change to adopt its recommendations for purposes of applying that Opinion.

.02 Paragraph 4 of *APB Opinion No. 20* [section 1051.04] indicates that each APB Opinion specifies how to report a change to conform with the conclusions of the Opinion and further states:

> 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.

.03 At the time *APB Opinion No. 20* [section 1051] was issued in July 1971, the Accounting Principles Board issued Opinions on financial accounting and reporting and various AICPA industry committees issued industry audit guides that dealt with both the specialized auditing procedures and the specialized accounting practices applicable to enterprises in those industries. Subsequently, specialized industry accounting practices were dealt with in a new series of industry accounting guides issued by the AICPA, each of which specified how to report a change in accounting to conform with the conclusions of the guide. In July 1973, the FASB replaced the APB; the AICPA discontinued the industry accounting guides and its Accounting Standards Division began issuing statements of position[1] covering specialized industry accounting practices.

[1] In the introduction to previously issued statements of position, the AICPA indicates that "Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Account-

.04 The FASB believes that in due course *APB Opinion No. 20* [section 1051] should be reconsidered. The FASB believes further, however, that pending that reconsideration, issuance of this Interpretation will result in improvements in financial accounting and reporting.

INTERPRETATION

.05 For purposes of applying *APB Opinion No. 20* [section 1051], an enterprise making a change in accounting principle to conform with the recommendations of an AICPA statement of position shall report the change as specified in the statement. If an AICPA statement of position does not specify the manner of reporting a change in accounting principle to conform with its recommendations, an enterprise making a change in accounting principle to conform with the recommendations of the statement shall report the change as specified by Opinion No. 20 [section 1051].

EFFECTIVE DATE

.06 This Interpretation shall be effective December 1, 1977.

The next page is 7491.

ing Standards Executive Committee, which is the senior technical body of the [AICPA] authorized to speak for the [AICPA] in the areas of financial accounting and reporting and cost accounting.

"The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Divison believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the [AICPA's] Code of Professional Ethics."

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AC Section 1071

Financial Statements Restated for General Price-Level Changes

[Source: APB Statement No. 3, as amended.]

Issue date, unless otherwise indicated: June, 1969

STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

FOREWORD

This Statement sets forth the conclusions and recommendations of the Accounting Principles Board concerning general price-level information. Presentation of such information is not mandatory. The principles and procedures on which general price-level information is based have been tested (see paragraph .16 of this section) and have been discussed with representatives of organizations that have responsibilities which involve financial reporting.

INTRODUCTION

.01 This section explains the effects on business enterprises and their financial statements of changes in the general purchasing power of money, describes the basic nature of financial statements restated for general price-level changes ("general price-level financial statements"), and gives general guidance on how to prepare and present these financial statements.[1]

.02 In Section 4071 (issued in 1953), the committee on accounting procedure stated that it ". . . gives its full support to the use of supplementary financial schedules, explanations or footnotes by which management may ex-

[1] A more detailed discussion of general price-level financial statements is found in *Accounting Research Study No. 6,* "Reporting the Financial Effects of Price-Level Changes," by the Staff of the Accounting Research Division, American Institute of Certified Public Accountants, 1963. (Accounting research studies are not statements of this Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.)

plain the need for retention of earnings [in the face of rising general price levels]." Section 4071 continues in "full force and effect without change" according to *APB Opinion 6*. The present section is an expansion of the ideas in section 4071; it provides recommendations on how to prepare and present supplementary information restated for general price-level changes.

.03 General price-level financial statements take into account changes in the general purchasing power of money. These changes are now ignored in preparing financial statements in the United States. In conventional financial statements the individual asset, liability, stockholders' equity, revenue, expense, gain, and loss items are stated in terms of dollars of the period in which these items originated. Conventional financial statements may be referred to as "historical-dollar financial statements."

.04 The basic difference between general price-level and historical-dollar financial statements is the unit of measure used in the statements. In general price-level statements the unit of measure is defined in terms of a single specified amount of purchasing power—the general purchasing power of the dollar at a specified date. Thus, dollars which represent the same amount of general purchasing power are used in general price-level statements whereas dollars which represent diverse amounts of general purchasing power are used in historical-dollar statements.

.05 The cost principle on which historical-dollar statements are based is also the basis of general price-level statements. In general, amounts shown at historical cost in historical-dollar statements are shown at historical cost restated for changes in the general purchasing power of the dollar in general price-level statements. The amount may be restated, but it still represents cost and not a current value. The process of restating historical costs in terms of a specified amount of general purchasing power does not introduce any factors other than general price-level changes. The amounts shown in general price-level financial statements are not intended to represent appraisal values, replacement costs, or any other measure of current value. (See section 1071D for further discussion.)

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.06 Changes in the general purchasing power of money have an impact on almost every aspect of economic affairs, including such diverse matters as investment, wage negotiation, pricing policy, international trade, and government fiscal policy. The effects of changes in the general purchasing power of money on economic data expressed in monetary terms are widely recognized, and economic data for the economy as a whole are commonly restated to eliminate these effects. General price-level financial statements should prove useful to investors, creditors, management, employees, government officials, and others who are concerned with the economic affairs of business enterprises.

BACKGROUND INFORMATION

Changes in the General Purchasing Power of Money

.07 The general purchasing power of the dollar—its command over goods and services in general—varies, often significantly, from time to time. Changes in the general purchasing power of money are known as inflation or deflation. During inflation, the general purchasing power of money declines as the general level of prices of goods and services rises. During deflation, the general purchasing power of money increases as the general level of prices falls. The general purchasing power of money and the general price level are reciprocals.

.08 A change in the general price level is a composite effect of changes in the prices of individual goods and services. The prices of all goods and services do not change at the same rate or in the same direction. Some rise while others fall, some rise or fall more rapidly than others, and some remain unchanged. This section is concerned with changes in the general purchasing power of money and therefore with changes in the *general* price level, not with changes in the relationships between *specific* prices of individual goods and services. (See section 1071D.)

Measuring General Price-Level Changes

.09 Changes in the general price level are measured by the use of index numbers. The most comprehensive indicator of the general price level in the United States is the Gross National Product Implicit Price Deflator (GNP De-

flator), issued quarterly by the Office of Business Economics of the Department of Commerce. The Consumer Price Index which is issued monthly by the Bureau of Labor Statistics of the Department of Labor is less inclusive than the GNP Deflator. Because of differences in coverage and in the system of weights used, the two indexes may change at different rates in the short run. Over the long run, however, the two indexes have changed at approximately the same rate.

.10 Published general price-level indexes in the United States are stated in terms of a base year (currently 1958 for the GNP Deflator). Index numbers for current periods are expressed as percentages of the base year general price level. Through the use of indexes, amounts stated in terms of dollars at any point in time can be restated in terms of dollars of the base year of the index, dollars of the current year, or dollars of any year that is chosen. For example, the cost of land purchased for $10,000 in 1964 (GNP Deflator index = 108.9) can be restated as 9,183 dollars of 1958 general purchasing power (index = 100.0) by multiplying the cost by 100.0/108.9, or as 11,185 dollars of 1968 general purchasing power (index = 121.8) by multiplying the cost by 121.8/108.9. In all three cases the cost is the same but the units in which it is expressed are different. Similarly, the general level of prices in 1968 may be stated as 121.8% of the general level of prices in 1958, or the general level of prices in 1958 may be stated as

$\frac{100}{121.8} = 82.1\%$ of the general level of prices in 1968.

.11 General price levels seldom remain stable for long periods. For example, 35 of the 39 year to year changes in the United States GNP Deflator from 1929 to 1968 exceeded 1%. Ten of these changes were more than 5% and four were more than 10%. (See section 1071A.)

.12 Although general price levels can and have moved both up and down, inflation has been the general rule throughout the world for the last 30 years. Some countries have experienced slowly rising prices while others have experienced rapidly rising prices. The rise in the general price level in the United States, as measured by the GNP

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Deflator, was approximately 22% during the period 1958-1968 or a compound annual rate of 2% in contrast to approximately 130% in the preceding 20 years or a compound annual rate of about 4%. Price indexes in Brazil rose about 3,000% from 1958 to 1966. Inflation in China, Greece, and Hungary just before and after World War II was even more spectacular. General price-level increases of 25% to 50% per year have occurred recently in several countries.

Effects of General Price-Level Changes

.13 The effects of inflation or deflation on a business enterprise and on its financial statements depend on (1) the amount of change in the general price level and (2) the composition of the assets and liabilities of the enterprise.

.14 *Effects of Rate of Inflation.* Large changes in the general price level obviously have a greater effect than small changes. It is perhaps less obvious that moderate changes in the general price level may also significantly affect business enterprises and their financial statements. The nature of the income statement and the cumulative effect over time of moderate changes in the general price level tend to magnify the effects of changes in the general price level. Thus, in the income statement, differences which represent relatively small percentage changes in comparatively large revenue and expense items may be substantial in relation to net income. Also, if assets are held for a number of years the effect of inflation or deflation depends on the cumulative inflation or deflation since acquisition of the assets. The general price-level change in any one year is only a part of the total effect. Thus, the 3.8% inflation experienced in 1968 is only a small part of the total inflation effect on fixed assets appearing in 1968 statements. For fixed assets purchased in 1950, for example, there is a cumulative inflation effect of 54% (total inflation measured by the GNP Deflator from 1950 to 1968) on undepreciated cost and depreciation expense in 1968 general price-level financial statements. Furthermore, the effects of inflation compound over a period of years (for example, a constant 2% rate of inflation results in a 22% cumulative general price-level change in ten years and a 49% cumulative general price-level change in 20 years). Nonrecognition

of the effects of inflation may therefore have a substantial effect on financial statement representations of assets held over long periods (such as investments, and property, plant, and equipment), even though the amount of inflation each year has been relatively small.

.15 *Effects of Different Kinds of Assets and Liabilities.* The holders of some types of assets and liabilities are affected differently by inflation and deflation than are the holders of other types of assets and liabilities. For example, holders of cash and similar assets always lose general purchasing power during a period of inflation, but holders of other assets may or may not lose general purchasing power during inflation. The effects on holders of different types of assets and liabilities are discussed more fully in paragraphs .17 to .23.

.16 *Determining Combined Effects.* The effects of general price-level changes on a business enterprise and its financial statements therefore cannot be approximated by a simple adjustment. If users attempt to adjust for general price-level changes on an uninformed basis, they are likely to draw misleading inferences. The effects of general price-level changes can only be determined by comprehensive restatement of the items which comprise its financial statements. The need for comprehensive restatement was illustrated by a field test of general price-level restatement procedures.[2] For many companies in the test, net income was a smaller numerical amount on the general price-level basis than on the historical-dollar basis for the same period; for other companies it was a larger amount. The percentage differences between the amounts of net income for each company on the two bases varied widely, even with the relatively mild inflation in the United States in recent years.

Monetary and Nonmonetary Assets and Liabilities and General Price-Level Gains and Losses

.17 During inflation, a given amount of money can be used to buy progressively fewer goods and services in general. Consequently, holders of money lose general purchasing power as a result of inflation. This loss may be

[2] See Paul Rosenfield, "Accounting for Inflation—A Field Test," *The Journal of Accountancy,* June 1969, pp. 45 to 50.

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called a "general price-level loss."[3] General price-level losses also occur when certain other assets, mainly contractual claims to fixed amounts of money, are held during a period of inflation. The amount of money expected to be received represents a diminishing amount of general purchasing power simply as a result of the inflation. Similarly, a fixed amount of money payable in the future becomes less burdensome in a time of inflation because it is payable in dollars of reduced general purchasing power; those who owe money during inflation therefore have "general price-level gains." The effects of deflation are the opposite of the effects of inflation on holders of assets and liabilities of the type described in this paragraph.

.18 Assets and liabilities are called "monetary" for purposes of general price-level accounting if their amounts are fixed by contract or otherwise in terms of numbers of dollars regardless of changes in specific prices or in the general price level. Examples of monetary assets and liabilities are cash, accounts and notes receivable in cash, and accounts and notes payable in cash. Holders of monetary assets and liabilities gain or lose general purchasing power during inflation or deflation simply as a result of general price-level changes.[4] General price-level gains and losses on monetary items cannot be measured in historical-dollar financial statements and are not now reported.

.19 Assets and liabilities other than monetary items are called "nonmonetary" for general price-level accounting purposes. Examples of nonmonetary items are inventories, investments in common stocks, property, plant, and equipment, deferred charges which represent costs expended in the past, advances received on sales contracts, liabilities

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[3] Gains and losses of this type are often called "purchasing power gains and losses" in discussions of general price-level accounting (for example, see *Accounting Research Study No. 6*, page 137), but the Board prefers the term "general price-level gains and losses" to distinguish them from other gains and losses of general purchasing power experienced by business enterprises, such as those discussed in paragraph .19 of this section.

[4] See *Accounting Research Study No. 6*, page 137, for discussion of monetary and nonmonetary items in general price-level accounting. Assets and liabilities may be classified as "monetary" for purposes other than general price-level accounting. Classification of assets and liabilities as monetary for general price-level accounting purposes should be based on the fact that holders gain or lose general purchasing power simply as a result of general price-level changes rather than on criteria developed for other purposes.

for rent collected in advance, deferred credits which represent reductions of prior expense, and common stock. Holders of nonmonetary items do not gain or lose general purchasing power simply as a result of general price-level changes. If the price of a nonmonetary item changes at the same rate as the general price level, no gain or loss of general purchasing power results. Holders of nonmonetary assets and liabilities gain or lose general purchasing power if the specific price of the item owned or owed rises or falls faster or slower than the change in the general price level. Holders of nonmonetary assets and liabilities also gain or lose general purchasing power if the specific price of a nonmonetary item remains constant while the general price level changes. Gains and losses on nonmonetary items differ from general price-level gains and losses on monetary items because they are the joint result of changes in the structure of prices (the relationships between specific prices) and changes in the general level of prices, and not the result simply of changes in the general price level. (See section 1071B for additional examples of monetary and nonmonetary items.)

.20 Historical-dollar financial statements report gains and losses on nonmonetary items, usually when the items are sold, and corresponding gains and losses should also be reported in general price-level financial statements in the same time period as in the historical-dollar statements. The amounts reported as gains or losses may differ, however, because the costs and proceeds in the general price-level statements are restated for changes in the general price level. Thus, if the market price of an asset increases more than the increase in the general price level and the asset is sold, in historical-dollar statements the entire market price increase is shown as a gain in the period of sale but only the excess of the market price increase over the cost restated for the increase in the general price level is shown as a gain in the general price-level statements. The timing of reporting these gains and losses is the same in historical-dollar and general price-level financial statements but the amounts differ because of the effect of the change in the general price level. Similarly, if the asset is used instead of sold, depreciation or amortization deducted from the related revenue is reported in the same time periods in

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both historical-dollar and general price-level statements, although the amounts differ because of the restatement made in the general price-level statements. The Internal Revenue Code does not recognize general price-level restatements for tax purposes and income taxes are therefore assessed on the basis of historical-dollar amounts rather than amounts restated for general price-level changes. The income tax expense presented in general price-level statements is not computed in direct relationship to specific amounts of gains or losses on the statements or to the amount of net income before taxes. A few members of the Board believe that federal income tax should be allocated in general price-level statements to achieve a more direct relationship between the tax and various elements presented in these statements.

.21 The fact that the market price of an item does not change over long periods of time does not in itself indicate that the item is monetary. Thus gold is nonmonetary because its price can fluctuate. The fact that the price did not fluctuate for over 30 years does not make gold a monetary item. When general price levels moved upward, the holder of gold lost general purchasing power because the price of his asset did not move as much as other prices, and not simply as a result of general price-level changes. Foreign currency, accounts receivable and payable in foreign currency, and similar items are also nonmonetary. The price of foreign currency, that is, the foreign exchange rate, can change. Therefore, the holder of foreign currency items does not gain or lose general purchasing power simply as a result of general price-level changes. If the exchange rate does not change when the general price level changes because of international controls or other factors, the price of foreign currency is rising or falling at a different rate than the general price level. The effect on the holder is the joint result of a change in the structure of prices and a change in the general level of prices, and therefore the items are nonmonetary. Even though foreign currency items are nonmonetary, they may be stated at the current foreign exchange rate in general price-level financial statements. Under these circumstances they would be treated as nonmonetary items carried at current market value.

.22 A different viewpoint than that expressed in paragraph .21, held by a few Board members, is that foreign currency, accounts receivable and payable in foreign currency, and similar foreign currency items are similar to domestic monetary items. Foreign currency items should therefore be stated directly at the current (closing) foreign exchange rate in the general price-level balance sheet. The effect on the income of the holder of foreign currency items is the joint result of both the change in the foreign exchange rate and the change in the domestic general price level, and the items are therefore complex. Both effects are measurable, however, and should be disclosed separately. In the general price-level income statement, the effect of the general price-level change should be reported as a general price-level gain or loss on monetary items and the effect of the change in the exchange rate should be reported as a foreign exchange gain or loss. If the foreign exchange rate does not change, only a general price-level gain or loss should be reported.

.23 A few assets and liabilities have characteristics of both monetary and nonmonetary items. For example, debentures held as an investment may have both a market price and fixed interest and principal payments. The fixed interest and principal payments do not change when prices change and therefore holders have general price-level gains or losses during inflation or deflation with respect to this characteristic. On the other hand, the market price of the debentures can and does change, and this feature does not yield general price-level gains or losses. Similarly, convertible debt owed is fixed in amount when considered as debt, but may be converted into capital stock. The fixed amount of debt owed is a monetary liability, which gives rise to general price-level gains or losses when general price levels change. The conversion feature is nonmonetary in nature, and does not give rise to gains or losses of general purchasing power simply as a result of general price-level changes. (See paragraph .34.)

General Price-Level Restatements

.24 Economic data are commonly restated to eliminate the effects of changes in the general purchasing power of money. In the President's Economic Reports, National

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Income data of the United States, for example, have been restated in "constant" 1947-1949 dollars and "constant" 1954 dollars and are now expressed in "constant" 1958 dollars. The restatement procedures necessary for preparing general price-level financial statements are similar to those employed in restating other economic data. Some companies now use general price-level statements to report on their operations in countries in which the currency has suffered severe loss of general purchasing power.

RECOMMENDATIONS

.25 The Board believes that general price-level financial statements or pertinent information extracted from them present useful information not available from basic historical-dollar financial statements. General price-level information may be presented in addition to the basic historical-dollar financial statements, but general price-level financial statements should not be presented as the basic statements. The Board believes that general price-level information is not required at this time for fair presentation of financial position and results of operations in conformity with generally accepted accounting principles in the United States.

.26 The Board recognizes that the degree of inflation or deflation in an economy may become so great that conventional statements lose much of their significance and general price-level statements clearly become more meaningful, and that some countries have experienced this degree of inflation in recent years.[5] The Board concludes that general price-level statements reported in the local currency of those countries are in that respect in conformity with accounting principles generally accepted in the United States, and that they preferably should be presented as the basic foreign currency financial statements of companies operating in those countries when the statements are intended for readers in the United States.[6]

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[5] Although the Board believes that this conclusion is obvious with respect to some countries, it has not determined the degree of inflation or deflation at which general price-level statements clearly become more meaningful.

[6] This paragraph applies only to statements prepared in the currency of the country in which the operations reported on are conducted. Only conventional statements of foreign subsidiaries should be used to prepare historical-dollar consolidated statements.

Restatement of Financial Statements

.27 General guidelines for preparing general price-level statements, with explanatory comments, are set forth in paragraphs .28 to .46. More specific procedures are illustrated in section 1071C.

.28 *The same accounting principles used in preparing historical-dollar financial statements should be used in preparing general price-level financial statements except that changes in the general purchasing power of the dollar are recognized in general price-level financial statements.* General price-level financial statements are an extension of and not a departure from the "historical cost" basis of accounting. Many amounts in general price-level statements, however, are different from amounts in the historical-dollar statements because of the effects of changing the unit of measure.

.29 *An index of the general price level, not an index of the price of a specific type of goods or services, should be used to prepare general price-level financial statements.* Price indexes vary widely in their scope; some measure changes in the prices of a relatively limited group of goods and services, such as construction costs or retail food prices in a specific city, while others measure changes in the prices of a broad group of goods and services in a whole economy. The purpose of the general price-level restatement procedures is to restate historical-dollar financial statements for changes in the general purchasing power of the dollar, and this purpose can only be accomplished by using a general price-level index.

.30 Indexes which approximate changes in the general price level are now available for most countries. As noted in paragraph .09, the GNP Deflator is the most comprehensive indicator of the general price level in the United States. Consequently, it should normally be used to prepare general price-level statements in U. S. dollars.

.31 The GNP Deflator is issued on a quarterly basis. The deflator for the last quarter of a year can ordinarily be used to approximate the index as of the end of the year. The Bureau of Labor Statistics Consumer Price Index has the practical advantage of being issued on a monthly basis.

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The consumer price index may therefore be used to approximate the GNP Deflator unless the two indexes deviate significantly.

.32 *General price-level financial statements should be presented in terms of the general purchasing power of the dollar at the latest balance sheet date.* The Board has selected current general purchasing power as the basis for presentation because it believes that financial statements in "current dollars" are more relevant and more easily understood than those employing the general purchasing power of any other period. Current economic actions must take place in terms of current dollars, and restating items in current dollars expresses them in the context of current action.

.33 *Monetary and nonmonetary items should be distinguished for the purpose of preparing general price-level financial statements.* Monetary items are stated in terms of current general purchasing power in historical-dollar statements. General price-level gains and losses arise from holding monetary items. On the other hand, nonmonetary items are generally stated in terms of the general purchasing power of the dollar at the time they were acquired. Holding nonmonetary items does not give rise to general price-level gains and losses. Distinguishing monetary and nonmonetary items therefore permits (1) restatement of nonmonetary items in terms of current general purchasing power and (2) recognition of general price-level gains and losses on monetary items which are not recognized under historical-dollar accounting. Paragraphs .17 to .23 give criteria for distinguishing monetary and nonmonetary items for general price-level accounting purposes.

.34 Assets and liabilities that have both monetary and nonmonetary characteristics (see paragraph .23) should be classified as monetary or nonmonetary based on the purpose for which they are held, usually evidenced by their treatment in historical-dollar accounting. Thus, carrying debentures at acquisition cost (perhaps adjusted to lower of cost and market) and classifying them as marketable securities provides evidence that market price may be important and the debentures may be nonmonetary. On the other hand, classifying debentures held as a long-

term investment and amortizing premium or discount is evidence that the debentures are held for the fixed principal and interest and therefore are monetary assets. Similarly, convertible debt is usually treated as straight debt and therefore is usually a monetary liability.

.35 *The amounts of nonmonetary items should be restated to dollars of current general purchasing power at the end of the period.* Nonmonetary items are typically stated in historical-dollar financial statements in terms of the general purchasing power of the dollar at the dates of the originating transactions. They should be restated by means of the general price index to dollars of current general purchasing power at the end of the period. Restatement of nonmonetary items does not introduce current values or replacement costs. For example, restatement of the cost of land that cost $100,000 in 1958 to $123,500 in 1968 statements does not imply that the market price of the land is $123,500 in 1968. Restatement merely presents the *cost* in a unit which represents the general purchasing power of the dollar at the end of 1968.

.36 Nonmonetary items are sometimes already stated in historical-dollar financial statements in dollars of current general purchasing power, for example, inventory purchased near the end of the fiscal period or assets carried at current market price. The fact that the amount of an item is not changed in restatement does not necessarily identify it as a monetary item on which general price-level gains and losses should be computed.

.37 Some nonmonetary items such as inventories are stated at the lower of cost and market in historical-dollar financial statements. These items should also be stated at the lower of cost and market in general price-level financial statements. Market may sometimes be below restated cost even though it is not below historical-dollar cost, and application of the cost or market rule will therefore sometimes result in a write-down to market in general price-level statements even though no write-down was required in the historical-dollar statements.

.38 *Monetary assets and liabilities in the historical-dollar balance sheet are stated in dollars of current general*

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purchasing power; consequently, they should appear in current general price-level statements at the same amounts. The fact that the amounts of monetary assets and liabilities are the same in general price-level and historical-dollar statements should not obscure the fact that general price-level gains and losses result from holding them during a period of general price-level change (see paragraphs .17 and .18). Monetary assets and liabilities which appear in financial statements of prior periods presented for comparative purposes are updated to dollars of current general purchasing power by the "roll-forward" procedure described in paragraph .44.

.39 *The amounts of income statement items should be restated to dollars of current general purchasing power at the end of the period.* Revenue and expenses are typically stated in historical-dollar statements in terms of the general purchasing power of the dollar at the dates of the originating transactions and should be restated by means of the general price index to dollars of current general purchasing power at the end of the period. The components of gains and losses (costs and proceeds) are also stated in terms of historical dollars and should be restated. All revenue, expenses, gains, and losses recognized under historical-dollar accounting are recognized in the same time period under general price-level accounting, but their amounts are different in the case of items that are recorded in noncurrent dollars, such as depreciation, amortization, and cost of goods sold. Transactions that give rise to gains in historical-dollar financial statements may even give rise to losses in general price-level financial statements and vice versa. Income tax amounts in general price-level statements are based on income taxes reflected in historical-dollar statements and are not computed in direct relationship to the income before taxes on the general price-level statements.

.40 *General price-level gains and losses should be calculated by means of the general price index and included in current net income.* General price-level gains and losses on monetary items described in paragraphs .17 and .18 should be calculated by restating the opening bal-

ances and transactions in the accounts for monetary assets and liabilities to dollars of general purchasing power at the end of the period and comparing the resulting restated balances at the end of the period with the actual balances at the end of the period. (See section 1071C.)

.41 General price-level gains and losses on monetary items arise from changes in the general price level, and are not related to subsequent events such as the receipt or payment of money. Consequently, the Board has concluded that these gains and losses should be recognized as part of the net income of the period in which the general price level changes.

.42 A different viewpoint than that expressed in paragraph .41, held by a Board member, is that all of a monetary gain should not be recognized in the period of general price-level increase. Under this view, a portion of the gain on net monetary liabilities in a period of general price-level increase should be deferred to future periods as a reduction of the cost of nonmonetary assets, since the liabilities represent a source of funds for the financing of these assets. The proponent of this view believes that the gain from holding net monetary liabilities during inflation is not realized until the assets acquired from the funds borrowed are sold or consumed in operations.[7] The Board does not agree with this view, however, because it believes that the gain accrues during the period of the general price-level increase and is unrelated to the cost of nonmonetary assets.

.43 *General price-level gains and losses should be reported as a separate item in general price-level income statements.* General price-level gains and losses on monetary items are not part of the revenue and expenses reported in historical-dollar financial statements. They should be separately identified in the general price-level statements. General price-level gains may, however, be offset against general price-level losses and only a single figure representing net general price-level gain or loss for the period need be reported.

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[7] For further discussion of this view see Marvin M. Deupree, "Accounting for Gains and Losses in Purchasing Power of Monetary Items" in *Accounting Research Study No. 6*, pp. 153-165.

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.44 *General price-level financial statements of earlier periods should be updated to dollars of the general purchasing power at the end of each subsequent period for which they are presented as comparative information.* Statements of an earlier period are updated by multiplying each item by the ratio of the current general price level to the general price level of the earlier period. This "rolling forward" of earlier statements could cause confusion and convey the erroneous impression that previously reported information has been changed in substance rather than merely updated in terms of a later unit of measure.[8] Consequently, comparative general price-level financial statements and related financial information should be described in a way that makes clear that the general price-level statements of prior periods represent previously reported information updated to dollars of current general purchasing power to provide comparability with the current general price-level statements. (See paragraph .48, point f.)

.45 *Restatement of financial statements of foreign branches or subsidiaries of U. S. companies for inclusion in combined or consolidated financial statements stated in terms of U. S. dollars should be based on an index of the general level of prices in the United States.* General price-level financial statements stated in terms of U. S. dollars use a unit of measure that represents the general purchasing power of the U. S. dollar at a specified date. An index of changes in the general purchasing power of the U. S. dollar should therefore be used to restate the financial statements of a company and its combined or consolidated foreign branches and subsidiaries. Financial statements of foreign branches or subsidiaries to be combined or consolidated with the financial statements of their United States parent company should first be translated into U. S. dollars using presently accepted methods and then restated for changes in the general purchasing power of the U. S. dollar.

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[8] The "roll-forward" process results in stating financial statement items at different amounts than they were stated before being "rolled forward." The differences are not gains or losses but are merely differences between the same items measured in two different units of measure. If a cost stated at 100 dollars of general purchasing power current at the beginning of the year is "rolled forward" to 105 dollars of general purchasing power current at the end of the year, the difference of 5 is not a gain. It is similar, for example, to the difference of 2 between 1 yard and 3 feet.

.46 *All general price-level information presented should be based on complete general price-level calculations.* Financial statements in which only some of the items, such as depreciation, have been restated disclose only part of the effects of changing general price levels on an enterprise. Partially restated financial statements and information based on them are likely to be misleading and should not be presented. General price-level information should therefore be based on complete calculations, although it need not be presented in the same detail as the historical-dollar financial statements. If any general price-level information is given, at least sales, net general price-level gains and losses on monetary items, extraordinary items, net income, and common stockholders' equity should be disclosed.

Presentation of General Price-Level Financial Information

.47 Presentation of general price-level financial information as a supplement to the basic historical-dollar financial statements should be designed to promote clarity and minimize possible confusion. Because the two types of data are prepared on different bases, presentations of general price-level financial information should generally encourage comparisons with other general price-level data rather than with historical-dollar data. If general price-level financial statements are presented in their entirety, they preferably should be presented in separate schedules, not in columns parallel to the historical-dollar statements. Financial information extracted from general price-level statements (see paragraph .46) may be presented in either chart or narrative form, and may emphasize ratios and percentages instead of or in addition to dollar amounts.

.48 The basis of preparation of general price-level information and what it purports to show should be clearly explained in the notes to the general price-level financial statements or other appropriate places. The explanation should include the following points:

a. The general price-level statements (or information) are supplementary to the basic historical-dollar financial statements [except as provided in paragraph .26].

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b. All amounts shown in general price-level statements are stated in terms of units of the same general purchasing power by use of an index of changes in the general purchasing power of the dollar.

c. The general price-level gain or loss in the general price-level statements indicates the effects of inflation (or deflation) on the company's net holdings of monetary assets and liabilities. The company gains or loses general purchasing power as a result of holding these assets and liabilities during a period of inflation (deflation).

d. In all other respects, the same generally accepted accounting principles used in the preparation of historical-dollar statements are used in the preparation of general price-level statements (or information).

e. The amounts shown in the general price-level statements do not purport to represent appraised value, replacement cost, or any other measure of the current value of assets or the prices at which transactions would take place currently.

f. The general price-level statements (or information) of prior years presented for comparative purposes have been updated to current dollars. This restatement of prior years' general price-level statements is required to make them comparable with current information. It does not change the prior periods' statements in any way except to update the amounts to dollars of current general purchasing power.

.49 Disclosure involving the following items should also be made:

a. The difference between the balance of retained earnings at the end of the preceding year in beginning-of-the-year dollars and at the beginning of the year in end-of-the-year dollars, which arises in the roll-forward process discussed in paragraph .44, should be explained somewhat as follows:

Retained earnings at the beginning of the year:

Restated to general purchasing power at the beginning of the year	xxx
Amount required to update to general purchasing power at the end of the year	xxx
Restated to general purchasing power at the end of the year	xxx

b. The fact should be disclosed that when assets are used or sold, federal income taxes are based on cost before restatement for general price-level changes because inflation is not recognized in the Internal Revenue Code.

NOTE

.50 *Statements 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. This Statement is not an "Opinion of the Accounting Principles Board" covered by action of the Council of the Institute in its May 7, 1973 Resolution designating the Financial Accounting Standards Board as the body to establish accounting principles pursuant to Rule 203 of the Rules of Conduct of the American Institute of Certified Public Accountants.* [*As amended, effective May 7, 1973 by Council Resolution.*] *(See section 510.08.)*

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AC Section 1071A

Financial Statements Restated for General Price-Level Changes—Appendix A

Gross National Product Implicit Price Deflator

Annual Averages 1929-1968
Quarterly Averages 1947-1968

.01 **Annual Averages**

Year	Deflator (1958 = 100)	Percent Increase (Decrease) From Previous Year
1929	50.6	
1930	49.3	(2.6)
1931	44.8	(9.1)
1932	40.3	(10.0)
1933	39.3	(2.5)
1934	42.2	7.4
1935	42.6	.9
1936	42.7	.2
1937	44.5	4.2
1938	43.9	(1.3)
1939	43.2	(1.6)
1940	43.9	1.6
1941	47.2	7.5
1942	53.0	12.3
1943	56.8	7.2
1944	58.2	2.5
1945	59.7	2.6
1946	66.7	11.7
1947	74.6	11.8
1948	79.6	6.7
1949	79.1	(.6)
1950	80.2	1.4
1951	85.6	6.7
1952	87.5	2.2
1953	88.3	.9

Annual Averages—*Continued*

Year	Deflator (1958 = 100)	Percent Increase (Decrease) From Previous Year
1954	89.6	1.5
1955	90.9	1.5
1956	94.0	3.4
1957	97.5	3.7
1958	100.0	2.6
1959	101.6	1.6
1960	103.3	1.7
1961	104.6	1.3
1962	105.7	1.1
1963	107.1	1.3
1964	108.9	1.7
1965	110.9	1.8
1966	113.9	2.7
1967	117.3	3.0
1968	121.8	3.8

.02 **Quarterly Averages**

Year	Quarter	Deflator
1947	1	73.0
	2	73.7
	3	74.9
	4	77.0
1948	1	78.2
	2	79.2
	3	80.6
	4	80.3
1949	1	79.7
	2	79.1
	3	78.8
	4	78.9
1950	1	78.3
	2	79.0
	3	80.8
	4	82.3

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Quarterly Averages—*Continued*

Year	Quarter	Deflator
1951	1	84.8
	2	85.4
	3	85.6
	4	86.7
1952	1	86.7
	2	87.1
	3	87.7
	4	88.3
1953	1	88.4
	2	88.3
	3	88.4
	4	88.4
1954	1	89.5
	2	89.6
	3	89.5
	4	89.8
1955	1	90.2
	2	90.6
	3	91.0
	4	91.6
1956	1	92.6
	2	93.4
	3	94.6
	4	95.4
1957	1	96.4
	2	97.1
	3	98.0
	4	98.5
1958	1	99.3
	2	99.7
	3	100.1
	4	100.6
1959	1	101.1
	2	101.4
	3	101.9
	4	102.1

Quarterly Averages—Continued

Year	Quarter	Deflator
1960	1	102.6
	2	103.0
	3	103.4
	4	104.0
1961	1	104.3
	2	104.5
	3	104.5
	4	105.1
1962	1	105.4
	2	105.5
	3	105.8
	4	106.2
1963	1	106.6
	2	107.0
	3	107.1
	4	107.8
1964	1	108.3
	2	108.4
	3	109.0
	4	109.6
1965	1	110.1
	2	110.7
	3	111.0
	4	111.6
1966	1	112.6
	2	113.5
	3	114.4
	4	115.3
1967	1	116.0
	2	116.6
	3	117.7
	4	118.9
1968	1	120.0
	2	121.2
	3	122.3
	4	123.5

Source: United States Department of Commerce, *Survey of Current Business*, issued monthly. Quarterly figures are available only since 1947. The deflators for 1929 to 1964 were recapitulated on pages 52 and 53 of the August 1965 issue of the *Survey*.

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AC Section 1071B

Financial Statements Restated for General Price-Level Changes—Appendix B

MONETARY AND NONMONETARY ITEMS

.01 Section 1071.17-.23 presents criteria for distinguishing between monetary and nonmonetary items for general price-level accounting purposes and gives examples of each kind of item. This section provides additional examples, with an explanation of the reason for classification when needed.

.02 **Assets**	Monetary	Non-monetary
Cash on hand and demand bank deposits (domestic currency)	X	
Time deposits (domestic currency)	X	
Foreign currency on hand and claims to foreign currency		X
See discussion in section 1071.21.		
Marketable securities		
Stocks		X
Bonds	(see discussion)	
Bonds held as a short-term investment may be held for price speculation. If so, they are nonmonetary. If the bonds are held primarily for the fixed income characteristic, they are monetary.		
Accounts and notes receivable	X	
Allowance for doubtful accounts and notes receivable	X	
Inventories produced under fixed price contracts accounted for at the contract price	X	
These items are in effect receivables of a fixed amount.		

	Monetary	Non-monetary
Other inventories		X
Advances to employees	X	
Prepaid insurance, taxes, advertising, rent These represent an amount of services for which expenditures have been made and which will be amortized to expense in the future. In financial statements they are substantially the same kind of item as fixed assets.		X
Prepaid interest Related to notes payable, a monetary item.	X	
Receivables under capitalized financing leases	X	
Long-term receivables	X	
Refundable deposits	X	
Advances to unconsolidated subsidiaries If there is no expectation that the advances will ever be collected, they are in effect additional investments and are nonmonetary.	X	
Investments in unconsolidated subsidiaries If an investment is carried at cost, it is nonmonetary. If an investment is carried on the equity basis, the statements of the subsidiary should be restated for general price-level changes (in accordance with section 1071.45 for foreign affiliates) and the equity method should then be applied.	(see discussion)	
Pension, sinking, and other funds Depends on composition of the fund—bonds are generally monetary and stocks nonmonetary.	(see discussion)	
Investments in convertible bonds If the bond is held for price speculation or with expectation of converting	(see discussion)	

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	Monetary	Non-monetary
into common stock the investment is nonmonetary. If the bond is held for the fixed principal and interest, it is monetary.		
Property, plant, and equipment		X
Allowance for depreciation		X
Cash surrender value of life insurance	X	
Advances paid on purchase contracts		X
The items to be received are nonmonetary.		
Deferred charges for income taxes—deferred method		X
A cost deferred as an expense of future periods is nonmonetary.		
Other deferred charges which represent costs incurred to be charged against future income		X
Patents, trademarks, licenses, formulas		X
Goodwill		X
Other intangible assets		X

[As amended, effective October 1, 1971, by APB Opinion No. 21.]

.03 Liabilities

	Monetary	Non-monetary
Accounts and notes payable	X	
Accrued expenses payable (salaries, wages, etc.)	X	
Similar to accounts payable, amount is fixed.		
Cash dividends payable	X	
Debts payable in foreign currency		X
See section 1071.21.		
Refundable deposits	X	
Advances received on sales contracts		X
The obligation will be satisfied by delivery of goods that are nonmonetary.		
Accrued losses on firm purchase commitments	X	
Bonds payable	X	

	Monetary	Non-monetary
Unamortized discount on bonds payable	X	
[As amended, effective October 1, 1971, by APB Opinion No. 21.]		
Convertible bonds payable	X	
Treated as monetary debt until converted.		
Obligations under capitalized leases	X	
Other long-term debt	X	
Deferred taxes—deferred method		X
Cost savings deferred as a reduction of expenses of future periods.		
Deferred investment credits		X
Accrued pension cost	X	
Reserve for self-insurance		X
Although reserve for self-insurance is nonmonetary, it may be stated in the same amount in both the historical-dollar and general price-level statements if the adequacy of the reserve in terms of current costs has been determined at year end for the historical-dollar statements.		
Deferred income		X
Provision for guarantees		X
Provision for guarantees is nonmonetary because it is a liability to provide goods or services. It may be stated in the same amount in both the historical-dollar and general price-level statements if the adequacy of the provision in terms of current costs has been determined at year end for the historical-dollar statements.		
Accrued vacation pay	(see discussion)	
Accrued vacation pay is monetary if it is based on a fixed contract. It is nonmonetary if it is payable based on wage or salary rates that may change after the balance sheet date.		

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	Monetary	Non-monetary
.04 Owners' Equity		
Minority interest		X
Preferred stock		X

Classifying preferred stock as nonmonetary is based on the fact that the amount accounted for is the proceeds received when the stock was issued. The proceeds must be restated to present them in terms of the general purchasing power of the dollar at the balance sheet date.

The amount of a nonconvertible callable preferred stock should not exceed the call price in the general price-level balance sheet. The periodic change in the excess of the restated proceeds over the call price, if any, should not be included in net income, but should be added to net income to determine net income to common stockholders in the same manner as preferred dividends are deducted to determine net income to common stockholders.

A different viewpoint held by some Board members is that preferred stock is a monetary item and that general price-level gains or losses from preferred stock outstanding should be included in the computation of net income.

	Monetary	Non-monetary
Common stock		X
Additional paid-in capital		X
Retained earnings	(see discussion)	

Retained earnings is a residual and need not be classified as either monetary or nonmonetary.

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AC Section 1071C

Financial Statements Restated for General Price-Level Changes—Appendix C

PROCEDURES TO PREPARE FINANCIAL STATEMENTS RESTATED FOR GENERAL PRICE-LEVEL CHANGES

.01 This section illustrates procedures to apply the general guidelines discussed in section 1071.28-.46. Procedures for restating historical-dollar financial statements for general price-level changes are described and illustrated for two years, 1967 and 1968. Restating the statements for 1967 illustrates the procedures for the first year of restatement; restating the 1968 statements illustrates the procedures for all subsequent years. The procedures for the first year a company restates its financial statements are more time consuming than those for subsequent years.

.02 Financial statements used in this illustration contain a variety of items designed to demonstrate various facets of the restatement technique. Indexes of the general price-level changes which occurred in the United States in recent years are used. For convenience, the general assumptions used in the illustration are summarized below:

a. The XYZ Company was formed in 1957, ten years before the year for which its statements are first restated.

b. All significant costs of the year-end finished goods inventory, carried at FIFO, were incurred in the last quarter of the year; costs incurred before the last quarter of the year are assumed to be not material.

c. Year-end balances of raw materials and parts and supplies inventories, carried at FIFO, were acquired fairly evenly throughout the year.

d. Market value of inventories is above the restated cost of inventories, and the market price of inventories to be delivered is below the restated amount of deferred income.

e. Depreciation is computed on the straight-line basis. A full year's depreciation is taken in the year of acquisition, and no depreciation is taken in the year of sale. Depreciable assets have a ten-year life and no salvage value.

f. Sales, purchases, and selling and administrative expenses (other than depreciation, amortization of prepaid expenses, and deferred income realized) have taken place fairly evenly throughout the year, and federal income taxes accrue ratably throughout the year.

g. Interest expense is included in selling and administrative expenses.

.03 To perform restatement procedures, a company needs (1) its historical-dollar financial statements for the year, (2) index numbers, and (3) conversion factors derived from the index numbers, as described in the following paragraphs.

.04 The historical-dollar financial statements needed for the first year for which statements are to be restated are balance sheets at the beginning and end of the year and the statements of income, retained earnings, and other changes in owners' equity for the year. For each subsequent year, only the balance sheet at the end of the year and the statements of income, retained earnings, and other changes in owners' equity for the year are needed. The historical-dollar balance sheet at the beginning of the first year is restated to determine the restated amount of retained earnings at the beginning of the first year. In the illustration for the 1967 restatement, the historical-dollar balance sheets appear in paragraph .23 and the historical-dollar statement of income and retained earnings appears in paragraph .24. For the 1968 restatement, the historical-dollar balance sheet appears in paragraph .36 and the historical-dollar statement of income and retained earnings appears in paragraph .37.

.05 The Gross National Product Implicit Price Deflator is used in the illustration as the index of changes in the general price level.[1] This index is available on both

[1] See section 1071.30.

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a quarterly and annual average basis. Indexes are needed for the average and the quarters for each year since the inception of the company or 1945,[2] whichever is later. The annual average index may be used for any year in which its use would produce results not materially different from those which would be produced by using quarterly indexes. The index at the end of a year may be approximated by using the average for the last quarter of the year. To simplify the illustration, quarterly indexes are used only for 1967 and 1968. Indexes used in the 1967 restatement appear in paragraph .22. Indexes used in the 1968 restatement appear in paragraph .35. (Also see section 1071A.)

.06 Conversion factors used in restatement are computed from general price-level index numbers by dividing the index number for the current balance sheet date by each of the other index numbers. To illustrate, assume that 1957 and 1960 expenditures are to be restated to dollars of December 1968 general purchasing power. The following GNP Deflators (general price-level index numbers) are applicable:

Average for 1957	97.5
Average for 1960	103.3
Fourth quarter 1968	123.5

To compute the conversion factors for restatement to dollars of general purchasing power current at December 31, 1968, divide the index number for the fourth quarter of 1968 by each of the other index numbers:

$$1957: 123.5 \div 97.5 = 1.267$$
$$1960: 123.5 \div 103.3 = 1.196$$

[2] The precision of the measure of change in the general price level by any series of index numbers decreases over time because new commodities are continuously introduced and others disappear. No method has been devised to measure the percentage change in the general price level between two periods in which the bulk of commodities in either period is unique. A large portion of the dollar amount of current exchange transactions involves goods and services that originated in discoveries and innovations that grew out of the war effort (World War II) and postwar developments. Consequently, comparison of current prices with prices during and prior to World War II would probably not be reliable enough for accounting purposes because of the dissimilarity of goods and services exchanged then and now. A cutoff date is therefore indicated. The year 1945 is probably the earliest point that offers reasonable comparability of goods and services with later periods. All assets acquired, liabilities incurred, or owners' equity accumulated prior to 1945 should generally be treated as if they had originated during 1945.

To restate a nonmonetary item purchased in 1957, for example, its cost in 1957 dollars is multiplied by 1.267:

Cost in 1957 dollars	$1,500
	× 1.267
Cost in dollars current at December 31, 1968	$1,900

The cost of $1,500 in 1957 dollars is equal to a cost of $1,900 in December 31, 1968 dollars. The cost is not changed; it is merely stated in a larger number of a smaller unit of measure. Conversion factors for the 1967 restatement are computed in paragraph .22. Conversion factors for the 1968 restatement are computed in paragraph .35.

.07 The exhibits and worksheets which comprise the illustration are presented together in paragraphs .20 to .44. Restatement procedures are discussed in eight steps in paragraphs .08 to .19. Each step is first described in general terms and then keyed to the two years in the illustration in two columns below the general description.

General Steps to Prepare General Price-Level Financial Statements

STEP 1: *Identify monetary and nonmonetary assets and liabilities.*

.08 The nature of each asset and liability item must be determined inasmuch as restatement procedures for monetary items are different from those for nonmonetary items as discussed in section 1071.35-.38. Section 1071.17-.23 discusses the difference between monetary and nonmonetary items and gives examples of each. Additional examples are given in section 1071B.

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1967 Restatement

STEP 1: Monetary items in the December 31, 1966 and 1967 balance sheets in paragraph .23 are:

Cash
Receivables
Current liabilities
Long-term debt

Nonmonetary items are:
Marketable securities
Raw materials
Finished goods
Parts and supplies
Prepaid expenses
Property, plant, and equipment
Accumulated depreciation
Deferred income—payments received in advance *
Capital stock
Additional paid-in capital
Retained earnings

*Deferred income—payments received in advance is a nonmonetary liability because it represents an obligation to deliver nonmonetary assets—the company's products.

1968 Restatement

STEP 1: Monetary and nonmonetary items in the December 31, 1968 balance sheet in paragraph .36 are the same as in the December 31, 1966 and 1967 balance sheets.

STEP 2: *Analyze all nonmonetary items in the balance sheet of the current year (and the prior year for the first year of restatement) to determine when the component money amounts originated.*

.09 Schedule the data by years, and by quarters whenever significant general price-level changes occurred during a year. If no significant general price-level changes occurred during a year, or if acquisitions were spread fairly evenly throughout a year, assume the items were acquired when the average general price level for the year was in effect. All balances accumulated prior to 1945 may be treated as if acquired in 1945. See Step 3 for treatment of special problems in restating inventories.

.10 Retained earnings need not be analyzed. Retained earnings in the restated balance sheet at the beginning of the first year for which general price-level restatements

are prepared can be computed as the balancing amount. This avoids the impractical alternative of restating all prior financial statements since the inception of the company. Retained earnings in subsequent restated balance sheets is determined from the restated statements of income and retained earnings.

1967 Restatement

STEP 2: Analysis of raw materials, finished goods, and parts and supplies inventories is discussed in notes 3 and 4 in paragraph .23. Marketable securities, capital stock, and additional paid-in capital are analyzed in columns 3, 5, and 7 in paragraph .25. Prepaid expenses, property, plant, and equipment, accumulated depreciation, and deferred income are analyzed in columns 3 to 6 in paragraphs .26 to .29.

1968 Restatement

STEP 2: Much of the analysis needed for the 1968 restatement has been prepared for the 1967 restatement and merely needs to be updated. Analysis of raw materials, finished goods, and parts and supplies inventories, capital stock, and additional paid-in capital is discussed in notes 4, 5, and 6 in paragraph .36. Prepaid expenses, property, plant, and equipment, accumulated depreciation, and deferred income are analyzed in columns 3 to 6 in paragraphs .38 to .41.

STEP 3: *Analyze all revenue, expense, gain, and loss items in the income statement of the current year, and all dividends and other changes in retained earnings during the year, to determine when the amounts originated that ultimately resulted in the charges and credits in the statements of income and retained earnings.*

.11 A wide range in degree of difficulty is likely to be encountered in restating inventories and cost of goods sold to dollars of current general purchasing power. Raw materials priced on a first-in, first-out basis may already be in dollars of current general purchasing power and need no restatement. If turnover is rapid and spread fairly evenly throughout the year, purchases may be in dollars whose general purchasing power can be approximated by using the average general price level for the year. Restatement of inventories of work in process and finished goods, however, can be quite complicated and time consuming. Weighted average or last-in, first-out pricing increases the amount of detail.

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.12 Short cuts to the restatement of inventories and purchases often produce results that do not differ enough from amounts derived by detailed computation to warrant the additional effort. For example, costs of inventories based on weighted average include, in part, every expenditure ever made to buy or produce them. A short cut would be to assume that the beginning inventory had all been acquired in one turnover period. In the case of beginning LIFO inventories, using the assumption that different layers were acquired each year when the average general price level was in effect for that year will usually approximate the results of a detailed computation, purchase by purchase. Elements of overhead costs included in work in process and finished goods inventories can usually be restated from dollars of average general purchasing power for the year when overhead was applied to that segment of the inventory. Depreciation is the overhead cost element most likely to require extensive analysis, but only when the effect would be material.

.13 Many revenue and expense items are, of course, recognized in the accounts at approximately the same time that the receipts and expenditures occurred (for example, salaries). If these items are spread fairly evenly throughout the year, it can be assumed that the receipts and expenditures all occurred when the average general price level for the year was in effect. When peak and slack periods occur during the year, and the general price level changes significantly between periods, revenue and expense items in this category should be determined for each calendar quarter.

.14 The restatement of revenue and expense items should, of course, reconcile with the restatement of the related balance sheet accounts, and they can be restated as part of the same computation. For example, the beginning balance of merchandise inventory plus purchases, both stated in current dollars, should equal the sum of the cost of sales and the ending balance of merchandise inventory, also stated in current dollars.

1967 Restatement

STEP 3: Sales, cost of sales, selling and administrative expenses, and loss on sale of equipment are analyzed in column 1 in paragraphs .30 and .31. Depreciation is analyzed in column 4 in paragraph .28. Amortization of prepaid expenses is analyzed in column 5 in paragraph .26. Deferred income realized is analyzed in column 5 in paragraph .29. Federal income taxes and dividends are analyzed in paragraph .24.

1968 Restatement

STEP 3: Sales, cost of sales, selling and administrative expenses, gain on sale of equipment, and gain or loss on sale of marketable securities are analyzed in column 1 in paragraphs .42 and .43. Depreciation is analyzed in column 4 in paragraph .40. Amortization of prepaid expenses is analyzed in column 5 in paragraph .38. Deferred income realized is analyzed in column 5 in paragraph .41. Federal income taxes and dividends are analyzed in paragraph .37.

STEP 4: *Restate the nonmonetary items.*

.15 Multiply the component amounts of nonmonetary items in the balance sheet of the current year (and the prior year for the first year of restatement) and in the statement of income and retained earnings for the current year by the conversion factors applicable to the components. The restated amount of each nonmonetary item is the sum of the restated amounts of its components.

1967 Restatement

STEP 4: Restatement of nonmonetary items is demonstrated on the pages in which the nonmonetary items are analyzed in accordance with Steps 2 and 3.

1968 Restatement

STEP 4: Restatement of nonmonetary items is demonstrated on the pages in which the nonmonetary items are analyzed in accordance with Steps 2 and 3. Components which originated in 1967 or earlier generally are restated by merely "rolling forward" their restated amounts from the worksheets for the 1967 restatement.

STEP 5: *Restate the monetary items in the balance sheet at the beginning of the first year.*

.16 Monetary items in the balance sheet at the beginning of the first year for which statements are restated are stated in prior year dollars and are each restated to

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dollars of current general purchasing power by the conversion factor applicable to the end of the prior year. Monetary items in the balance sheet at the end of each year for which statements are restated are stated in dollars of current general purchasing power and need no restatement.

1967 Restatement	*1968 Restatement*
STEP 5: Restatement of the monetary items in the balance sheet at December 31, 1966 is discussed in note 1 in paragraph .23.	STEP 5: (Not applicable after the first year statements are restated.)

STEP 6: *Apply the "cost or market" rule after restatement to the items to which it applies before restatement.*

.17 To determine that marketable securities and inventories are not stated above market in the restated statements, and that current nonmonetary liabilities are not stated below market, the restated amounts are compared with market and adjusted if necessary.

1967 Restatement	*1968 Restatement*
STEP 6: Market is assumed to be higher than restated marketable securities and inventories and lower than restated deferred income.	STEP 6: Market is assumed to be higher than restated inventories and lower than restated deferred income.

STEP 7: *Compute the general price-level gain or loss for the current year.*

.18 The general price-level gain or loss which arises from holding net balance sheet monetary items during inflation or deflation appears in the general price-level statements but does not appear in the historical-dollar statements. The format used to prepare a statement of source and application of net balance sheet monetary items is a convenient device to use in calculating the general price-level gain or loss. In this calculation the items which cause changes in the monetary items are analyzed and the net balance of the monetary items if there were no gain or loss is determined. A comparison of this net balance with the actual net balance of monetary items at the balance sheet date determines the gain or loss.

1967 Restatement	*1968 Restatement*
STEP 7: The general price-level gain for 1967 is computed in paragraph .32.	STEP 7: The general price-level gain for 1968 is computed in paragraph .44.

STEP 8: *"Roll forward" the restated statements of the prior year to dollars of current general purchasing power.*

.19 Financial statements of the prior year which were restated to dollars current at the end of the prior year are restated to dollars current at the end of the current year simply by multiplying each amount by the conversion factor applicable to the end of the prior year. This "rolling forward" serves two purposes: (1) it provides the amount of retained earnings at the end of the prior year in current dollars for the current year statement of retained earnings, and (2) it provides the prior year statements in current dollars for use as comparative statements.

1967 Restatement	*1968 Restatement*
STEP 8: (Not applicable for the first year statements are restated.)	STEP 8: The restated balance sheet at the end of 1967 is "rolled forward" in columns 1 and 2 in paragraph .36. The restated statement of income and retained earnings for 1967 is "rolled forward" in columns 1 and 2 in paragraph .37.

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1967 RESTATEMENT—XYZ COMPANY

EXHIBIT A

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XYZ Company
General Price-Level Balance Sheet
December 31, 1967

ASSETS	General Price-Level Basis (Restated to 12/31/67)
Current assets:	
Cash	$(67) 1,700,000
Marketable securities, at cost	1,654,000
Receivables (net)	5,050,000
Inventories, at the lower of cost and market on a first-in, first-out basis:	
Raw materials	2,849,000
Finished goods	2,560,000
Parts and supplies	578,000
Prepaid expenses	49,000
Total current assets	14,440,000
Property, plant, and equipment, at cost	29,580,000
Less: Accumulated depreciation	21,156,000
	8,424,000
	$(67)22,864,000

LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities	$(67) 4,770,000
Deferred income—payments received in advance	101,000
Long-term debt	5,000,000
Stockholders' equity:	
Capital stock – common	2,109,000
Additional paid-in capital	3,785,000
Retained earnings	7,099,000
Total stockholders' equity	12,993,000
	$(67)22,864,000

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EXHIBIT B

XYZ Company
General Price-Level Statement
of Income and Retained Earnings
Year Ended December 31, 1967

	General Price-Level Basis (Restated to 12/31/67)
Sales	$(67)30,424,000
Operating expenses:	
Cost of sales	23,232,000
Depreciation	2,616,000
Selling and administrative expenses	2,615,000
	28,463,000
Operating profit	1,961,000
Loss on sale of equipment	(12,000)
General price-level gain	138,000
	126,000
Income before federal income taxes	2,087,000
Federal income taxes	923,000
Net income	1,164,000
Retained earnings, December 31, 1966	6,137,000
	7,301,000
Less: Dividends paid	202,000
Retained earnings, December 31, 1967	$(67) 7,099,000

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12/31/67
R-1

XYZ COMPANY
General Price-Level Restatement—1967
Gross National Product Implicit Price Deflators and Conversion Factors

Year	*Quarter*	*GNP deflators*	*Conversion factors 1967 (4th q.) = 1.000*
Annual average			
1957		97.5	1.219
1958		100.0	1.189
1959		101.6	1.170
1960		103.3	1.151
1961		104.6	1.137
1962		105.7	1.125
1963		107.1	1.110
1964		108.9	1.092
1965		110.9	1.072
1966		113.9	1.044
1967		117.3	1.014
Quarterly			
1966	4th	115.3	1.031
1967	1st	116.0	1.025
	2nd	116.6	1.020
	3rd	117.7	1.010
	4th	118.9	1.000

Source: *Survey of Current Business,* U.S. Department of Commerce, Office of Business Economics (Deflators of 1957-1964 from issue of August, 1965, page 53)

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XYZ COMPANY
General Price-Level Restatement—1967
Working Balance Sheets—12/31/66 and 12/31/67

12/31/67
R-2

	12/31/66			12/31/67		
	Historical	Conversion factor or source	Restated to 12/31/67 $'s	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Assets						
Cash	810,000	(1) 1.031	835,110	1,700,000	(2)	1,700,000
Marketable securities (at cost)	1,470,000	R-4	1,623,340	1,500,000	R-4	1,654,090
Receivable—net	1,900,000	(1) 1.031	1,958,900	5,050,000	(2)	5,050,000
Inventories						
Raw materials (FIFO)	2,680,000	(3) 1.044	2,797,920	2,810,000	(3) 1.014	2,849,340
Finished goods (FIFO)	2,450,000	(4) 1.031	2,525,950	2,560,000	(4) 1.000	2,560,000
Parts and supplies (FIFO)	700,000	(3) 1.044	730,800	570,000	(3) 1.014	577,980
Prepaid expenses	50,000	R-5	52,720	48,000	R-5	49,261
Total current assets	10,060,000		10,524,740	14,238,000		14,440,671
Property, plant, and equipment (at cost)	25,400,000	R-6	29,154,200	25,900,000	R-6	29,579,550
Less: Accumulated depreciation	16,350,000	R-7	19,016,680	18,260,000	R-7	21,156,145
	9,050,000		10,137,520	7,640,000		8,423,405
	19,110,000		20,662,260	21,878,000		22,864,076
Liabilities						
Current liabilities	2,950,000	(1) 1.031	3,041,450	4,770,000	(2)	4,770,000
Deferred income—payments received in advance	120,000	R-8	125,280	100,000	R-8	100,900
Long-term debt	5,300,000	(1) 1.031	5,464,300	5,000,000	(2)	5,000,000
	8,370,000		8,631,030	9,870,000		9,870,900
Stockholders' Equity						
Capital stock—common	1,760,000	R-4	2,109,120	1,760,000	R-4	2,109,120
Additional paid-in capital	3,150,000	R-4	3,784,550	3,150,000	R-4	3,784,550
Retained earnings	5,830,000	(5)	6,137,560	7,098,000	R-3	7,099,506
	10,740,000		12,031,230	12,008,000		12,993,176
	19,110,000		20,662,260	21,878,000		22,864,076

Notes

(1) 12/31/66 monetary items before restatement are stated in 12/31/66 $'s. The conversion factor for the end of 1966 is used to restate them to 12/31/67 $'s.

(2) 12/31/67 monetary items need no restatement because they are stated in 12/31/67 $'s.

(3) Year-end balance assumed acquired fairly evenly throughout the year.

(4) Assumed that all significant costs of year-end finished goods were incurred in last quarter of the year. Costs incurred before last quarter of the year (e.g., depreciation) assumed not material.

(5) 12/31/66 retained earnings restated in the amount which makes the balance sheet balance.

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XYZ COMPANY
General Price-Level Restatement—1967
Working Statement of Income and Retained Earnings

12/31/67
R-3

	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Sales	30,000,000	R-9	30,424,220
Operating expenses:			
Cost of sales (except depreciation)	22,735,000	R-9	23,232,180
Depreciation	2,310,000	R-7	2,616,635
Selling and administrative expenses	2,577,000	R-10	2,614,704
	27,622,000		28,463,519
Operating profit	2,378,000		1,960,701
Loss of sale of equipment	–0–	R-10	(11,730)
General price-level gain	–0–	R-11	137,715
	–0–		125,985
Income before federal income taxes	2,378,000		2,086,686
Federal income taxes	910,000	(1) 1.014	922,740
Net income	1,468,000		1,163,946
Retained earnings—12/31/66	5,830,000	R-2	6,137,560
	7,298,000		7,301,506
Dividends paid			
June 1967	100,000	1.020	102,000
December 1967	100,000	1.000	100,000
	200,000		202,000
Retained earnings—12/31/67	7,098,000		7,099,506

(1) Assumed accrued ratably throughout the year

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XYZ COMPANY 12/31/67

General Price-Level Restatement—1967 R-4

Analysis of Marketable Securities, Capital Stock, and Additional Paid-in Capital

Year acquired	Factor to restate to 12/31/67 $'s	Marketable securities		Capital stock		Additional paid-in capital	
		Historical	Restated to 12/31/67 $'s	Historical	Restated to 12/31/67 $'s	Historical	Restated to 12/31/67 $'s
1957	1.219			1,000,000	1,219,000	2,000,000	2,438,000
1958	1.189			500,000	594,500	750,000	891,750
1959	1.170						
1960	1.151						
1961	1.137	500,000	568,500	260,000	295,620	400,000	454,800
1962	1.125						
1963	1.110						
1964	1.092	750,000	819,000				
1965	1.072	220,000	235,840				
1966	1.044						
Balances 12/31/66		1,470,000	1,623,340	1,760,000	2,109,120	3,150,000	3,784,550
1967							
1st q.	1.025	30,000	30,750				
2nd q.	1.020						
3rd q.	1.010						
4th q.	1.000						
average	1.014						
Balances 12/31/67		1,500,000	1,654,090	1,760,000	2,109,120	3,150,000	3,784,550

Note: All marketable securities assumed to be nonmonetary

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XYZ COMPANY

General Price-Level Restatement—1967

Analysis of Prepaid Expenses

12/31/67

R-5

Year acquired	Factor to restate to 12/31/67 $'s	Historical: Balance 12/31/66	Historical: Additions	Historical: Amortization	Historical: Balance 12/31/67	Restated to 12/31/67 $'s: Balance 12/31/66	Restated: Additions	Restated: Amortization	Restated: Balance 12/31/67
1964	1.092	5,000		5,000		5,460		5,460	
1965	1.072	10,000		7,000	3,000	10,720		7,504	3,216
1966	1.044	35,000		25,000	10,000	36,540		26,100	10,440
1967									
1st q.	1.025		25,000	8,000	17,000		25,625	8,200	17,425
2nd q.	1.020								
3rd q.	1.010		20,000	2,000	18,000		20,200	2,020	18,180
4th q.	1.000								
		50,000	45,000	47,000	48,000	52,720	45,825	49,284	49,261

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XYZ COMPANY

General Price-Level Restatement—1967 12/31/67

Analysis of Property, Plant, and Equipment R-6

Year acquired	Factor to restate to 12/31/67 $'s	Historical: Balance 12/31/66	Historical: Additions	Historical: Retirements	Historical: Balance 12/31/67	Restated to 12/31/67 $'s: Balance 12/31/66	Restated: Additions	Restated: Retirements	Restated: Balance 12/31/67
1957	1.219	3,000,000		200,000	2,800,000	3,657,000		243,800	3,413,200
1958	1.189	3,000,000		100,000	2,900,000	3,567,000		118,900	3,448,100
1959	1.170	4,000,000		100,000	3,900,000	4,680,000		117,000	4,563,000
1960	1.151	3,600,000			3,600,000	4,143,600			4,143,600
1961	1.137	800,000			800,000	909,600			909,600
1962	1.125	5,000,000			5,000,000	5,625,000			5,625,000
1963	1.110	3,000,000			3,000,000	3,330,000			3,330,000
1964	1.092	2,000,000		100,000	1,900,000	2,184,000		109,200	2,074,800
1965	1.072	500,000			500,000	536,000			536,000
1966	1.044	500,000			500,000	522,000			522,000
1967									
1st q.	1.025		250,000		250,000		256,250		256,250
2nd q.	1.020		300,000		300,000		306,000		306,000
3rd q.	1.010		200,000		200,000		202,000		202,000
4th q.	1.000		250,000		250,000		250,000		250,000
		25,400,000	1,000,000	500,000	25,900,000	29,154,200	1,014,250	588,900	29,579,550

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XYZ COMPANY
General Price-Level Restatement—1967
Analysis of Accumulated Depreciation

12/31/67
R-7

Year assets acquired	Factor to restate to 12/31/67 $'s	Historical				Restated to 12/31/67 $'s			
		Balance 12/31/66	Depreciation (1)	Retirements	Balance 12/31/67	Balance 12/31/66	Depreciation (1)	Retirements	Balance 12/31/67
1957	1.219	3.000,000		200,000	2,800,000	3,657,000		243,800	3,413,200
1958	1.189	2,700,000	290,000	90,000	2,900,000	3,210,300	344,810	107,010	3,448,100
1959	1.170	3,200,000	390,000	80,000	3,510,000	3,744,000	456,300	93,600	4,106,700
1960	1.151	2,520,000	360,000		2,880,000	2,900,520	414,360		3,314,880
1961	1.137	480,000	80,000		560,000	545,760	90,960		636,720
1962	1.125	2,500,000	500,000		3,000,000	2,812,500	562,500		3,375,000
1963	1.110	1,200,000	300,000		1,500,000	1,332,000	333,000		1,665,000
1964	1.092	600,000	190,000	30,000	760,000	655.200	207.480	32,760	829,920
1965	1.072	100,000	50,000		150,000	107,200	53,600		160,800
1966	1.044	50,000	50,000		100,000	52,200	52,200		104,400
1967									
1st q.	1.025		25,000		25,000		25,625		25,625
2nd q.	1.020		30,000		30,000		30,600		30,600
3rd q.	1.010		20,000		20,000		20,200		20,200
4th q.	1.000		25,000		25,000		25,000		25,000
		16,350,000	2,310,000	400,000	18,260,000	19,016,680	2,616,635	477,170	21,156,145

(1) Depreciation basis: Straight line
10 year life
No salvage value
Full year's depreciation in year of acquisition
No depreciation in year of disposition

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XYZ COMPANY

General Price-Level Restatement—1967

Analysis of Deferred Income

12/31/67

R-8

Year acquired	Factor to restate to 12/31/67 $'s	Historical: Balance 12/31/66	Historical: Additions	Historical: Realized	Historical: Balance 12/31/67	Restated to 12/31/67 $'s: Balance 12/31/66	Restated: Additions	Restated: Realized	Restated: Balance 12/31/67
1966	1.044	120,000		120,000		125,280		125,280	
1967									
1st q.	1.025		40,000	40,000			41,000	41,000	
2nd q.	1.020		50,000	30,000	20,000		51,000	30,600	20,400
3rd q.	1.010		50,000		50,000		50,500		50,500
4th q.	1.000		30,000		30,000		30,000		30,000
		120,000	170,000	190,000	100,000	125,280	172,500	196,880	100,900

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XYZ COMPANY
General Price-Level Restatement—1967
Analysis of Sales and Cost of Sales

12/31/67
R-9

	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Sales			
Current sales	29,810,000	(1) 1.014	30,227,340
Deferred sales realized	190,000	R-8	196,880
Total sales	30,000,000		30,424,220
Cost of sales (except depreciation)			
Inventories 12/31/66			
Raw materials	2,680,000	R-2	2,797,920
Finished goods	2,450,000	R-2	2,525,950
Parts and supplies	700,000	R-2	730,800
Purchases during 1967	22,845,000	(1) 1.014	23,164,830
	28,675,000		29,219,500
Inventories 12/31/67			
Raw materials	2,810,000	R-2	2,849,340
Finished goods	2,560,000	R-2	2,560,000
Parts and supplies	570,000	R-2	577,980
	5,940,000		5,987,320
	22,735,000		23,232,180

(1) Spread fairly evenly throughout the year

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XYZ COMPANY
General Price-Level Restatement—1967
Analysis of Expenses

12/31/67
R-10

	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Selling and administrative expenses			
Amortization of prepaid expenses	47,000	R-5	49,284
Other	2,530,000	(1) 1.014	2,565,420
	2,577,000		2,614,704

(1) Spread fairly throughout the year

	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Loss on sale of equipment			
Cost	500,000	R-6	588,900
Accumulated depreciation	400,000	R-7	477,170
	100,000		111,730
Proceeds, December, 1967	100,000	1.000	100,000
Loss	-0-		11,730

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XYZ COMPANY
General Price-Level Restatement—1967
General Price-Level Gain or Loss

12/31/67
R-11

	Source	12/31/66 Historical	12/31/66 Restated to 12/31/67 $'s	12/31/67 Historical (stated in 12/31/67 $'s)
Net monetary items				
Cash	R-2	810,000	835,110	1,700,000
Receivables	R-2	1,900,000	1,958,900	5,050,000
Current liabilities	R-2	(2,950,000)	(3,041,450)	(4,770,000)
Long-term debt	R-2	(5,300,000)	(5,464,300)	(5,000,000)
		(5,540,000)	(5,711,740)	(3,020,000)

	Historical	Source	Restated to 12/31/67 $'s
General price-level gain or loss			
Net monetary items—12/31/66	(5,540,000)	as above	(5,711,740)
Add:			
Current sales	29,810,000	R-9	30,227,340
Additions to deferred income	170,000	R-8	172,500
Proceeds from sale of equipment	100,000	R-10	100,000
	24,540,000		24,788,100
Deduct:			
Purchases	22,845,000	R-9	23,164,830
Selling and administrative expenses—other	2,530,000	R-10	2,565,420
Federal income taxes	910,000	R-3	922,740
Dividends	200,000	R-3	202,000
Purchase of marketable securities	30,000	R-4	30,750
Purchases of property, plant, and equipment	1,000,000	R-6	1,014,250
Additions to prepaid expenses	45,000	R-5	45,825
	27,560,000		27,945,815
Net monetary items—historical—12/31/67 (as above)	(3,020,000)		
Net monetary items—restated—12/31/67 (if there were no gain)			(3,157,715)
Net monetary items—12/31/67 (as above)			(3,020,000)
General price-level gain			137,715

1968 RESTATEMENT—XYZ COMPANY

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EXHIBIT A

XYZ Company
Comparative General Price-Level Balance Sheets
December 31, 1968 and December 31, 1967

	General Price-Level Basis (Restated to 12/31/68)	
ASSETS	Dec. 31, 1968	Dec. 31, 1967
Current assets:		
Cash	$(68) 2,120,000	$(68) 1,766,000
Marketable securities, at cost		1,719,000
Receivables (net)	6,170,000	5,247,000
Inventories, at the lower of cost and market on a first-in, first-out basis:		
Raw materials	2,575,000	2,960,000
Finished goods	2,390,000	2,660,000
Parts and supplies	621,000	601,000
Prepaid expenses	43,000	51,000
Total current assets	13,919,000	15,004,000
Property, plant, and equipment, at cost	31,208,000	30,733,000
Less: Accumulated depreciation	24,253,000	21,981,000
	6,955,000	8,752,000
	$(68)20,874,000	$(68)23,756,000

LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities	$(68) 2,521,000	$(68) 4,957,000
Deferred income — payments received in advance	51,000	105,000
Long-term debt	4,700,000	5,195,000
Stockholders' equity:		
Capital stock—common	2,191,000	2,191,000
Additional paid-in capital	3,932,000	3,932,000
Retained earnings	7,479,000	7,376,000
Total stockholders' equity	13,602,000	13,499,000
	$(68)20,874,000	$(68)23,756,000

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EXHIBIT B

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XYZ Company
Comparative General Price-Level Statements of Income and Retained Earnings Years Ended December 31, 1968 and December 31, 1967

	General Price-Level Basis (Restated to 12/31/68)	
	1968	1967
Sales	$(68)27,381,000	$(68)31,611,000
Operating expenses:		
Cost of sales	21,379,000	24,138,000
Depreciation	2,408,000	2,719,000
Selling and administrative expenses	2,658,000	2,717,000
	26,445,000	29,574,000
Operating profit	936,000	2,037,000
Gain (or loss) on sale of equipment	41,000	(12,000)
Loss on sale of securities	(118,000)	
General price-level gain	85,000	143,000
	8,000	131,000
Income before federal income taxes	944,000	2,168,000
Federal income taxes	639,000	959,000
Net income	305,000	1,209,000
Retained earnings, beginning of year	7,376,000	6,377,000
	7,681,000	7,586,000
Less: Dividends paid	202,000	210,000
Retained earnings, end of year	$(68) 7,479,000	$(68) 7,376,000

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12/31/68
R-1

XYZ COMPANY
General Price-Level Restatement—1968
Gross National Product Implicit Price Deflators and Conversion Factors

Year	*Quarter*	*GNP deflators*	*Conversion factors 1968 (4th q.) = 1.000*
Annual average			
1957		97.5	1.267
1958		100.0	1.235
1959		101.6	1.216
1960		103.3	1.196
1961		104.6	1.181
1962		105.7	1.168
1963		107.1	1.153
1964		108.9	1.134
1965		110.9	1.114
1966		113.9	1.084
1967		117.3	1.053
1968		121.8	1.014
Quarterly			
1966	4th	115.3	1.071
1967	1st	116.0	1.065
	2nd	116.6	1.059
	3rd	117.7	1.049
	4th	118.9	1.039
1968	1st	120.0	1.029
	2nd	121.2	1.019
	3rd	122.3	1.010
	4th	123.5	1.000

Source: *Survey of Current Business,* U.S. Department of Commerce, Office of Business Economics

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12/31/68
R-2

XYZ COMPANY
General Price-Level Restatement—1968
Working Balance Sheets—12/31/67 and 12/31/68

	12/31/67		12/31/68		
	Restated to 12/31/67 $'s (1)	Restated to 12/31/68 $'s (2)	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Assets					
Cash	1,700,000	1,766,300	2,120,000	(3)	2,120,000
Marketable securities (at cost)	1,654,090	1,718,600			
Receivables—net	5,050,000	5,246,950	6,170,000	(3)	6,170,000
Inventories					
Raw materials (FIFO)	2,849,340	2,960,464	2,540,000	(4) 1.014	2,575,560
Finished goods (FIFO)	2,560,000	2,659,840	2,390,000	(5) 1.000	2,390,000
Parts and supplies (FIFO)	577,980	600,521	612,000	(4) 1.014	620,568
Prepaid expenses	49,261	51,182	42,000	R-4	43,030
Total current assets	14,440,671	15,003,857	13,874,000		13,919,158
Property, plant, and equipment (at cost)	29,579,550	30,733,153	26,400,000	R-5	31,208,277
Less: Accumulated depreciation	21,156,145	21,981,235	20,210,000	R-6	24,253,021
	8,423,405	8,751,918	6,190,000		6,955,256
	22,864,076	23,755,775	20,064,000		20,874,414
Liabilities					
Current liabilities	4,770,000	4,956,030	2,521,000	(3)	2,521,000
Deferred income—payments received in advance	100,900	104,835	50,000	R-7	50,490
Long-term debt	5,000,000	5,195,000	4,700,000	(3)	4,700,000
	9,870,900	10,255,865	7,271,000		7,271,490
Stockholders' Equity					
Capital stock—common	2,109,120	2,191,376	1,760,000	(6)	2,191,376
Additional paid-in capital	3,784,550	3,932,147	3,150,000	(6)	3,932,147
Retained earnings	7,099,506	7,376,387	7,883,000	R-3	7,479,401
	12,993,176	13,499,910	12,793,000		13,602,924
	22,864,076	23,755,775	20,064,000		20,874,414

Notes

(1) From R-2 of 12/31/67

(2) Each item "rolled-forward" from 12/31/67 $'s to 12/31/68 $'s by using conversion factor for the last quarter of 1967—1.039

(3) Monetary items—no restatement needed

(4) Year-end balance assumed acquired fairly evenly throughout the year.

(5) See note 4 in R-2 of 12/31/67

(6) No change in historical balances during 1968. The restated balances in the 12/31/68 balance sheet are therefore the same as the balances in the 12/31/67 balance sheet restated to 12/31/68 $'s in column 2 of this worksheet.

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XYZ COMPANY
General Price-Level Restatement—1968
Working Statements of Income and Retained Earnings

12/31/68
R-3

	1967		1968		
	Restated to 12/31/67 $'s (1)	Restated to 12/31/68 $'s (2)	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Sales	30,424,220	31,610,764	27,000,000	R-8	27,381,735
Operating expenses:					
Cost of sales (except depreciation)	23,232,180	24,138,235	20,856,000	R-8	21,379,109
Depreciation	2,616,635	2,718,684	2,070,000	R-6	2,407,937
Selling and administrative expenses	2,614,704	2,716,677	2,620,000	R-9	2,658,412
	28,463,519	29,573,596	25,546,000		26,445,458
Operating profit	1,960,701	2,037,168	1,454,000		936,277
Gain or (loss) on sale of equipment	(11,730)	(12,187)	61,000	R-9	41,354
Gain or (loss) on sale of securities			100,000	R-9	(118,600)
General price-level gain	137,715	143,086	-0-	R-10	84,703
	125,985	130,899	161,000		7,457
Income before federal income taxes	2,086,686	2,168,067	1,615,000		943,734
Federal income taxes	922,740	958,727	630,000	(3) 1.014	638,820
Net income	1,163,946	1,209,340	985,000		304,914
Retained earnings beginning of year	6,137,560	6,376,925	7,098,000	R-2 (1967, 8)	7,376,387
	7,301,506	7,586,265	8,083,000		7,681,301
Dividends paid					
June 1968	102,000	105,978	100,000	1.019	101,900
December 1968	100,000	103,900	100,000	1.000	100,000
	202,000	209,878	200,000		201,900
Retained earnings—end of year	7,099,506	7,376,387	7,883,000		7,479,401

(1) From R-3 of 12/31/67
(2) Each item "rolled-forward" from 12/31/67 $'s to 12/31/68 $'s by using conversion factor for the last quarter of 1967—1.039
(3) Assumed accrued ratably throughout the year

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XYZ COMPANY
General Price-Level Restatement—1968
Analysis of Prepaid Expenses

12/31/68
R-4

Year acquired	Factor to restate 1968 additions	Historical: Balance 12/31/67	Historical: Additions	Historical: Amortization	Historical: Balance 12/31/68	Balance 12/31/67 in 12/31/67 $'s (1)	Restated to 12/31/68 $'s: Balance 12/31/67 (2)	Restated: Additions	Restated: Amortization	Restated: Balance 12/31/68
1965		3,000		3,000		3,216	3,341		(3) 3,341	
1966		10,000		8,000	2,000	10,440	10,847		(3) 8,678	2,169
1967										
1st q.		17,000		10,000	7,000	17,425	18,105		(3) 10,650	7,455
3rd q.		18,000		12,000	6,000	18,180	18,889		(3) 12,593	6,296
1968										
3rd q.	1.010		14,000	3,000	11,000			14,140	3,030	11,110
4th q.	1.000		20,000	4,000	16,000			20,000	4,000	16,000
		48,000	34,000	40,000	42,000	49,261	51,182	34,140	42,292	43,030

(1) From R-5 of 12/31/67

(2) Each item restated by factor for 4th quarter 1967 1.039

(3) Restated amortization is same percentage of restated 12/31/67 balance as historical amortization is of historical 12/31/67 balance.

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XYZ COMPANY
General Price-Level Restatement—1968
Analysis of Property, Plant, and Equipment

12/31/68
R-5

Year acquired	Factor to restate 1968 additions	Historical				Balance 12/31/67 in 12/31/67 $'s (1)	Restated to 12/31/68 $'s			
		Balance 12/31/67	Additions	Retirements	Balance 12/31/68		Balance 12/31/67 (2)	Additions	Retirements	Balance 12/31/68
1957		2,800,000			2,800,000	3,413,200	3,546,315			3,546,315
1958		2,900,000			2,900,000	3,448,100	3,582,576			3,582,576
1959		3,900,000			3,900,000	4,563,000	4,740,957			4,740,957
1960		3,600,000			3,600,000	4,143,600	4,305,200			4,305,200
1961		800,000			800,000	909,600	945,074			945,074
1962		5,000,000			5,000,000	5,625,000	5,844,375			5,844,375
1963		3,000,000			3,000,000	3,330,000	3,459,870			3,459,870
1964		1,900,000		300,000	1,600,000	2,074,800	2,155,717		(3) 340,376	1,815,341
1965		500,000			500,000	536,000	556,904			556,904
1966		500,000			500,000	522,000	542,358			542,358
1967										
1st q.		250,000			250,000	256,250	266,244			266,244
2nd q.		300,000			300,000	306,000	317,934			317,934
3rd q.		200,000			200,000	202,000	209,878			209,878
4th q.		250,000			250,000	250,000	259,751			259,751
1968										
1st q.	1.029		300,000		300,000			308,700		308,700
2nd q.	1.019		200,000		200,000			203,800		203,800
3rd q.	1.010		300,000		300,000			303,000		303,000
4th q.										
		25,900,000	800,000	300,000	26,400,000	29,579,550	30,733,153	815,500	340,376	31,208,277

(1) From R-6 of 12/31/67
(2) Restated to 12/31/68 $'s by factor for 4th quarter 1967—1.039
(3) Restated retirement amount is same percentage of restated 12/31/67 balance as historical retirement amount is of historical 12/31/67 balance.

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XYZ COMPANY
General Price-Level Restatement—1968
Analysis of Accumulated Depreciation

12/31/68
R-6

Year assets acquired	Factor to restate to 12/31/68 $'s	Historical: Balance 12/31/67	Historical: Depreciation (1)	Historical: Retirements	Historical: Balance 12/31/68	Balance 12/31/67 in 12/31/67 $'s (2)	Restated to 12/31/68 $'s: Balance 12/31/67 (4)	Restated to 12/31/68 $'s: Depreciation (1)	Restated to 12/31/68 $'s: Retirements	Restated to 12/31/68 $'s: Balance 12/31/68
1957		2,800,000			2,800,000	3,413,200	3,546,316			3,546,316
1958		2,900,000			2,900,000	3,448,100	3,582,576			3,582,576
1959		3,510,000	390,000		3,900,000	4,106,700	4,266,861	474,096		4,740,957
1960		2,880,000	360,000		3,240,000	3,314,880	3,444,160	430,520		3,874,680
1961		560,000	80,000		640,000	636,720	661,552	94,507		756,059
1962		3,000,000	500,000		3,500,000	3,375,000	3,506,625	584,437		4,091,062
1963		1,500,000	300,000		1,800,000	1,665,000	1,729,935	345,987		2,075,922
1964		760,000	160,000	120,000	800,000	829,920	862,287	181,534	(3) 136,151	907,670
1965		150,000	50,000		200,000	160,800	167,071	55,690		222,761
1966		100,000	50,000		150,000	104,400	108,472	54,236		162,708
1967										
1st q.		25,000	25,000		50,000	25,625	26,624	26,624		53,248
2nd q.		30,000	30.000		60,000	30,600	31,793	31,793		63,586
3rd q.		20,000	20,000		40,000	20,200	20,988	20,988		41,976
4th q.		25,000	25,000		50,000	25,000	25,975	25,975		51,950
1968										
1st q.	1.029		30,000		30,000			30,870		30,870
2nd q.	1.019		20,000		20,000			20,380		20,380
3rd q.	1.010		30,000		30,000			30,300		30,300
4th q.										
		18,260,000	2,070,000	120,000	20,210,000	21,156,145	21,981,235	2,407,937	136,151	24,253,021

(1) Depreciation basis: Straight line
10 year life
No salvage value
Full year's depreciation in year of acquisition
No depreciation in year of disposition

(2) From R-7 of 12/31/67

(3) Restated accumulated depreciation on assets retired is same percentage of restated 12/31/67 balance as historical accumulated depreciation on retirements is of historical 12/31/67 balance.

(4) Restated to 12/31/68 $'s by factor for 4th quarter 1967—1.039.

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XYZ COMPANY
General Price-Level Restatement—1968
Analysis of Deferred Income

12/31/68
R-7

Year acquired	Factor to restate to 12/31/68 $'s	Historical				Balance 12/31/67 in 12/31/67 $'s (1)	Restated to 12/31/68 $'s			
		Balance 12/31/67	Additions	Realized	Balance 12/31/68		Balance 12/31/67 (2)	Additions	Realized	Balance 12/31/68
1967										
2nd q.		20,000		20,000		20,400	21,196		21,196	
3rd q.		50,000		50,000		50,500	52,469		52,469	
4th q.		30,000		30,000		30,000	31,170		31,170	
1968										
1st q.	1.029		20,000	20,000				20,580	20,580	
2nd q.	1.019		10,000		10,000			10,190		10,190
3rd q.	1.010		30,000		30,000			30,300		30,300
4th q.	1.000		10,000		10,000			10,000		10,000
		100,000	70,000	120,000	50,000	100,900	104,835	71,070	125,415	50,490

(1) From R-8 of 12/31/67
(2) Each item restated by factor for 4th quarter 1967—1.039

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XYZ COMPANY
General Price-Level Restatement—1968 12/31/68
Analysis of Sales and Cost of Sales R-8

	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Sales			
Current sales	26,880,000	(1) 1.014	27,256,320
Deferred sales realized	120,000	R-7	125,415
Total sales	27,000,000		27,381,735
Cost of sales (except depreciation)			
Inventories 12/31/67			
Raw materials	2,810,000	R-2 (1967, 8)	2,960,464
Finished goods	2,560,000	R-2 (1967, 8)	2,659,840
Parts and supplies	570,000	R-2 (1967, 8)	600,521
Purchases	20,458,000	(1) 1.014	20,744,412
	26,398,000		26,965,237
Inventories 12/31/68			
Raw materials	2,540,000	R-2	2,575,560
Finished goods	2,390,000	R-2	2,390,000
Parts and supplies	612,000	R-2	620,568
	5,542,000		5,586,128
	20,856,000		21,379,109

(1) Spread fairly evenly throughout the year

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XYZ COMPANY
General Price-Level Restatement—1968 12/31/68
Analysis of Expenses R-9

	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Selling and administrative expenses			
Amortization of prepaid expenses	40,000	R-4	42,292
Other	2,580,000	(1) 1.014	2,616,120
	2,620,000		2,658,412

(1) Spread fairly evenly throughout the year

	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Gain or (loss) on sale of equipment			
Cost	300,000	R-5	340,376
Accumulated depreciation	120,000	R-6	136,151
	180,000		204,225
Proceeds, June 1968	241,000	1.019	245,579
Gain	61,000		41,354
Gain or (loss) on sale of marketable securities			
Cost	1,500,000	R-2 (1967, 8)	1,718,600
Proceeds, December 1968	1,600,000	1.000	1,600,000
Gain (loss)	100,000		(118,600)

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XYZ COMPANY
General Price-Level Restatement—1968 12/31/68
General Price-Level Gain or Loss R-10

	Source	12/31/67 Historical	12/31/67 Restated to 12/31/68 $'s	12/31/68 Historical (stated in 12/31/68 $'s)
Net monetary items				
Cash	R-2	1,700,000	1,766,300	2,120,000
Receivables	R-2	5,050,000	5,246,950	6,170,000
Current liabilities	R-2	(4,770,000)	(4,956,030)	(2,521,000)
Long-term debt	R-2	(5,000,000)	(5,195,000)	(4,700,000)
		(3,020,000)	(3,137,780)	1,069,000

General price-level gain or loss	Historical	Source	Restated to 12/31/68 $'s
Net monetary items—12/31/67	(3,020,000)	as above	(3,137,780)
Add:			
Current sales	26,880,000	R-8	27,256,320
Additions to deferred income	70,000	R-7	71,070
Proceeds from sale of equipment	241,000	R-9	245,579
Proceeds from sale of securities	1,600,000	R-9	1,600,000
	25,771,000		26,035,189
Deduct:			
Purchases	20,458,000	R-8	20,744,412
Selling and administrative expenses—other	2,580,000	R-9	2,616,120
Federal income taxes	630,000	R-3	638,820
Dividends	200,000	R-3	201,900
Purchases of property, plant, and equipment	800,000	R-5	815,500
Additions to prepaid expenses	34,000	R-4	34,140
	24,702,000		25,050,892
Net monetary items—historical—12/31/68 (as above)	1,069,000		
Net monetary items—restated—12/31/68 (if there were no gain)			984,297
Net monetary items—12/31/68 (as above)			1,069,000
General price-level gain			84,703

The next page is 7581.

AC Section 1071D

Financial Statements Restated for General Price-Level Changes—Appendix D

GENERAL PRICE-LEVEL CHANGES AND SPECIFIC PRICE CHANGES

.01 General price-level statements deal with changes in the general purchasing power of money. Adjustments for changes in the specific prices of nonmonetary assets and liabilities either by use of market prices or specific indexes, on the other hand, deal with changes in market or replacement values. Restatement for general price-level changes does not attempt to deal with specific market price changes; adjustments for specific price changes do not deal with the effects of inflation as such. The effects of general price-level changes and specific price changes may be dealt with separately or they may be dealt with simultaneously. Dealing with one is not a substitute for dealing with the other. Restatement for general price-level changes is appropriate if the effects of inflation are important, regardless of whether or not specific price changes are recognized currently. The effects of inflation are not treated if only specific price changes are recognized.

.02 The following illustration shows the differences between recognition of general price-level changes and specific price changes. Four different bases of accounting are illustrated:

1. Historical cost, not restated for general price-level changes.
2. Historical cost restated for general price-level changes (the method covered in section 1071).
3. Current value, not restated for general price-level changes.
4. Current value, restated for general price-level changes.

.03 The illustration brings out the following points:

A. In the income statement

1. General price-level statements change the amounts but not the timing of revenue, expenses, gains, and losses.
2. Specific price adjustments (without general price-level restatements) change the timing of recognition of revenue, expenses, gains, and losses, but not the amounts.
3. Recognition of changes in both specific prices and in the general price level (1) changes the timing of recognition of revenue, expenses, gains, and losses and (2) changes the amounts.

B. In the balance sheet

1. General price-level accounting presents restated historical cost.
2. Specific price adjustments present assets at current market value or replacement cost or approximations of them.

Information for Illustration

.04 Land was purchased in year 1 for $20,000. Market price did not change in year 1.

Land was held during year 2, during which market price advanced to $26,000.

Land was sold for $34,000 at the end of year 3.

GNP Deflator indexes:

Year 1	100
Year 2	110
Year 3	120

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	Historical Cost		Current Value	
	Not restated (Col. 1)	Restated (Col. 2)	Not restated (Col. 3)	Restated (Col. 4)
Balance sheet amount of land				
End of year 1	$20,000	$20,000	$20,000	$20,000
End of year 2	$20,000	$22,000	$26,000	$26,000
Year 3 before sale	$20,000	$24,000	$34,000	$34,000
Income statement gains reported				
In year 1	$ –0–	$ –0–	$ –0–	$ –0–
In year 2	–0–	–0–	6,000	4,000(1)
In year 3	14,000	10,000	8,000	5,640(2)
Total gains for 3 years	$14,000	$10,000	$14,000	$10,000(3) (year 3 dollars)

Notes

(1) Market price, end of year 2 — $26,000

Restated market from year 1: 20,000 x 110/100 = — 22,000

Gain from appreciation — $ 4,000

(2) Selling price, year 3 — $34,000

Restated market from year 2: 26,000 x 120/110 = — 28,360

Gain from sale — $ 5,640

(3) The $4,000 gain in year 2 must be restated to year 3 dollars.

Total gain:		
Year 2 appreciation—		
In year 2 dollars	$4,000	
In year 3 dollars	$4,000 x 120/110	$ 4,360
Year 3 sale		5,640
Total in year 3 dollars		$10,000

Comments

.05 1. Column (1) is presented in accordance with present generally accepted accounting principles. Column (2) is presented in accordance with the recommendations of section 1071.

2. Columns (3) and (4) are not discussed in section 1071. They are presented for illustrative purposes only.

3. The restated historical cost balance sheet (column 2) preserves the cost basis. It does not result in presenting assets at market value or the recognition of unrealized gains or losses.

4. Restating the income statement for changes in the general price level changes the amount but not the timing of gains and losses. Recognizing current values changes the timing but not the amount of gains and losses in the income statement. Thus, in the illustration:

a. In the historical cost columns (1 and 2), the timing of the gains is the same, but the amounts differ ($14,000 and $10,000).

b. In the current value columns (3 and 4), the timing of the gains is the same, but the amounts differ ($14,000 and $10,000).

c. In the unrestated columns (1 and 3), the total gain is the same ($14,000), but the timing and description of the gains are different.

d. In the restated columns (2 and 4), the total gain is the same ($10,000), but the timing and description of the gains are different.

The next page is 7591.

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AC Section 1081

Foreign Operations and Foreign Exchange*

[Source: ARB No. 43, Chap. 12, as amended.]

Issue date, unless otherwise indicated: June, 1953

.01 The recommendations made in this section apply to United States companies which have branches or subsidiaries operating in foreign countries.

.02 Since World War I foreign operations have been influenced to a marked degree by wars, departures from the gold standard, devaluations of currencies, currency restrictions, government regulations, etc.

.03 Although comparatively few countries in recent years have had unrestricted currencies and exchanges, it is nevertheless true that many companies have been doing business in foreign countries having varying degrees of restrictions; in some cases they have been carrying on all operations regarded as normal, including the transmission of funds. In view of the difficulties mentioned above, however, the accounting treatment of assets, liabilities, losses, and gains involved in the conduct of foreign business and to be included or reflected in the financial statements of United States companies requires careful consideration.

.04 A sound procedure for United States companies to follow is to show earnings from foreign operations in their own accounts only to the extent that funds have been received in the United States or unrestricted funds are available for transmission thereto. Appropriate provision should be made also for known losses.

.05 Any foreign earnings reported beyond the amounts received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant. [As amended, effective for fiscal years beginning on or after January 1, 1976, by FASB Statement No. 8.] (See section 1083.)

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* See also section 2081, *Financial Reporting for Segments of a Business Enterprise*.

.06 As to assets held abroad, the accounting should take into consideration the fact that most foreign assets stand in some degree of jeopardy, so far as ultimate realization by United States owners is concerned. Under the conditions it is important that especial care be taken in each case to make full disclosure in the financial statements of United States companies of the extent to which they include significant foreign items.

[.07] [Superseded, effective for fiscal years beginning on or after January 1, 1976, by FASB Statement No. 8.] (See section 1083.)

CONSOLIDATION OF FOREIGN SUBSIDIARIES

.08 In view of the uncertain values and availability of the assets and net income of foreign subsidiaries subject to controls and exchange restrictions and the consequent unrealistic statements of income that may result from the translation of many foreign currencies into dollars, careful consideration should be given to the fundamental question of whether it is proper to consolidate the statements of foreign subsidiaries with the statements of United States companies. Whether consolidation of foreign subsidiaries is decided upon or not, adequate disclosure of foreign operations should be made.

.09 The following are among the possible ways of providing information relating to such foreign subsidiaries:

(a) To exclude foreign subsidiaries from consolidation and to furnish (1) statements in which only domestic subsidiaries are consolidated and (2) as to foreign subsidiaries, a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company's equity therein. The total amount of investments in foreign subsidiaries should be shown separately, and the basis on which the amount was arrived at should be stated. If these investments include any surplus of foreign subsidiaries and such surplus had previously been included in consolidated surplus, the amount should be separately shown or earmarked in stating the consolidated surplus in the statements here suggested. The exclusion of foreign subsidiaries from consolidation does not make it acceptable practice to include intercompany profits

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which would be eliminated if such subsidiaries were consolidated.

(b) To consolidate domestic and foreign subsidiaries and to furnish in addition the summary described in (a)(2) above.

(c) To furnish (1) complete consolidated statements and also (2) consolidated statements for domestic companies only.

(d) To consolidate domestic and foreign subsidiaries and to furnish in addition parent company statements showing the investment in and income from foreign subsidiaries separately from those of domestic subsidiaries.

[.10—.22] [Superseded, effective for fiscal years beginning on or after January 1, 1976, by FASB Statement No. 8.] (See section 1083.)

The next page is 7595.

AC Section 1083

Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements

[Source: FASB Statement No. 8.]

October 1975

INTRODUCTION

.001 The expansion of international business activities, extensive currency realignments—including two U. S. dollar devaluations — that followed the recent major revision of the international monetary system, and the acceptance in practice of significantly different methods of accounting have highlighted problems concerning **foreign currency translation.** (Terms defined in the glossary in Appendix E are in boldface type the first time they appear in this Statement.) Appendix B presents background information for this Statement.

.002 This Statement establishes standards of financial accounting and reporting for **foreign currency transactions** in financial statements of a **reporting enterprise** (hereinafter *enterprise*). It also establishes standards of financial accounting and reporting for translating **foreign currency financial statements** incorporated in the financial statements of an enterprise by consolidation, combination, or the equity method of accounting. Translation of financial statements from one currency to another for purposes other than consolidation, combination, or the equity method is beyond the scope of this Statement. For example, this Statement does not cover translation of the financial statements of an enterprise from its **reporting currency** into another currency for the convenience of readers accustomed to that other currency.

.003 To incorporate foreign currency transactions and foreign currency financial statements in its financial statements, an enterprise must translate — that is, express in its reporting

currency[1] — all assets, liabilities, revenue, or expenses that are *measured in foreign currency* or *denominated in foreign currency*[2] and that arise in either of two ways:

> *Foreign currency transactions* — an enterprise (a) buys or sells on credit goods or services whose prices are stated in foreign currency, (b) borrows or lends funds and the amounts payable or receivable are denominated in foreign currency, (c) is a party to an unperformed forward exchange contract, or (d) for other reasons, acquires assets or incurs liabilities denominated in foreign currency.
>
> *Foreign operations* — an enterprise conducts activities through a foreign operation whose assets, liabilities, revenue, and expenses are measured in foreign currency.

The need for translation is discussed further in Appendix C.

.004 This Statement supersedes paragraphs 7 and 10-22 of Chapter 12, "Foreign Operations and Foreign Exchange," of *ARB No. 43* [sections 1081.07 and 1081.10-.22]; paragraph 18 of *APB Opinion No. 6,* "Status of Accounting Research Bulle-

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[1] For convenience, this Statement assumes that the enterprise uses the U.S. dollar (dollar) as its reporting currency and unit of measure. A currency other than the dollar may be the reporting currency in financial statements that are prepared in conformity with U.S. generally accepted accounting principles. For example, a foreign enterprise may report in its local currency in conformity with U.S. generally accepted accounting principles. If so, the requirements of this Statement apply.

[2] To *measure in foreign currency* is to quantify an attribute of an item in a unit of currency other than the reporting currency. Assets and liabilities are *denominated in foreign currency* if their amounts are fixed in terms of a foreign currency regardless of exchange rate changes. An asset or liability may be both measured and denominated in one currency, or it may be measured in one currency and denominated in another. To illustrate: two foreign branches of a U.S. company, one Swiss and one German, purchase on credit identical assets from a Swiss vendor at identical prices stated in Swiss francs. The German branch measures the cost (an attribute) of that asset in German marks. Although the corresponding liability is also *measured* in marks, it remains *denominated* in Swiss francs since the liability must be settled in a specified number of Swiss francs. The Swiss branch measures the asset and liability in Swiss francs. Its liability is both measured and denominated in Swiss francs. Assets and liabilities can be measured in various currencies. However, currency and rights to receive or obligations to pay fixed amounts of a currency are denominated only in that currency.

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tins"; and *FASB Statement No. 1*, "Disclosure of Foreign Currency Translation Information." It also amends the last sentence of paragraph 5 of *ARB No. 43*, Chapter 12 [section 1081.05], to delete "and they should be reserved against to the extent that their realization in dollars appears to be doubtful," and paragraph 13 of *APB Opinion No. 22* [section 2045.13], "Disclosure of Accounting Policies," to delete "translation of foreign currencies" as an example of disclosure "commonly required with respect to accounting policies."

.005 Standards of financial accounting and reporting for the translation of foreign currency transactions and foreign currency financial statements (*foreign statements*) are presented in paragraphs .006-.037. Those paragraphs deal in sequence with the following: objective of translation, foreign currency transactions, foreign statements, exchange gains and losses, income tax consequences of rate changes, forward exchange contracts, use of averages or reasonable approximations, exchange rates, disclosure, and effective date and transition. The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in Appendix D.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Objective of Translation

.006 For the purpose of preparing an enterprise's financial statements, the objective of translation is to measure and express (a) in dollars and (b) in conformity with U.S. generally accepted accounting principles the assets, liabilities, revenue, or expenses that are measured or denominated in foreign currency. Remeasuring in dollars the assets, liabilities, revenue, or expenses measured or denominated in foreign currency should not affect either the measurement bases for assets and liabilities or the timing of revenue and expense recognition otherwise required by generally accepted accounting principles. That is, translation should change the unit of measure without changing accounting principles.

Foreign Currency Transactions

.007 The objective of translation requires that the following shall apply to all foreign currency transactions of an enterprise other than forward exchange contracts (paragraphs .022-.028):

a) At the transaction date, each asset, liability, revenue, or expense arising from the transaction shall be translated into (that is, measured in) dollars by use of the exchange rate (*rate*) in effect at that date, and shall be recorded at that dollar amount.

b) At each balance sheet date, recorded dollar balances representing cash and amounts owed by or to the enterprise that are denominated in foreign currency shall be adjusted to reflect the current rate.[3]

c) At each balance sheet date, assets carried at market whose current market price is stated in a foreign currency shall be adjusted to the equivalent dollar market price at the balance sheet date (that is, the foreign currency market price at the balance sheet date multiplied by the current rate).

.008 Although paragraph .007 refers to foreign currency transactions of an enterprise whose reporting currency is the dollar, the conclusions expressed therein also apply to a foreign operation that has transactions whose terms are stated in a currency other than its local currency.

Foreign Statements

.009 The objective of translation requires that the assets, liabilities, revenue, and expenses in foreign statements be translated and accounted for in the same manner as assets, liabilities, revenue, and expenses that result from foreign currency transactions of the enterprise. Foreign currency transactions of an enterprise involve amounts denominated or measured in foreign currency, but the assets, liabilities, revenue, and expenses from foreign currency transactions are initially measured and recorded in dollars, and in conformity with U.S. generally accepted accounting principles, following the procedures in paragraph .007(a). In contrast, assets, liabilities, revenue, and expenses in foreign statements are initially measured and recorded in foreign currency and may not be in conformity with U.S. generally accepted accounting principles. Since translation cannot transform the results obtained under dissimilar foreign accounting principles into acceptable measurements under U.S. accounting principles,

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[3] Debt securities held that are essentially equivalent to notes receivable shall be adjusted to reflect the current rate (paragraph .039).

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special procedures are necessary to ensure that the translated statements are prepared in conformity with U.S. generally accepted accounting principles.

.010 Accordingly, before translation, foreign statements that are to be included by consolidation, combination, or the equity method in an enterprise's financial statements shall be prepared in conformity with U.S. generally accepted accounting principles. Those financial statements shall then be translated into dollars following the standards in this Statement.[4]

.011 In preparing foreign statements, balances representing cash and amounts receivable or payable that are denominated in other than the local currency shall be adjusted to reflect the current rate between the local and the foreign currency.[5]

Those adjusted balances and other balances representing cash and amounts receivable or payable that are denominated in the local currency shall be translated into dollars at the current rate.

.012 For assets and liabilities other than those described in paragraph .011, the particular measurement basis used shall determine the translation rate. Several measurement bases are used in financial accounting under present generally accepted accounting principles.[6] A measurement may be based on a price in a past exchange (for example, historical cost), a price in a current purchase exchange (for example, replacement cost), or a price in a current sale exchange (for example, market price). Foreign statements may employ various measurement bases. Accordingly, accounts in foreign statements that are carried at exchange prices shall be translated in a manner that retains their measurement bases as follows:

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[4] In multilevel consolidation, foreign statements may be translated into another foreign currency and consolidated with other foreign statements before being consolidated with the enterprise's financial statements. Translation at each step of a multilevel consolidation shall be in conformity with the standards in this Statement.

[5] Since foreign statements are expressed in local currency, the term *foreign currency* in this context includes the dollar.

[6] Various measurement bases are described in paragraphs 70 and 179 of *APB Statement No. 4* [sections 1023.31 and 1027.05], "Basic Concepts of Accounting Principles Underlying Financial Statements of Business Enterprises."

a) Accounts carried at prices in past exchanges (past prices) shall be translated at historical rates.

b) Accounts carried at prices in current purchase or sale exchanges (current prices) or future exchanges (future prices) shall be translated at the current rate.

.013 Revenue and expense transactions shall be translated in a manner that produces approximately the same dollar amounts that would have resulted had the underlying transactions been translated into dollars on the dates they occurred. Since separate translation of each transaction is usually impractical, the specified result can be achieved by using an average rate for the period. However, revenue and expenses that relate to assets and liabilities translated at historical rates shall be translated at the historical rates used to translate the related assets or liabilities.

.014 The procedures specified in paragraphs .010-.013 generally result in translated statements in which the assets, liabilities, revenue, and expenses are measured in dollars in the same manner as those resulting from foreign currency transactions of the enterprise. Occasionally, however, translation of foreign statements in strict conformity with those paragraphs does not result in dollar measurements required by U.S. generally accepted accounting principles. For example, the test of *cost or market, whichever is lower*, must be applied *in dollars* to ensure that inventory in the translated statements conforms to that rule — a procedure that can result in dollar measurements that are sometimes different from translating inventory in foreign statements in the manner described in paragraph .012. Similarly, timing differences that affect deferred tax accounting sometimes increase or decrease *in dollars* even though their amounts measured in foreign currency remain unchanged.

.015 Appendix A, "Translation of Certain Accounts," (paragraphs .038-.052) explains and illustrates certain applications of the procedures set forth in paragraphs .011-.013. It also describes and illustrates ways to ensure that amounts in translated statements conform to U. S. generally accepted accounting principles in those situations indicated in paragraph .014.

Exchange Gains and Losses

.016 A change in the rate between the dollar and the foreign currency in which assets and liabilities are measured or de-

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nominated can result in an exchange gain or loss if the translation method uses the dollar as the unit of measure. Exchange gains or losses are a consequence of translation, that is, of remeasuring in dollars. They result from the procedures specified in paragraphs .007(b)and .011-.013 (see paragraphs .167-.169). Exchange gains or losses also result from the **conversion** of foreign currency or the settlement of a receivable or payable denominated in foreign currency at a rate different from that at which the item is recorded.

.017 Exchange gains and losses shall be included in determining net income for the period in which the rate changes. Exchange gains and losses are *gains* and *losses* as those terms are used in paragraph 15(d) of *APB Opinion No. 28* [section 2071.15d], "Interim Financial Reporting," which states: "Gains and losses that arise in any interim period similar to those that would not be deferred at year end should not be deferred to later interim periods within the same fiscal year."

Income Tax Consequences of Rate Changes

.018 Interperiod tax allocation is required in accordance with *APB Opinion No. 11* [section 4091], "Accounting for Income Taxes," if taxable exchange gains or tax-deductible exchange losses resulting from an enterprise's foreign currency transactions are included in income in a different period for financial statement purposes than for tax purposes. Partial or complete elimination of a foreign operation's exchange gains or losses through translation of its statements into dollars shall not alter current inclusion in the dollar income statement of the effects, if any, of the exchange gains or losses on foreign taxes (see paragraph .200).

.019 The use of historical rates to translate certain revenue or expense items may result in an unusual relationship between the translated amounts of foreign pretax income and foreign income taxes. However, that effect of a rate change is not a timing difference as defined in *APB Opinion No. 11* [section 4091], and interperiod tax allocation is not appropriate.

.020 To the extent that exchange gains or losses arising from translating subsidiaries' and investees' foreign statements into dollars are not included currently in U. S. taxable income, the need for deferred taxes shall be determined in accordance with the provisions of *APB Opinion No. 23* [section 4095], "Accounting for Income Taxes—Special Areas," and *APB Opinion No.*

24 [section 4096], "Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)."

.021 Deferred taxes shall be recorded in accordance with *APB Opinion No. 11* [section 4091], for exchange gains or losses that are timing differences arising from including the operations of foreign branches of U. S. companies and certain foreign subsidiaries and investees in determining U. S. taxable income. Since various methods are allowed to measure exchange gains or losses for tax purposes, the determination of whether exchange gains or losses are timing differences or permanent differences must depend on the circumstances in each situation.

Forward Exchange Contracts

.022 A forward exchange contract (*forward contract*) is an agreement to exchange at a specified future date currencies of different countries at a specified rate (the *forward rate*). The purpose of a forward contract may be to hedge either a foreign currency commitment or a foreign currency exposed net asset position or exposed net liability position or to speculate in anticipation of a gain.

.023 A gain or loss shall be included in determining net income for the period in which the rate changes if the gain or loss pertains to a forward contract that is intended to be a (a) hedge of a foreign currency exposed net asset or net liability position, (b) hedge of a foreign currency commitment that does not meet the conditions described in paragraph .027, or (c) speculation.

.024 A gain or loss shall be deferred and included in the measurement of the dollar basis of the related foreign currency transaction if the gain or loss pertains to a forward contract that is intended to be a hedge of an identifiable foreign currency commitment that meets the conditions described in paragraph .027. Losses on a forward contract shall not be deferred, however, if deferral could lead to recognizing losses in later periods.[7]

[7] For example, a loss on a forward contract shall not be deferred if future revenue from sale or other disposition of an asset is estimated to be less than the sum of (a) the asset's dollar cost including the deferred loss on the related forward contract and (b) reasonably predictable costs of sale or disposal.

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.025 A gain or loss on a forward contract that is intended to be a hedge (paragraphs .023(a), .023(b), and .024) shall be determined by multiplying the foreign currency amount of the forward contract by the difference between the spot rate at the balance sheet date[8] and the spot rate at the date of inception of the contract (or the spot rate last used to measure a gain or loss on that contract for an earlier period). The discount or premium on the forward contract (that is, the foreign currency amount of the contract multiplied by the difference between the contracted forward rate and the spot rate at the date of inception of the contract) shall be accounted for separately from the gain or loss on the contract and shall be included in determining net income over the life of the forward contract. If a gain or loss is deferred under paragraph .024, however, the forward contract's discount or premium that relates to the commitment period may be included in the measure of the dollar basis of the related foreign currency transaction when recorded.

.026 A gain or loss on a forward contract that is a speculation shall be determined by multiplying the foreign currency amount of the forward contract by the difference between the forward rate available for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). No separate accounting recognition is given to the discount or premium on a forward contract that is a speculation.

.027 There shall be the presumption that the intent of entering into a forward contract is described in paragraph .023. However, a forward contract shall be considered a hedge of an identifiable foreign currency commitment (paragraph 024), provided *all* of the following conditions are met:

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[8] If the transaction date for a commitment that is hedged by a forward contract (paragraph .024) occurs during the period before the balance sheet date, the spot rate at the transaction date shall be used instead of the spot rate at the subsequent balance sheet date.

a) The life of the forward contract extends from the foreign currency commitment date to the anticipated transaction date[9] or a later date.[10]

b) The forward contract is denominated in the same currency as the foreign currency commitment.

c) The foreign currency commitment is firm and uncancelable.

The portion of a forward contract that shall be accounted for pursuant to paragraph .024 is limited to the amount of the related commitment. If a forward contract that meets conditions (a) through (c) above exceeds the amount of the related commitment, the gain or loss pertaining to a portion of the forward contract in excess of the commitment shall be deferred to the extent that the forward contract is intended to provide a hedge on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the period in which such tax effects are recognized. A gain or loss that has been offset against related tax effects shall not be included in the aggregate exchange gain or loss disclosure required by paragraph .032. A gain or loss pertaining to the portion of a forward contract in excess of the amount that provides a hedge on an after-tax basis shall not be deferred. Likewise, a gain or loss pertaining to a period after the transaction date of the related commitment shall not be deferred. [As amended, effective January 1, 1978 by FASB Statement No. 20.] (See section 1084.)

.028 If a forward contract previously considered a hedge of a foreign currency commitment is sold or otherwise terminated before the transaction date, the deferred gain or loss, if any, shall continue to be deferred and accounted for in accordance with the requirements of paragraph .024.

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[9] A long-term commitment may have more than one transaction date. For example, the due date of each progress payment under a construction contract is an anticipated transaction date. For purposes of this Statement, each future progress payment due is a commitment, and the period between the commitment date for the entire contract and the due date of each progress payment is the minimum life for a forward contract that hedges that payment.

[10] The intended use of successive forward contracts satisfies the condition in paragraph .027(a) if the nature of the forward exchange market precludes a single forward contract's covering the entire period, provided the first contract commences at the commitment date.

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Use of Averages or Reasonable Approximations

.029 Since literal application of several of the standards in this Statement would require a degree of detail in record-keeping and computations that might be burdensome as well as unnecessary to produce reasonable approximations of the results desired, the use of averages or other methods of approximation is appropriate, provided the results obtained do not differ materially from the results prescribed by the standards. For example, the propriety of average rates in translating certain revenue and expense amounts is noted in paragraph .013. Likewise, the use of averages and other time- and effort-saving methods to approximate the results of detailed calculations will often prove useful in translating certain inventory, deferred income tax, and other accounts that involve translation of numerous individual elements at historical rates.

Exchange Rates

.030 The exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. For purposes of applying this Statement, the *current rate* is the rate in effect at the balance sheet date (see paragraph .034), and the *historical rate* is the rate in effect at the date a specific transaction or event occurred.[11] The following shall apply if multiple rates exist:

a) *Foreign Currency Transactions.* The applicable rate at which a particular transaction could be settled at the transaction date shall be used to translate and record the transaction. At a subsequent balance sheet date, the current rate is that rate at which the related receivable or payable could be settled at that date.

b) *Foreign Statements.* In the absence of unusual circumstances, the rate applicable to conversion of a

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[11] If exchangeability between the dollar and the foreign currency is temporarily lacking at the transaction date or balance sheet date, the first subsequent rate at which exchanges could be made shall be used for purposes of this Statement. If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the enterprise shall be carefully considered (*ARB No. 43*, Chapter 12, paragraph 8 [section 1081.08]).

currency for purposes of dividend remittances shall be used to translate foreign statements.[12]

.031 If a foreign operation whose balance sheet date differs from that of the enterprise is consolidated or combined with or accounted for by the equity method in the financial statements of the enterprise, the current rate is the rate in effect at the foreign operation's balance sheet date for purposes of applying the requirements of this Statement to that foreign operation.

Disclosure

.032 The aggregate exchange gain or loss included in determining net income for the period shall be disclosed in the financial statements or in a note thereto.[13] For the purpose of that disclosure, gains and losses on forward contracts determined in conformity with the requirements of paragraphs .025 and .026 shall be considered exchange gains or losses.

.033 Effects of rate changes on reported results of operations, other than the effects included in the disclosure required by paragraph .032, shall, if practicable, be described and quantified. If quantified, the methods and the underlying assumptions used to determine the estimated effects shall be explained (paragraphs .223-.225).

.034 An enterprise's financial statements shall not be adjusted for a rate change that occurs after the date of the financial statements or after the date of the foreign statements of a foreign operation that are consolidated or combined with or accounted for by the equity method in the financial statements of the enterprise. However, disclosure of the rate change and its effects, if significant, may be necessary.

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[12] If unsettled intercompany transactions are subject to preference or penalty rates, translation at the rate applicable to dividend remittances may cause a difference between intercompany receivables and payables measured in dollars. Until that difference is eliminated by settlement of the intercompany transaction, it shall be treated as a receivable or payable in the enterprise's financial statements.

[13] Certain enterprises, primarily banks, are dealers in foreign exchange. Although certain gains or losses from dealer transactions may fit the definition of exchange gains or losses in this Statement, they need not be included in the aggregate exchange gain or loss required to be disclosed if dealer gains or losses are disclosed.

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Effective Date and Transition

.035 This Statement shall be effective for fiscal years beginning on or after January 1, 1976,[14] although earlier application is encouraged. Thereafter, if financial statements for periods before the effective date, and financial summaries or other data derived therefrom, are presented, they shall be restated, if practicable, to conform to the provisions of paragraphs .007-.031 of this Statement. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period restated. For purposes of applying the provisions of paragraph .027(a) of this Statement, *FASB Statement No. 20* [section 1084] provides a limited exception for forward contracts that are intended to hedge commitments entered into before the provisions of this Statement are initially applied. [As amended, effective January 1, 1978 by FASB Statement No. 20.] (See section 1084.)

.036 If restatement of financial statements or summaries for all prior periods presented is not practicable, information presented shall be restated for as many consecutive periods immediately preceding the effective date of this Statement as is practicable, and the cumulative effect of applying paragraphs .007-.031 on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which the Statement is first applied if it is not practicable to restate any prior periods) shall be included in determining net income of that period (see paragraph 20 of *APB Opinion No. 20* [section 1051.20], "Accounting Changes").[15] The effect on income before extraordinary items, net income, and related per share amounts of applying this Statement in a period in which the cumulative effect is included in determining net income shall be disclosed for that period, and the reason for not restating all of the prior periods presented shall be explained.

.037 Financial statements for periods beginning on or after the effective date of this Statement shall include the disclosures specified by paragraphs .032 and .033 of this Statement. To

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[14] For enterprises having fiscal years of 52 or 53 weeks instead of the calendar year, this Statement shall be effective for fiscal years beginning in late December 1975.

[15] Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* [sections 1051.19d and 1051.21] are not applicable.

the extent practicable, those disclosures shall also be included in financial statements for earlier periods that have been restated pursuant to paragraph .035 or paragraph .036.

The provisions of this Statement need not be applied to immaterial items.

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Appendix A

TRANSLATION OF CERTAIN ACCOUNTS

.038 Paragraphs .011 and .012 distinguish those balance sheet accounts in foreign statements that shall be translated at either current or historical rates. The table on the following page indicates the rates at which certain common balance sheet accounts in foreign statements shall be translated. In addition, the following paragraphs discuss certain additional aspects of translating foreign statements. Two topics included in the discussion—applying the rule of cost or market, whichever is lower, to inventory and applying *APB Opinion No. 11* [section 4091] to deferred income taxes—require procedures not described in paragraphs .011 and .012 (see paragraph .014).

Holdings of Debt Securities

.039 Debt securities held that are essentially equivalent to notes receivable shall be translated at the current rate. An example is a bond that is intended to be held to maturity and is carried at an amount that is the present value of future interest and principal payments based on the effective rate of interest at the date of purchase (that is, at maturity amount plus or minus an unamortized premium or discount). A debt security held that is not essentially equivalent to a note receivable shall be translated (a) at the current rate if carried at current market price or (b) at the historical rate if carried at cost.

Translation After a Business Combination [16]

.040 The method an enterprise uses to account for the acquisition of a foreign operation affects certain aspects of translation. If a business combination with a foreign operation is accounted for by the *pooling-of-interests method*, the assets and liabilities of the foreign operation

[16] *APB Opinion No. 16* [section 1091], "Business Combinations," prescribes generally accepted accounting principles for business combinations. Paragraphs 87-92 [section 1091.87-.92] are particularly pertinent.

Rates Used to Translate Assets and Liabilities

	Translation Rates	
	Current	Historical
ASSETS		
Cash on hand and demand and time deposits	X	
Marketable equity securities:		
Carried at cost		X
Carried at current market price	X	
Accounts and notes receivable and related unearned discount	X	
Allowance for doubtful accounts and notes receivable	X	
Inventories:		
Carried at cost		X
Carried at current replacement price or current selling price	X	
Carried at net realizable value	X	
Carried at contract price (produced under fixed price contracts)	X	
Prepaid insurance, advertising, and rent		X
Refundable deposits	X	
Advances to unconsolidated subsidiaries	X	
Property, plant, and equipment		X
Accumulated depreciation of property, plant, and equipment		X
Cash surrender value of life insurance	X	
Patents, trademarks, licenses, and formulas		X
Goodwill		X
Other intangible assets		X
LIABILITIES		
Accounts and notes payable and overdrafts	X	
Accrued expenses payable	X	
Accrued losses on firm purchase commitments	X	
Refundable deposits	X	
Deferred income		X
Bonds payable or other long-term debt	X	
Unamortized premium or discount on bonds or notes payable	X	
Convertible bonds payable	X	
Accrued pension obligations	X	
Obligations under warranties	X	

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shall be translated as if the foreign operation had always been a subsidiary of the enterprise. Therefore, assets and liabilities that are translated at historical rates shall be translated at the rates in effect at the date the foreign operation recognized the specific transactions or events.

.041 If a business combination with a foreign operation is accounted for by the *purchase method*, assets and liabilities that are translated at historical rates shall be translated at the rates in effect when the enterprise acquired its interest in the assets or liabilities. Thus, assets and liabilities of a foreign operation at the date of its acquisition shall be adjusted to their fair values in local currency and then translated at the rate in effect at the date of acquisition. A difference between the translated net assets and the dollar cost of acquisition by the enterprise is *goodwill* or *an excess of acquired net assets over cost* as those terms are used in *APB Opinion No. 16* [section 1091]. Translation at the date of acquisition, as described, establishes the dollar measures of the assets acquired and liabilities assumed as of the date of acquisition that are translated at historical rates in subsequent balance sheets.

Translation of an Investment Accounted for by the Equity Method[17]

.042 The foreign statements of an investee that are accounted for by the equity method first shall be translated into dollars in conformity with the requirements of this Statement; then the equity method shall be applied.

Minority Interests

.043 The minority interest reported in an enterprise's consolidated financial statements shall be based on the financial statements of the subsidiary in which there is a minority interest after they have been translated according to the requirements of this Statement.

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[17] *APB Opinion No. 18* [section 5131], "The Equity Method of Accounting for Investments in Common Stock," prescribes generally accepted accounting principles for the equity method.

Preferred Stock

.044 Preferred stock that is essentially a permanent stockholder investment shall be translated in the same manner as common stock, that is, at historical rates. However, if preferred stock not owned by the enterprise is carried in the foreign operation's balance sheet at its liquidation or redemption price, and liquidation or redemption is either required or imminent, that preferred stock shall be translated at the current rate. If translation at the historical rate would result in stating a preferred stock above its stated liquidation or redemption price in foreign currency translated at the current rate, the preferred stock shall be carried at the lesser dollar amount.

Revenue and Expense Transactions

.045 Paragraph .013 permits the use of average rates to translate revenue and expense transactions that do not relate to balance sheet accounts translated at historical rates. Average rates used shall be appropriately weighted by the foreign currency volume of transactions occurring during the accounting period. For example, to translate revenue and expense accounts for an annual period, individual revenue and expense accounts for each quarter or month may be translated at that quarter's or month's average rate. The translated amounts for each quarter or month should then be combined for the annual totals.

Applying the Rule of Cost or Market, Whichever Is Lower

.046 To apply the rule of *cost or market, whichever is lower* (as described in Statement 6 of Chapter 4, "Inventory Pricing," of *ARB No. 43)* [section 5121.09], *translated historical cost* shall be compared with *translated market.* Application of the rule *in dollars* may require write-downs to market in the translated statements even though no write-down in the foreign statements is required by the rule. It may also require a write-down in the foreign statements to be reversed before translation if the translated market amount exceeds translated historical cost; the foreign currency cost shall then

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be translated at the historical rate.[18] Once inventory has been written down to market in the translated statements, that dollar amount shall continue to be the carrying amount in the dollar financial statements until the inventory is sold or a further write-down is necessary.[19]

.047 Paragraphs .048 and .049 illustrate two different situations.

.048 A foreign subsidiary of a U. S. company purchases a unit of inventory at a cost of FC500 when the rate is FC1=$2.40. At the balance sheet date the *market* (as the term is used in Chapter 4 of *ARB No. 43*) [section 5121] of the item is FC450 and the rate is FC1 = $3.00. Thus, the item's historical cost is $1,200 (FC500 × $2.40) and its market is $1,350 (FC450 × $3.00). If inventory is written down to FC450 in the foreign accounting records, translation of that amount at the current rate would not result in the lower of cost or market measured in dollars. Therefore, the write-down should be reversed in the foreign statements before translation. After translating the foreign currency cost at the historical rate, the inventory will be properly stated in the dollar financial statements at its historical cost of $1,200.

.049 A situation different from the one in the preceding paragraph could also exist. For example, a foreign operation purchases a unit of inventory at a cost of FC500 when the rate is FC1=$2.40. At the balance sheet date the *market* of the item is FC600 and the rate is FC1=$1.80. Thus, the item's historical cost is $1,200 (FC500 x $2.40), its market is $1,080 (FC600 x $1.80), and a write-down of the inventory to market in the translated financial statements is necessary.

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[18] An asset other than inventory may sometimes be written down from historical cost. Although that write-down is not under the rule of cost of market, whichever is lower, the standards prescribed in this paragraph shall be applied. That is, a write-down may be required in the translated statements even though not required in the foreign statements, and a write-down in the foreign statements may need to be reversed before translation to prevent the translated amount from exceeding translated historical cost.

[19] This paragraph is not intended to preclude recognition of gains in a later interim period to the extent of inventory losses recognized from market declines in earlier interim periods if losses on the same inventory are recovered in the same year, as provided by paragraph 14(c) of *APB Opinion No. 28* [section 2071.14(c)], "Interim Financial Reporting."

Deferred Income Taxes

.050 Present accounting for income taxes is governed by *APB Opinion No. 11* [section 4091], which requires the *deferred method* of interperiod tax allocation. Consistent with the requirements of *APB Opinion No. 11* [section 4091] and paragraph .009 of this Statement, deferred taxes in the translated balance sheet of a foreign operation shall be stated the same as would the deferred tax effects of timing differences from foreign currency transactions of the enterprise that are subject to foreign taxes but measured and recorded in dollars. Accordingly, the following procedures shall apply:

a) Deferred taxes that (1) are determined by the *gross change* method (*APB Opinion No. 11,* paragraph 37(a) [section 4091.36(a)] and (2) do not relate to assets or liabilities translated at the current rate shall be translated at historical rates.

b) Deferred taxes that (1) are determined by the *net change* method (*APB Opinion No. 11,* paragraph 37(b) [section 4091.36(b)] and (2) do not relate to assets or liabilities translated at the current rate shall be measured in dollars by adding to or subtracting from the dollar balance at the beginning of the period the amount determined by translating (in accordance with paragraph .013 of this Statement) the foreign currency deferred tax expense or credit included in the foreign operation's income statement for the period. (Paragraph .051 illustrates that procedure.)

c) Deferred taxes that relate to assets or liabilities translated at the current rate shall be translated at the current rate. (Paragraph .052 illustrates that procedure.)

Applying the current rate to the balance of deferred taxes in (c) above complies with the objective of translation. Translating at the current rate the item in the foreign statements that gave rise to a timing difference remeasures the timing difference in dollars, and, therefore, the tax effect *in dollars* of the change in the timing difference should be recognized.

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Illustrations of Applying Paragraph .050

.051 A foreign subsidiary of a U.S. company uses the net change method of deferred tax allocation for timing differences from using an accelerated depreciation method on plant and equipment for tax purposes and the straight-line method of depreciation for financial statement purposes. The dollar measure of the deferred tax credit at the beginning of the year is $100,000 (determined in conformity with the requirements of paragraph .050(b)). The current year's deferred tax expense is FC50,000, and the average exchange rate for translating income tax expense is FC1=$.50. Accordingly, the dollar amount of deferred taxes in the translated balance sheet is $125,000 [$100,000+.50(50,000)].

.052 A foreign subsidiary of a U.S. company accrues warranty obligations for financial statement purposes but is on the cash basis for tax purposes. The accrued warranty obligation at the beginning and end of the year is FC900. No warranty claims are paid during the year. The deferred tax charge using the net change method is FC450 (determined at the 50% local tax rate) at the beginning and end of the year. The exchange rate at the beginning and end of the year is FC1=$1 and FC3=$1, respectively. The dollar measure of the deferred tax charge at the beginning of the year is $450. Accordingly, the dollar amount of the deferred tax charge in the translated balance sheet at year end is $150 (FC450 ÷ 3). The warranty obligation measured in dollars has decreased $600 during the year; therefore, the deferred tax charge should be decreased by $300.

Appendix B

BACKGROUND INFORMATION

.053 Before this Statement was issued, existing accounting pronouncements on foreign currency translation (summarized in paragraphs .060-.064) dealt only with translating foreign statements and not with foreign currency transactions. Since publication of the basic existing pronouncement, the international business activities of U.S. companies have expanded rapidly. In addition, the international business environment has been affected by recent, significant changes in the world monetary system, exemplified by the U.S. dollar devaluations of 1971 and 1973 and the current prevalence of *floating* rather than *fixed* rates in most foreign exchange markets.

.054 Because of those factors and the acceptance in practice of several different methods of accounting for foreign currency translation, the FASB in April 1973 placed on its technical agenda a project on "Accounting for Foreign Currency Translation."

.055 A task force of 14 persons from industry, public accounting, the financial community, and academe was appointed in May 1973 to counsel the Board in preparing a Discussion Memorandum analyzing issues related to the project.

.056 In the meantime, because a variety of methods of determining and accounting for exchange gains and losses existed in practice and not all companies completely disclosed their translation methods or their accounting for exchange gains and losses, the Board issued in October 1973 an Exposure Draft of a proposed FASB Statement on "Disclosure of Foreign Currency Translation Information." After considering the comments received on that Exposure Draft, the Board issued *FASB Statement No. 1* on that topic in December 1973.

.057 The Board issued the Discussion Memorandum, "Accounting for Foreign Currency Translation," on February 21, 1974, and held a public hearing on the subject on June

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10 and 11, 1974. The Board received 90 position papers, letters of comment, and outlines of oral presentations in response to the Discussion Memorandum. Fifteen presentations were made at the public hearing.

.058 In 1972, the AICPA and the Canadian Institute of Chartered Accountants both published research studies on this subject.[20] While the Discussion Memorandum was being prepared, the Financial Executives Institute completed a survey of the translation practices of 45 major U.S. companies.[21] In addition to the availability of those studies, pronouncements of other professional accounting bodies, and other published research studies and articles that are cited in the Discussion Memorandum, the FASB staff prepared a *Financial Statement Model on Accounting for Foreign Currency Translation.*[22] Its purpose was to aid in identifying possible implementation problems related to adopting a particular method or combination of methods from among those that had been proposed or that were currently used in practice. The FASB staff also reviewed the disclosure of translation practices in recent annual financial statements of 77 companies engaged in foreign activities.

.059 The Board received 190 letters of comment on its Exposure Draft of a proposed Statement on "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," dated December 31, 1974.

SUMMARY OF PAST PRONOUNCEMENTS AND PRACTICES

.060 Chapter 12 of *ARB No. 43* as modified by paragraph 18 of *APB Opinion No. 6* [section 1081], was the basic authoritative pronouncement on accounting for foreign currency translation before this Statement. Chapter 12 [section 1081] called for trans-

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[20] Leonard Lorensen, *Accounting Research Study No. 12*, "Reporting Foreign Operations of U.S. Companies in U.S. Dollars" (New York: AICPA, 1972); R. MacDonald Parkinson, *Translation of Foreign Currencies* (Toronto: Canadian Institute of Chartered Accountants, 1972).

[21] Financial Executives Institute, *Survey of U.S. Company Foreign Translation Practices*, 31 July 1973.

[22] Financial Accounting Standards Board, *Financial Statement Model on Accounting for Foreign Currency Translation* (Stamford, Connecticut: FASB, March 1974).

lation of current assets and liabilities at the current rate and translation of noncurrent assets and liabilities at historical rates, that is, the *current-noncurrent* method. Under Chapter 12 [section 1081], exchange losses and realized exchange gains were included in net income, and unrealized exchange gains were preferably deferred, except that unrealized exchange gains might be included in net income to the extent that they offset exchange losses previously included in net income.

.061 Chapter 12 of *ARB No. 43* [section 1081] provided certain exceptions to those general rules. Under special circumstances, inventory could be stated at historical rates. Long-term debt incurred or capital stock issued in connection with the acquisition of long-term assets shortly before a substantial and presumably permanent change in the rate could be restated at the new rate. If the debt or stock was restated, the difference was an adjustment of the cost of the assets acquired.

.062 A research report[23] published in 1960 described the current-noncurrent distinction as one that "seems to reflect the use of an established balance sheet classification for a purpose to which it is not relevant." In addition, the report described the *monetary-nonmonetary* method, which had been proposed earlier.[24] Under that method, inventory is translated at historical rates because it is a nonmonetary asset, and both current and noncurrent receivables and payables are translated at the current rate because they are monetary items.

.063 Translating all payables and receivables at the current rate received official recognition with the issuance in 1965 of *APB Opinion No. 6*. Paragraph 18 of *APB Opinion No. 6* stated, without specifying the circumstances, that "translation of long-term receivables and long-term liabilities at current exchange rates is appropriate in many circumstances." That modification of Chapter 12 of *ARB No. 43* [section 1081] in effect permitted use of the monetary-nonmonetary method of translation.

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[23] National Association of Accountants, *Research Report No. 36*, "Management Accounting Problems in Foreign Operations" (New York: NAA, 1960), p. 17.

[24] Samuel R. Hepworth, *Reporting Foreign Operations* (Ann Arbor, Michigan: University of Michigan, 1956).

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.064 Because of extensive currency realignments in 1971, the APB considered the problem of foreign currency translation and issued an exposure draft proposing that companies using the monetary-nonmonetary method defer exchange gains and losses to the extent they did not exceed those attributable to long-term debt. Amounts deferred were to be accounted for in a manner similar to debt discount.[25] That draft in effect created another method of accounting for exchange gains and losses. *ARS No. 12* was in process at the time, and the U.S. dollar was devalued during the exposure period. The APB deferred action on the exposure draft and announced that companies should disclose how they accounted for exchange gains and losses. The APB also noted that some companies had adopted the recommendations of the exposure draft, thus achieving somewhat the same effect as translating long-term receivables and payables at historical rates.[26]

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[25] Proposed APB Opinion, "Translating Foreign Operations," Exposure Draft, 20 December 1971.

[26] *Accounting Research Association Newsletter*, 20 January 1972, p. 1.

Appendix C

NEED FOR TRANSLATION

FOREIGN CURRENCY TRANSACTIONS

.065 If an enterprise engages in a transaction that requires later settlement in a currency other than the one in which its accounts are maintained, translation is required to record the transaction.

.066 An enterprise may be involved in various types of transactions that require settlement in foreign currency, including:

a) Operating transactions (importing, exporting, licensing, etc.);

b) Financing transactions (borrowing and lending);

c) Forward exchange contracts.

.067 Foreign currency transactions may involve three stages:

a) Translation to record the transaction at the transaction date;

b) Subsequent adjustments of the unsettled portion of the transaction (the amount owed by or to the enterprise), if any, to reflect the current rate at balance sheet dates between the transaction date and the settlement date;

c) Conversion of one currency into the other at settlement date.[27]

[27] Although conversion may be at a rate other than the one at which cash, a receivable, or a payable is recorded, *translation* is not involved. However, an exchange gain or loss results from conversion at a different rate.

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Unit of Measure

.068 At the transaction date it is necessary to measure and record in a particular currency (a unit of measure) the amount of the goods or services purchased or sold or the amount of the loan received or granted and the corresponding amount owed by or to the enterprise. Once the amount of the goods or services purchased or sold is measured and recorded in dollars,[28] it is not subject to further *translation.*

.069 Because the dollar amount of any unsettled portion of the transaction (the amount to be paid in an import or borrowing transaction and the amount to be collected in an export or lending transaction) will be affected by a change in the rate between the dollar and the foreign currency (paragraphs .071 and .072), a potential for gain or loss exists.

.070 If a foreign currency transaction is not settled when the transaction occurs, the question arises whether the amount receivable or payable should be presented in the financial statements of the enterprise until the settlement date at the dollar equivalent established at the transaction date or whether it should be adjusted at each intervening balance sheet date for the rate changes that may have occurred in the meantime. Paragraph .007(b) of this Statement states the Board's conclusion regarding that question, and paragraphs .112-.115 and .161-.166 give the Board's reasoning.

Effect of a Rate Change

.071 An exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged (converted) at a particular time. For example, a spot rate of $1 = FC2 means that one dollar presently can be exchanged for two foreign currency units of

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[28] *APB Statement No. 4* (paragraph 165) [section 1026.29] states the following regarding the unit of measure:

> "In the United States, the U.S. dollar fulfills the functions of medium of exchange, unit of account, and store of value. It provides the unit of measure for financial accounting. Stating assets and liabilities and changes in them in terms of a common financial denominator is prerequisite to performing the operations — for example, addition and subtraction — necessary to measure financial position and periodic net income."

money. A change in rate means that more or fewer units of one currency can be subsequently exchanged for a unit of another currency. For example, if the spot rate changed from $1 = FC2 to $1 = FC1, it would take $2 to obtain the same FC2 that $1 could have obtained at the old rate. Therefore, rate changes have a direct economic effect on transactions that require exchanges between a particular unit of money (for example, the dollar) and another unit of money.

Unsettled Foreign Currency Transactions

.072 The effect of a rate change on foreign currency held is measurable in dollars. A rate change has a similar effect on an unsettled foreign currency transaction that was entered into before the rate change and involves the future payment or receipt of a fixed number of foreign currency units.

Future Foreign Currency Transactions

.073 Once a rate changes, all subsequent exchanges between the two currencies are effected at the new rate until another rate change occurs. Therefore, a rate change may also affect the future earnings of an enterprise that has foreign currency transactions. For example, the future revenue in dollars of a U.S. company that exports its domestically manufactured product for sale to customers in a foreign country at a price stated in foreign currency may be affected by a rate change. Whether or not the translation process should consider the future effect of a rate change is discussed in paragraphs .096-.111.

FOREIGN STATEMENTS

Unit of Measure

.074 Foreign statements are derived from accounting records that are not kept in dollars. The unit of measure in foreign statements is usually the local currency of the foreign country, but another foreign currency may be chosen as the unit of measure in particular circumstances. Either way, transactions of a foreign operation are not measured in dollars but in another currency. The foreign currency transactions of a foreign operation require the same translation process as foreign currency transactions of a U.S. company.

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.075 The need to translate foreign statements arises because an enterprise's financial statements cannot be prepared in dollars directly from accounting records kept in a different currency. The major issue raised in translating foreign statements is whether or not the statements should be translated, either for some or all foreign operations, in a manner that changes the unit of measure from the local currency to the dollar. Paragraph .006 states the Board's conclusion on that issue, and paragraphs .083-.095 give the Board's reasoning.

Effect of a Rate Change

.076 Paragraphs .072 and .073 mention the possible effects of a rate change on an enterprise's unsettled foreign currency transactions and future foreign currency transactions. That discussion applies equally to foreign currency transactions of U.S. and foreign operations. A rate change between the local currency of a foreign operation and the dollar may also affect the accounting results measured in dollars of future local currency transactions of that operation. For example, the measurement in dollars of future revenue and expenses of a French company whose transactions are solely in French francs may be affected by a rate change. Paragraphs .096-.111 consider that possible consequence.

Appendix D
BASIS FOR CONCLUSIONS

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Appendix D

BASIS FOR CONCLUSIONS

.077 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others. Some Board members gave greater weight to some factors than to others.

OBJECTIVE OF TRANSLATION

.078 The Board determined that the first step toward conclusions regarding the unique problems of translating foreign currency transactions and foreign statements should be to identify the objective of the translation process.

.079 Letters of comment received, personal views of Board and task force members, and thoughts expressed in various writings on the subject suggested the following objectives which were considered by the Board.

A. To present the financial statements of the enterprise in conformity with the U.S. generally accepted accounting principles that would apply had all assets, liabilities, revenue, and expenses been measured and recorded in dollars.

B. To retain in the enterprise's financial statements the accounting principles that are accepted in the foreign country for assets, liabilities, revenue, and expenses measured and recorded in foreign currency.

C. To have a single unit of measure for financial statements that include translated foreign amounts; that is, not only to express in dollars the assets, liabilities, revenue, or expenses that are measured or denominated in foreign currency, but also to measure them in dollars.

D. To retain as a unit of measure each currency in which assets, liabilities, revenue, and expenses are measured; that is, to express in dollars the assets, liabilities, revenue, and expenses that are measured in foreign currencies but to retain the foreign currencies as units of measure.

E. To produce an exchange gain or loss that is compatible with the expected economic effect of a rate change on business activities conducted in a currency other than dollars.

U.S. or Foreign Accounting Principles (Objective A v. Objective B)

.080 Unless the same accounting principles are generally accepted in both the U.S. and the countries in which foreign operations are located, Objectives A and B are mutually exclusive. The translation process cannot retain both if the principles are different. One view is that the only meaningful foreign statements for translation purposes are those based on accounting principles generally accepted in the foreign country. Thus, if an attribute of an asset is measured on a basis not in conformity with U.S. generally accepted accounting principles, that measurement basis should, nonetheless, be retained in the translation process.

.081 The opposing view is that U.S. generally accepted accounting principles have been developed and are well known. Accordingly, readers of dollar financial statements, although perhaps not cognizant of all the principles used to prepare the statements, generally understand what the statements represent. Therefore, it is inappropriate to combine in an enterprise's financial statements assets and liabilities that are measured by different accounting principles.

.082 After considering the alternatives, the Board concluded that it should require the concept that has been implicitly understood and applied in practice, namely, that all financial statements included in consolidated financial statements should be prepared in conformity with U.S. generally accepted accounting principles. The Board concluded that consistency of accounting procedures and measurement processes between foreign and domestic operations is desirable in the consolidation of foreign and domestic financial statements. Therefore, foreign statements prepared for purposes of combination, consolidation, or equity accounting should be prepared in conformity with U.S. generally accepted accounting principles, and translation should not change the measurement bases used in those foreign statements. The Board, therefore, accepted Objective A and rejected Objective B.

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Single or Multiple Units of Measure (Objective C v. Objective D)

.083 Objectives C and D are also mutually exclusive because after a rate change the translation process can either retain two or more currencies as units of measure or have a single unit of measure, but it cannot do both. For example, if an asset is acquired either by a foreign operation or a domestic operation for FC100 when the rate is FC1 = $1, its historical cost measured in either foreign currency or dollars can be expressed as $100 in the dollar financial statements. However, if the rate changes to FC1 = $2, the historical cost of the asset would be expressed as $200 (translated at the current rate) in the dollar financial statements to retain the foreign currency as the unit of measure. Expressing the cost as $100 after the rate change measures the historical cost of the asset in dollars, not in foreign currency.

.084 The desire to retain the foreign currency as the unit of measure stems from the belief that the foreign statements represent the most meaningful presentation of a foreign operation and that translation should preserve the relationships in those statements. That view also supports retaining the foreign accounting principles (paragraphs .080-.082) and is related to the view that the historical cost of a foreign asset can be measured only in foreign currency (paragraphs .133-.138).

.085 The unit-of-measure issue focuses principally on the assets and liabilities of foreign operations that are measured at past prices in foreign currency. There is general agreement that cash, receivables, and payables measured or denominated in foreign currency, and assets and liabilities measured at current or future prices in foreign currency are translated at the current rate regardless of which currency is considered the unit of measure.[29]

.086 An important conceptual distinction between the two opposing views involves the way in which the effect of the translation process is recognized. If the dollar is the unit of

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[29] Proposals to defer recognition of exchange gains and losses on long-term receivables and payables — either by deferring exchange gains and losses resulting from translating the assets and liabilities at the current rate or by translating the items at historical rates until collection or settlement (as, for example, by the current-noncurrent method) — raise issues separate from the unit-of-measure issue and are discussed in paragraphs .172-.194 and .129-.132.

measure, a change in the dollar carrying amounts of assets and liabilities resulting from a rate change affects net income. If, however, the foreign currency is the unit of measure in dollar statements of foreign operations, prior dollar translated statements need to be restated to current equivalent dollars to make them comparable with current translated statements. Restatement does not change the prior periods' statements in any way except to update the amounts to current equivalent dollars and, therefore, does not result in an exchange gain or loss.

.087 The Board considered the purpose of consolidated financial statements under present generally accepted accounting principles in assessing whether the dollar or the foreign currency should be the appropriate unit of measure for foreign statements included in an enterprise's financial statements. *ARB No. 51*, "Consolidated Financial Statements," paragraph 1 [section 2051.02], states:

> The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions.

.088 The Board believes that to be consistent with that purpose the translation process should reflect the transactions of the entire group, including foreign operations, as though the transactions were of a single enterprise. For example, when an enterprise purchases an entity, the cost of the investment to the enterprise establishes the cost for the assets acquired for consolidated financial statements regardless of the carrying amounts recorded by the acquired entity. Therefore, even though the acquired entity may have its own recorded cost for an asset, the acquiring enterprise's cost governs in the consolidation process (paragraph .041).

.089 The dollar is usually the unit of measure for financial statements of a U.S. enterprise, and there is no controversy regarding the cost of an asset acquired by a U.S. company in a foreign currency transaction that is settled at the rate in effect at the transaction date. *Cost* is measured in dollars at the transaction date, and that cost does not subsequently change as a result of rate changes. Although advocates of a one-transaction perspective (paragraph .113) have a different view of what constitutes cost if settlement is at a rate

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different from the one in effect at the transaction date, they nevertheless recognize the dollar as the unit of measure.

.090 Since translated cost in dollars may be affected by the foreign currency chosen, attempting to use a particular foreign currency as the unit of measure for foreign statements included in dollar financial statements creates a practical problem — that of selecting the particular currency to measure the cost of an asset. For example, if an oil tanker is acquired at a price negotiated in Japanese yen and its cost is recorded in financial statements that use the U.S. dollar as the unit of measure, the dollar cost of that asset remains constant regardless of rate changes (paragraph .089). If, however, the cost is measured and recorded in the financial statements of a foreign operation and translation retains the foreign currency as the unit of measure, the cost of the tanker reported in the dollar statements changes with changes in the dollar rate for that foreign currency. That is true regardless of the currency used to acquire the asset or the currency in which revenue from use of the asset will be generated. The tanker could be used to transport oil from the Middle East to France (and other European countries) and the revenue generated thereby might be stated in French francs (or other European currencies). But the historical cost of the asset in the translated dollar financial statements would fluctuate with changes in the dollar rate for, say, the pound sterling if that were the local currency in which the cost of the tanker was originally measured and recorded.

.091 Another example that also illustrates the potential consequences of selecting the local currency of a foreign operation as the unit of measure involves goodwill. If a U.S. enterprise acquires for cash a foreign operation located in Germany at a price in excess of the fair value of the net assets acquired, the difference is recognized as goodwill. If the enterprise acquires the interest directly, the goodwill is measured in dollars and it does not change solely because of a rate change. If, however, the enterprise's Swiss subsidiary acquires the interest with the proceeds of a Eurodollar borrowing or financing from the enterprise and records the investment in the Swiss accounts, the basis for the same goodwill reported in the dollar statements will change with changes in the dollar rate for the Swiss franc even though it does not change in the Swiss accounts. Moreover, the dollar basis of the goodwill will begin a new pattern of changes based on the relation of the new currency to the dollar if the

enterprise's investment in the foreign operation in Germany is shifted from the Swiss subsidiary to, say, a subsidiary in the United Kingdom, even if the shift is for good business or tax reasons. In other words, adopting a foreign currency rather than the dollar as the unit of measure allows the translated dollar cost of an asset to be affected by discretionary selection of the accounting records in which the asset is recorded.

.092 To use more than one unit of measure in a single set of financial statements raises questions about describing the results. If various foreign currencies are used as the units of measure in translated financial statements of foreign operations of an enterprise, aggregating the resulting dollar amounts with each other and with the dollar amounts from domestic operations would produce totals that are neither dollar measures nor measures in any other currency. In the Board's judgment, the notion of a single enterprise that underlies consolidated financial statements requires a single unit of measure.

.093 Since attempting to use a foreign currency as the unit of measure both produces results not in conformity with generally accepted accounting principles and creates conceptual and practical problems, the Board concluded that the dollar, not the local currency of the foreign operation, should be the unit of measure. Thus, the Board rejected Objective D and adopted Objective C.

.094 Objectives A and C, adopted by the Board, are combined in paragraph .006 of this Statement as a single objective of translation. Some respondents to the Exposure Draft criticized that objective as an attempt to account for local and foreign currency transactions of foreign operations as if they were dollar transactions or, to a few respondents, as if they were dollar transactions in the United States. In the Board's judgment, those criticisms are not valid. Neither the objective nor the procedures to accomplish it change the denomination of a transaction or the environment in which it occurs. The procedures adopted by the Board are consistent with the purpose of consolidated financial statements. The foreign currency transactions of an enterprise and the local and foreign currency transactions of its foreign operations are translated and accounted for as transactions of a single enterprise. The denomination of transactions and the location of assets are not changed; however, the separate

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corporate identities within the consolidated group are ignored. Translation procedures are merely a means of remeasuring in dollars amounts that are denominated or originally measured in foreign currency. That is, the procedures do *not* attempt to simulate what the cost of a foreign plant would have been had it been located in the United States; instead, they recognize the factors that determined the plant's cost in the foreign location and express that cost in dollars.

.095 If translation procedures were capable of changing the denomination of an asset or liability from foreign currency to dollars, no exchange risk would be present. Translation procedures obviously cannot accomplish that, and the procedures adopted in this Statement affirm the existence of an exchange risk in foreign currency transactions and foreign operations and specify accounting for the resulting exchange gains or losses.[30]

Compatibility with Expected Economic Effects of Rate Change (Objective E)

.096 In its deliberations on each of several translation methods, the Board considered the views of respondents to the Discussion Memorandum and Exposure Draft and others who suggested, directly or indirectly, that the translation method should produce an exchange gain or loss that is compatible with the expected economic effects of a rate change. That is, the translation method should produce an exchange gain (or at least avoid producing an exchange loss) if the economic effect of a rate change appears to be beneficial and an exchange loss (or at least not an exchange gain) if the economic effect appears to be detrimental.

.097 In the Board's opinion, that objective cannot be fulfilled without major changes in the present accounting model. The economic compatibility issue is usually raised in the context of a foreign operation with significant assets carried at cost in the foreign statements and significant long-term debt denominated in foreign currency. Methods used or proposed to achieve the compatibility objective fall into one or a combination of three categories: (a) exchange gains and

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[30] Some arguments supporting translation of all accounts at the current rate raise questions about whether translation can or should result in exchange gains and losses (paragraphs .080-.082, .084-.086, and .133-.138).

losses are recognized by translating both assets carried at cost and long-term liabilities at the current rate, (b) no exchange gains or losses are recognized when exchange rates change on either assets or liabilities by translating both at historical rates,[31] and (c) no exchange gain or loss is recognized on assets translated at historical rates, and the gain or loss computed on the liabilities translated at the current rate is deferred and recognized over later periods by accounting for it (i) as an adjustment of the translated cost of the assets, (ii) as an adjustment of the effective rate of interest on the liability (that is, as a premium or discount), or (iii) as a deferred credit or deferred charge.[32]

.098 All of the proposed methods meet the compatibility objective in the sense that they at least avoid producing an exchange loss if a rate change is one that the proponents deem beneficial and avoid producing an exchange gain if a rate change is one that the proponents deem detrimental. In addition, if assets exceed liabilities, methods that translate both assets and liabilities at the current rate (paragraph .097(a)) produce a gain or loss that is in the right direction according to the proponents of the proposed objective. In the Board's view, however, the result cannot be described as an accurate measure of the beneficial or detrimental effect of a rate change because its computation involves multiplying the unamortized historical cost of assets in foreign currency by the current rate (paragraphs .106, .107, and .147-.149). Further, in the Board's judgment, the proposed methods either conflict with present generally accepted accounting principles or are unacceptable for other reasons. The Board's views that are summarized in this and the preceding paragraph are expanded and illustrated in the following paragraphs.

.099 Under present generally accepted accounting principles, the time for recognizing gains or losses on assets and liabilities depends on their carrying bases. Thus, recognition of gains and losses on assets accounted for at cost is usually deferred until the assets are sold or their costs are otherwise deducted from operating revenue. The translation method adopted by the Board retains that timing for recognition of gains and losses and by so doing amplifies or highlights one

[31] The argument that a rate change can be ignored because it will probably reverse before a debt is paid or a receivable is collected is a different issue which is considered in paragraphs .166 and .192.

[32] The three categories are discussed individually in paragraphs .140-.152, .129-.132, and .172-.194.

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effect of carrying assets at cost. A simple example illustrates the type of translated result that proponents of the compatibility objective describe as not compatible with the expected economic effect of a rate change.

.100 The balance sheet of a hypothetical foreign operation consists of FC125 in cash, FC100 owed to a local bank, and FC25 of stockholders' equity. The exchange rate is FC1 = $1. Under the translation procedures adopted by the Board, the asset and liability are translated into $125 and $100, respectively. If the rate changes to FC.50 = $1, translation at the new rate gives $250 for the asset and $200 for the liability. The net exchange gain of $25 ($125 gain on the asset less $100 loss on the liability) is almost universally accepted as the result of a valid translation procedure and few, if any, question whether it is a reasonable representation of the economic effect of the rate change.

.101 However, a different pattern of gains and losses results and a difference of opinion arises if, instead of cash or a receivable, the asset held when the rate changes is one that is normally accounted for at its cost or amortized cost. If the foreign operation in the foregoing example spends its cash balance before the rate changes to buy an asset such as inventory, land, or equipment, the cost of the asset acquired is FC125 = $125. Under the procedures adopted by the Board, the translated dollar cost remains at $125 after the rate change. The liability is translated at $200, however, resulting in an exchange loss of $100 for the period of the rate change. Proponents of the compatibility objective hold that it is erroneous to report the $100 exchange loss on the liability when the rate changes because the expected economic effect of the rate change is beneficial by reason of an equal or greater expected eventual gain on the asset.

.102 The eventual gain or loss on the asset is usually recognized when the asset is sold or its translated cost is otherwise deducted from operating revenue (translated at the new rate). Assuming the rate remains stable and the revenue in foreign currency equals cost in foreign currency, the reported gain on the sale is $125 (sales price FC125 x 1/.50 = $250 less cost $125 = $125 gain), the same as the exchange gain in paragraph 100.

.103 Two criticisms of the translation procedures adopted by the Board may confuse discussions of the economic

compatibility issue. The first is that the Board's procedures result in recognizing only the loss on the liability, thereby ignoring the gain on the asset and misstating the profitability of a net foreign investment. However, the example shows that the gain on the asset is often recognized in a later period than the loss on the liability and is often included in gain or loss on sale of the asset (as in the example), reflected in operating income as the difference between operating revenue translated at the new rate and depreciation or amortization translated at the old rate, or otherwise included in income as other than exchange gain or loss.

.104 The second criticism is that the exchange loss on the liability, which is recognized by the Board's procedures, is not really a loss in dollars because the whole series of transactions from borrowing to repayment is in the same foreign currency. However, the difference between the original borrowing (initially translated as $100) and its repayment (equivalent to $200) must be accounted for. To satisfy the debt requires the equivalent of $200 whether dollars or foreign currency are paid. No question arises if a U.S. parent transfers $200 to settle the debt. The substance is the same if the debt is paid with foreign currency received from operations in the foreign country. The cash (FC100) used to pay the debt is translated as $200 at all times between the rate change or the receipt of the cash and immediately before its use to pay the debt. Repayment of the debt requires cash with an equivalent dollar value of $200, and the loss of $100 is undeniable because cash held or received after the rate change cannot reasonably be translated at other than the new rate (FC.50 = $1). The only way to avoid recognizing a loss of $100 is to translate the original borrowing as $200 by restating the earlier financial statements as if the rate had always been FC.50 = $1. However, that is appropriate only if the foreign currency is the unit of measure in the translated statements (paragraphs .083-.086), not if the dollar is the unit of measure.

.105 Since the *incompatible* loss result described in paragraph .101 can be avoided only by anticipating the gain on the asset or by deferring recognition of the loss on the liability, the proposed objective directly conflicts with present generally accepted accounting principles. Under present generally accepted accounting principles, recognition of gains on assets carried at cost must normally await sale (or depreciation or amortization), and those gains may not be anticipated indirectly by deferring otherwise recognizable

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losses. In contrast, under present principles, identified losses should be recognized when they occur and should not be deferred as assets or deferred charges, offset against gains on unsold assets, or treated as valuation accounts to unsold assets.[33]

.106 A major obstacle to implementing the compatibility objective is that to determine whether a translation method produces a compatible exchange gain or loss, one must first be able to ascertain the expected future economic effects of a rate change. The proposal seems to rest significantly on a general assumption that a local currency's strengthening is beneficial and its weakening is detrimental. That assumption rests on a further assumption that the relation between rate changes and economic effects is reasonably straightforward — that only the rate changes, while other variables — such as output, sales volume, production costs, and sales prices — remain essentially unaffected. However, determining the expected economic effect of a rate change is more complex than that.

.107 For example, to assess the expected economic effect of a rate change on a foreign operation's investment in plant and equipment, and possibly other long-lived assets, requires a long-term economic forecast in which many interrelated and interacting forces involved in a rate change should be considered. The Board believes it may be difficult or impossible under most circumstances to predict with reasonable certainty the general effects over an extended future period of a rate change. A foreign operation in a country that experiences a major rate change may be affected both directly and indirectly by the adaptations and shifts that occur in that country's economy as a result of the currency adjustment. The nature and effect of those adaptations and modifications depend on a complex relation among factors, such as the relative degree to which general demand for imports and exports responds to changes in the foreign exchange price, the level of income and employment, the rate of economic expansion, monetary and fiscal policies instituted by the country whose currency has either weakened or strengthened, and conditions and forces existing in countries that are major trading partners. Accordingly, a foreign operation may experience complex changes in the

[33] Matters relating to recognizing gains on assets carried at cost or deferring losses on liabilities are discussed further in paragraphs .147-.149 and .172-.194.

local market demand and market price for its goods, changes in its local cost of goods and services procured, and in the local availability and cost of financing. Moreover, not all operations in the same environment will be affected in the same way because of differences in activities and realignments of price and cost structures within the local economy. In addition, a foreign operation's exposure to the effect of a rate change may go beyond its recorded assets and liabilities. A foreign operation's unrecorded exposure to rate changes might include, for example, sales and purchase backlog commitments at fixed foreign currency prices or fixed foreign currency streams of revenue or expense, such as rent payments. The proposed objective could be impractical in many circumstances because of the foresight required to identify the future economic effects of a rate change at the time it occurs.

.108 Finally, the proposed compatibility objective seems to be based on an assumption that it is needed only in translating foreign statements that are to be incorporated in the financial statements of a U.S. enterprise. However, it appears to be a response to the fact that U.S. generally accepted accounting principles require certain assets to be accounted for at cost. The argument for economic compatibility of reported results with expected effects of rate changes could be directed with equal force to reporting foreign currency transactions of a U.S. enterprise or, with minor modification, even to reporting its domestic operations.

.109 For example, a U.S. enterprise serves the needs of important foreign customers by selling them the entire output of a plant located in the United States. The enterprise also owes long-term debt denominated in the foreign currency, and as a result of the dollar's weakening against the foreign currency it incurs an exchange loss. However, the rate change appears to be beneficial to the enterprise because, other things remaining constant, the dollar value of its foreign revenue (and therefore also its dollar net income) should increase. To report a result compatible with that assessment requires recognition of a gain from an upward adjustment of the related plant assets. Further, a rate change involving a weakening dollar has the same effects on expected dollar revenue and expected dollar gross profit as an increased selling price in a U.S. market. Consistent with the compatibility objective, therefore, an increase in the selling

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price of the output of a U.S. plant that produces for the U.S. market should, other things being equal, result in a reported gain from revaluation of the plant compatible with the expectation of its improved future revenue and profits. That those kinds of gains are not now recognized reflects a characteristic of present generally accepted accounting principles, not a defect in the Board's translation procedures.

.110 Present financial accounting and reporting reflects primarily the effects of past transactions and existing conditions, not future transactions or conditions. Accordingly, assets are generally carried at cost, and related gains are recognized only when assets are sold or the cost is otherwise deducted from revenue. Many have commented on the strengths and weaknesses of the present accounting model, and some have proposed major changes in it. This Statement pertains to translation of foreign currency transactions and foreign currency financial statements, and the Board believes that consideration of fundamental changes in generally accepted accounting principles relating to measurement bases of assets and liabilities is beyond this Statement's scope. The Board does not intend to use translation procedures to effect major changes in the accounting model presently in use.

.111 Since, for the reasons given, the Board chose an objective of translation and a translation procedure that preserve the present accounting model, it rejected proposed Objective E. The Board rejected the view that the objective of compatibility can be implemented by changing translation procedures without considering the implications for underlying concepts and measurements.

FOREIGN CURRENCY TRANSACTIONS

Import or Export of Goods or Services

.112 The Board's conclusions on accounting for foreign currency transactions reflect the view that collection of a receivable or payment of a liability is a transaction separate from the sale or purchase from which the receivable or liability arose. Thus, if an enterprise has foreign currency exchange exposure (*exchange exposure*) on a receivable from a sale or a liability from a purchase requiring settlement in foreign currency, the results, if any, of that exchange exposure should be accounted for separately from sales, cost

of sales, or inventory. A rate change does not affect previously recorded revenue from exports or the cost of imported goods or services.

.113 An alternate view, sometimes referred to as a one-transaction perspective, is that a transaction involving purchase or sale of goods or services with the price stated in foreign currency is incomplete until the amount in dollars necessary to liquidate the related payable or receivable is determined. The initial amount recorded in dollars as cost or revenue is considered to be an estimate until final settlement. According to that view, an exchange gain or loss related to the transaction should be treated as an adjustment of the cost of imports or revenue from exports.

.114 The Board considered and rejected the one-transaction view. Specifically, the Board rejected the idea that the cost of an imported asset or the reported revenue from an export sale is affected by later changes in the related liability or receivable. The exchange exposure in a purchase or sale transaction whose price is denominated in foreign currency stems not from the purchase or sale itself but from a delay in payment or receipt of the equivalent dollars. No exchange gain or loss can occur if, as soon as the price is fixed in foreign currency, the U.S. purchaser immediately buys foreign currency with dollars and pays the foreign seller, or the U.S. seller receives foreign currency from the foreign buyer and immediately converts it into dollars. In other words, exchange gains and losses on import or export transactions result from a combination of a rate change and one of the following: the U.S. buyer owes an amount denominated in foreign currency, or the U.S. seller holds a receivable denominated in foreign currency or holds foreign currency received from a foreign buyer.

.115 The exchange gain or loss that may result from an exchange exposure is the result of an event (a rate change) that is separate from the original purchase or sale transaction. Since an exchange exposure can usually be eliminated, a determination not to avoid exchange exposure should be accounted for by recognizing the gain or loss that results from that decision.

.116 Paragraph .007(a) specifies that the purchase or sale price in foreign currency be translated into dollars at the rate in effect at the transaction date. Since transactions are often

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preceded by commitments, and exchange exposure may be viewed as beginning at the commitment date if the price is fixed in foreign currency at that time, the dollar basis of the transaction might be established at the commitment date rather than the transaction date. However, a major obstacle to choosing the commitment date is the fact that, although certain commitments are often disclosed, rarely are commitments recorded under present generally accepted accounting principles. Losses on *firm* commitments are recorded [34] but not the commitments themselves. The Board believes that recognizing exchange gains and losses on a commitment date basis would be both impracticable and inconsistent with the timing of recognizing the underlying transaction in the financial statements.

.117 A commitment date basis could present implementation problems because various degrees of commitment are possible before consummation of a business transaction. For example, a noncancelable sales contract negotiated in a foreign currency might be considered by some as a reasonable basis on which to recognize an exchange gain or loss. However, a firm commitment to provide goods or services might require a commitment by the seller to purchase goods or services in foreign currency to fulfill his obligation. Both commitments would need to be considered to reflect exchange gains and losses properly on a commitment date basis, but the purchase obligations might not necessarily be in the form of fixed contractual commitments. Moreover, since commitments are not now recorded, measuring exchange gains and losses from a commitment date would require ascertaining the commitment date on each individual transaction. An importer or exporter with relatively few individual transactions might manage that, but it would be burdensome, if not impossible, for one with numerous foreign currency transactions or for a foreign operation to separate transactions with commitments from those without commitments and maintain a record of commitment dates, prices, and applicable exchange rates.

.118 The problem of inconsistency in using the commitment date under present generally accepted accounting principles is illustrated by a long-term supply contract for raw materials

[34] *ARB No. 43,* Chapter 4, Statement 10 [section 5121.17] reads: "Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts."

under which both the purchaser and the seller now recognize cost and revenue, respectively, in their financial statements on a performance basis. Since that kind of agreement might be considered a commitment, an enterprise that is party to a five-year supply contract requiring payments in a foreign currency may conceivably have a significant exchange gain or loss if the total future payments are considered on a commitment basis. Since the supplier recognizes revenue and operating profit over the life of the contract, for him to recognize as current gain or loss the expected effect of a rate change on future income would be inconsistent with the timing of recognition of the operating income from the contract. Likewise, an enterprise that must pay foreign currency for its raw materials could also have a significant exchange gain or loss, but its immediate recognition (except to the extent of "accrued net losses on firm purchase commitments"[35]) would be inappropriate for similar reasons.

Foreign Borrowing or Lending

.119 The Board's conclusions on accounting for foreign currency transactions involving the borrowing or lending of foreign currency reflect the view that the effect of a rate change on the repayment or collection of a loan should be accounted for separately from the original borrowing or lending transaction. An alternate treatment considered by the Board is based on a one-transaction perspective similar to that described in paragraph .113: that an exchange gain or loss related to a loan payable denominated in foreign currency is an adjustment of the cost of assets purchased with the borrowed funds. The Board's reasoning in rejecting a one-transaction perspective for borrowing foreign currency is similar to that stated in paragraphs .114 and .115.

.120 Another possibility in accounting for borrowing or lending of foreign currency is to treat a related exchange gain or loss as an adjustment of the cost of borrowing or the return from lending. Following that concept, an enterprise ideally would adjust the cost or return from funds borrowed or loaned by using the interest method to amortize expected exchange gains or losses on principal and interest over the life of the debt or receivable. Since at the date of lending or borrowing it is impossible to predict the rates that will prevail

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[35] *ARB No. 43,* Chapter 4, Statement 10 [section 5121.17].

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during the life of the loan, prospective (and partially retroactive) methods have been suggested to amortize the exchange gain or loss. The Board rejected those methods for the reasons stated in paragraphs .164, .181, and .182.

FOREIGN STATEMENTS

.121 Paragraphs .123-.139 compare four normative methods for translating assets and liabilities measured in foreign currency against the objective of translation adopted by the Board (a situational approach to the application of those methods is discussed in paragraphs .140-.152). The principal distinction among various normative methods of translation is the requirement to translate particular classifications of assets and liabilities at either the current or historical rate.

a) The temporal method translates cash, receivables and payables, and assets and liabilities carried at present or future prices at the current rate and assets and liabilities carried at past prices at applicable historical rates.

b) The monetary-nonmonetary method generally translates monetary assets and liabilities at the current rate and nonmonetary assets and liabilities at applicable historical rates. For translation purposes, assets and liabilities are monetary if they are expressed in terms of a fixed number of foreign currency units. All other balance sheet items are classified as nonmonetary.

c) The current-noncurrent method generally translates current assets and liabilities at the current rate and noncurrent assets and liabilities at applicable historical rates.

d) The current rate method translates all assets and liabilities at the current rate.

.122 The objective of translation requires that the assets, liabilities, revenue, and expenses in foreign statements be translated and accounted for in the same manner as assets, liabilities, revenue, and expenses that result from foreign currency transactions of the enterprise (paragraph .009). Since foreign statements are prepared in conformity with U.S. generally accepted accounting principles before translation, the objective is generally achieved by (a) translating cash,

receivables, and payables at the current rate and (b) translating other assets and liabilities in a way that retains the accounting principles used to measure them in the foreign statements. The Board adopted intact none of the four normative methods considered but found the temporal method, proposed by *ARS No. 12* (see footnote 20), the most useful in meeting the objective.

Temporal Method

.123 The temporal method generally translates assets and liabilities carried at past, current, or future prices expressed in foreign currency in a manner that retains the accounting principles used to measure them in the foreign statements. That is, the measurement bases of the assets and liabilities measured are the same after translation as before. Thus, the temporal method changes a measurement in foreign currency into a measurement in dollars without changing the basis of the measurement and thereby achieves one of the objectives of translation, which is to retain the measurement bases of foreign statement items (paragraph .082). The temporal method can also accommodate any basis of measurement — for example, historical cost, current replacement price, or current selling price — that is based on exchange prices.

.124 The translation procedures to apply the temporal method are generally the same as those now used by many U.S. enterprises under the monetary-nonmonetary method. The results of the temporal method and the monetary-nonmonetary method now coincide because under present generally accepted accounting principles monetary assets and liabilities are usually measured at amounts that pertain to the balance sheet date and nonmonetary assets and liabilities are usually measured at prices in effect when the assets or liabilities were acquired or incurred. The monetary-nonmonetary classification itself contains nothing to preserve the measurement bases and timing of revenue and expense recognition that are in the foreign statements (paragraphs .126 and .127). Rather, the coincidence of results between the monetary-nonmonetary method and the temporal method is due solely to the nature of present generally accepted accounting principles — assets and liabilities are measured on bases that happen to coincide with their classifications as monetary and nonmonetary. The results of the temporal method and the monetary-nonmonetary method would differ significantly under

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other accounting principles that, for example, required nonmonetary assets and liabilities to be measured at prices in effect at dates other than those at which they were acquired or incurred. Since the temporal method retains the measurement bases of the foreign statements equally as well under all accounting methods based on exchange prices as it does under historical cost accounting, the Board believes that it is the more generally valid method for achieving the objective of translation. It provides a conceptual basis for the procedures that are now used to apply the monetary-nonmonetary method.

.125 The same point as in the preceding paragraph also applies to the current-noncurrent method. Some of the translation procedures under that method are the same as under the temporal method, but the major exceptions include translation of current assets carried at cost (inventory and prepaid expenses) and noncurrent liabilities and receivables. The current-noncurrent classification itself contains nothing to preserve accounting principles after translation (paragraph .129), but under present generally accepted accounting principles the measurement bases of many assets and liabilities happen to coincide with their classification as current or noncurrent. The major exceptions — inventory and long-term debt — show the deficiencies of the method when the measurement bases and the classifications do not coincide. As long as most foreign currencies weakened against the dollar, as they usually did from the time of the original writing of Chapter 12 of *ARB No. 43* [section 1081] until about 1969, translating inventory at the current rate and long-term debt at historical rates under the current-noncurrent method probably produced conservative results. Inventory was stated lower in dollars than if translated at historical rates (though not necessarily at the lower of cost or market as described in paragraphs .046-.049), and exchange gains (not losses) on long-term debt were deferred until the time of settlement or classification as a current liability. Once the dollar began to weaken against foreign currencies, however, that translation method lost its conservative appeal because it produced the opposite results.

Monetary-Nonmonetary Method

.126 The monetary-nonmonetary method produces acceptable results under present generally accepted accounting principles (paragraph.124), but no comprehensive

principle of translation can be derived solely from the monetary-nonmonetary distinction. Nonmonetary assets and liabilities are measured on different bases (for example, past prices or current prices) under different circumstances, and translation at a past rate does not always fit. Translating nonmonetary items at a past rate produces reasonable results if the items are stated at historical cost but not if they are stated at current market price in foreign currency.

.127 For example, if a foreign operation purchases as an investment 100 shares of another company's common stock (a nonmonetary item) for FC1,000 when the rate is FC1 = $1, the cost of that investment is equivalent to $1,000. If the investment is carried at cost by the foreign operation, treating the investment as a nonmonetary item and translating it at the historical rate is appropriate. However, if the investment is carried at market price, translating that basis by the historical rate usually produces questionable results. For example, if the current market value of the investment is FC1,500 and the current rate is FC1 = $1.25, translating FC1,500 into $1,500 using the historical rate does not result in the current market value measured in dollars (FC1,500 x 1.25 = $1,875) or the historical cost in dollars. The monetary-nonmonetary method can produce the $1,875 current market value only if it is recognized that, under the method, the current rate is the applicable historical rate for nonmonetary assets carried at current prices. The point has been confusing enough to cause some proponents of the monetary-nonmonetary method to argue that nonmonetary assets, such as investments and inventories, become monetary assets if they are carried at market price.

.128 Although the deficiencies of the monetary-nonmonetary method have been recognized and dealt with in practice, the Board found the monetary-nonmonetary method concept inadequate as a comprehensive method of translation.

Current-Noncurrent Method

.129 Existing definitions of current and noncurrent assets and liabilities contain nothing to explain why that classification scheme should determine the rate used to translate. The attributes of assets and liabilities that are measured in financial statements differ from their characteristics that determine their classification as current or noncurrent. Consequently, different kinds of assets or

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liabilities may be measured the same way but classified differently or classified the same way but measured differently. For example, under present generally accepted accounting principles both inventory and plant and equipment are measured at historical cost, but inventory is classified as a current asset and plant and equipment as noncurrent assets. Since translation is concerned with measurement and not with classification, the characteristics of assets and liabilities that determine their classification for purposes of disclosure are not relevant for selecting the rate for translation. The weaknesses of the method are most pronounced in translating inventory and long-term debt.

.130 Under the current-noncurrent method, inventory carried at historical cost in foreign statements is generally translated at the current rate. As indicated in paragraph .134, that translation results in a measure in dollars that departs from historical-cost-based accounting. Later changes in market prices or rates cannot change the historical cost of an asset already owned. Once recorded, the historical cost of an asset can be amortized or otherwise included in expense in accounting records but cannot be changed because of varying prices without changing the basis of accounting from historical cost to something else. (Paragraphs .153-.158 give additional reasons for the Board's rejection of the current rate to translate inventory carried at cost.)

.131 Measured in local currency, long-term debt denominated in local currency and a related unamortized discount or premium (determined by the interest method) together represent the present value of future interest and principal payments based on the effective rate of interest at the date the debt was incurred. Translating long-term debt and a related discount or premium at the historical rate after a rate change, as required by the current-noncurrent method, does not retain that measurement basis. Translation at the historical rate produces a result that is unrelated to the current dollar equivalent of the present value of the remaining interest and principal payments based on the effective rate of interest at the date the debt was incurred. Furthermore, unless the rate change reverses before the debt is settled, translation at the historical rate merely delays recognition of the exchange gain or loss — it does not avoid the gain or loss. (Paragraph .164 gives additional reasons for translating long-term debt at the current rate.)

.132 For the reasons set forth in paragraphs .129-.131, the Board rejected the current-noncurrent method.

Current Rate Method

.133 The current rate method is, of the four normative methods discussed, the most significant departure from present practice. The arguments for the current rate method discussed in this section are related to those for using the foreign currency as the unit of measure (paragraphs .083-.093). The current rate is used under the situational approach, discussed in the next section, but the underlying concept there is different.

.134 The Board believes that a foreign operation's assets and liabilities should be measured in the foreign statements in conformity with U.S. generally accepted accounting principles applicable to the reporting enterprise and that those principles should be retained in the translation process (paragraphs .082 and .122). If assets and liabilities that are measured at past prices in foreign statements are translated at the current rate and included in dollar financial statements, the dollar financial statements depart from historical-cost-based accounting because inventory, property, plant, equipment, and other assets normally carried at cost are reflected at varying dollar amounts resulting from changes in rates. The dollar amounts do not, except by coincidence, represent reasonable measures of replacement cost or selling price and would be unacceptable under present U.S. generally accepted accounting principles even if they did.

.135 A contrary view expressed is that the historical cost of an asset acquired by a foreign operation can be measured only in the foreign currency and that the asset has no historical cost in dollars. According to that view, translating the foreign currency historical cost of an asset into a fewer or greater number of dollars following a rate change is simply the result of an *absolute, mathematical revision in the rate* and thus does not represent a departure from the historical-cost principle of accounting; the foreign currency cost is the only historical cost, and that cost has not changed.

.136 Some advocates of the view described in paragraph .135 believe that the results of the *absolute, mathematical revision* is an exchange gain or loss and others do not. Those who support the foreign currency as the unit of measure would restate prior financial statements because of the rate change

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and, therefore, would report no exchange gain or loss. Those who support the dollar as the unit of measure would report an exchange gain or loss as a result of a rate change. The Board believes that latter approach is inconsistent with the view that there can be no dollar measure of the historical cost.

.137 The Board believes that although an asset's acquisition price may have been stated in a particular currency, its equivalent cost in another currency can be approximated by multiplying the stated currency price by the rate in effect at the date of acquisition. Just as the length of an object can be measured in inches and then remeasured in centimeters by applying the appropriate conversion rate, the *cost* of an asset can likewise be measured in various units of measure (different currencies) by applying the appropriate translation rates.

.138 Assets in foreign countries can be purchased indirectly for dollars by acquiring the necessary foreign currency in a foreign exchange market. The situation is not fundamentally different if the foreign currency is acquired before the purchase; the dollar cost of the purchase is known through the measurement conversion process (paragraph .137). Or, viewed another way, spending foreign currency to buy an asset means that the currency cannot be converted into dollars for remission to a U.S. parent. The dollars not received in conversion because the foreign currency was used to buy an asset — the dollars foregone — are the cost of the asset acquired in the most literal sense of the word *cost.*

.139 Accordingly, the Board rejected the view that historical cost can be measured only in the foreign currency. It also rejected use of the current rate method based on that premise for the reason stated in paragraph .134 as well.

A Situational Approach to Translation

.140 Paragraphs .123-.139 compared the four basic normative methods for translating balance sheet accounts against the objectives of translation adopted by the Board. Another, somewhat different, approach to translation has also been suggested, which is not a normative method but looks instead at the nature of each foreign operation. It distinguishes between foreign operations that are extensions of affiliated

domestic operations (*dependent* operations [36]) and those whose operations are essentially self-contained and, therefore, not dependent on affiliated domestic operations (*independent* operations [36]). The situational argument is that since many factors influence the creation of a foreign operation, translation must look further than the location of a business operation; it should also look at its nature.

.141 According to that view, if a foreign operation depends on domestic operations, the foreign operation should be accounted for as an extension of those domestic operations (that is, as part of a single domestic operation) and its foreign statements should be translated by one of the normative methods other than the current rate method. If a foreign operation is independent, its foreign statements should be translated by the current rate method.

.142 A principal reason given to support using the current rate method to translate independent foreign operations is that the assets and liabilities of those operations are not individually at risk to rate changes; rather, the entire business is at risk. Since the foreign activities are conducted entirely in a foreign environment and future cash flows will be in a foreign currency, future operating results can be expressed in a meaningful way in dollars only if all revenue and costs (including those carried forward from a period before the rate change) are translated at the current rate. From the enterprise's viewpoint, its net investment in the foreign operation represents its total exposure to a rate change. Only by translating the net assets of the foreign operation at the current rate can the effect of rate changes be properly measured.

.143 The situational approach involves both practical and conceptual problems, including the difficulty of finding or developing criteria or conditions to distinguish *independent* and *dependent* foreign operations. Proponents of the situational approach have explained the distinctions only broadly and have not given specific criteria. A few circumstances have been suggested or implied as indicating independence, such as regulation of the foreign operation by local authorities or a minimum of intercompany sale and borrowing transactions between the foreign operation and its parent or other domestic affiliates.

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[36] The terms *dependent* and *independent* were used by Parkinson (see footnote 20) and are used in the same context here.

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.144 The Board considered criteria for independence of foreign operations but was unable to develop criteria that it believed to be satisfactory to identify an independent foreign operation. At least part of the difficulty lies in the inherently contradictory concept of an independent subsidiary, which seems to deny the single enterprise concept that underlies consolidated financial statements (*ARB No. 51*, paragraph 1 [section 2051.02]). If foreign operations are as independent of their U. S. parent companies as some proponents of the situational approach seem to argue, the validity of consolidating them is questionable. Further, since many domestic subsidiaries may also have the characteristics of independent operations, however *independence* is defined, the distinction has implications that reach beyond translation of foreign statements.

.145 Certain respondents to the Discussion Memorandum and Exposure Draft, recognizing the purpose of consolidated financial statements as set forth in paragraph .087, recommended that if the current rate method were deemed appropriate for certain foreign operations for the reasons set forth in paragraph .142, those operations should be accounted for under the equity method rather than line-by-line consolidation. The Board believes that the situational approach raises broad questions about concepts of consolidation and the equity method applicable to domestic as well as foreign operations that are beyond the scope of this Statement.

.146 Even if criteria could be developed, there are apt to be problems in applying any set of criteria to determine independence, including whether foreign operations should be viewed on the basis of country-by-country, foreign - operation - by - foreign - operation, or segment - by - segment of each foreign operation. In addition, changes in classification (from dependent to independent or vice versa) between reporting periods, presumably necessitating the use of different translation methods for each period, could produce results that would not be comparable with those of prior periods. It is also unclear how to translate the financial statements of a foreign operation that is independent of its parent but dependent on another foreign economy (for example, a foreign operation that manufactures its product in various European countries and sells its product to an unaffiliated or affiliated South American operation).

.147 The situational approach is a way of looking at the exchange exposure of foreign operations that are considered independent, and the effect of a rate change on the net investment is a gain or loss to be included in income of some accounting period. Proponents of the approach believe that the results are erroneous if exchange gains and losses on liabilities are recognized earlier than exchange gains and losses on assets, especially since the latter are not identified in operating results as exchange gains and losses (paragraphs .100-.102 contain an example). They argue that a foreign operation involves risk of rate changes in addition to the other risks involved in every business operation, and translation procedures should measure the effects of exchange risk. They argue further that since gains and losses can only be measured through valuations, translation must involve valuation at the current exchange rate — the effect of exchange risk is measured by valuing *all* assets and liabilities before and after movements in the rate. Or stated in another way, a net investment is an integrated whole on which the effect of a rate change can best be determined by multiplying the investment by the change in rate. According to that view, all independent foreign operations in a country whose currency weakens should be worth less (the net investment multiplied by the decline in rate gives an exchange loss) and, conversely, independent foreign operations in a country whose currency strengthens should be worth more.

.148 However, translation is a poor valuation process for assets carried in financial statements at cost because it relies on prices in a single market. It reflects only the exchange price between dollars and a single foreign currency and does not adequately reflect prices in other markets in which a foreign operation could buy or sell those assets. Thus, multiplying the historical foreign currency cost of an asset by the current rate cannot, except by coincidence, measure the value of the asset. For example, an enterprise in England acquired land in 1964 at a cost of 1,000,000 pounds sterling when the rate was £1=$2.80; the dollar equivalent historical cost was, therefore, $2,800,000. If the land being carried at cost in the foreign statements at December 31, 1974 is multiplied by the current rate £1=$2.35, the product will be $2,350,000. However, the current dollar equivalent of the value of that land may be more or less than $2,350,000 and depends on prices not included in either historical-cost-based financial statements or exchange rates. In other words,

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translation procedures cannot measure the dollar value of a foreign investment that is subject to exchange risk unless the current value of the investment is included in the foreign statements.

.149 Some respondents to the Exposure Draft interpreted the Board's emphasis on a translation method that preserves the measurement bases of assets and liabilities in foreign statements as a denial that translation at the current rate involves valuation. On the contrary, the Board recognizes that accounting for certain assets and liabilities (for example, inventory or investments carried at market price, obligations for pensions and warranties) involves estimates and valuation in the foreign statements and that translating those items at the current rate after a rate change introduces an additional value change in dollars. Foreign currency and receivables and payables denominated in foreign currency are stated in a fixed number of foreign currency units regardless of rate changes, and their foreign currency measures do not change when the rate changes. However, their dollar measurements change solely as a result of a rate change; that value change, which does not exist in the foreign statements, is the exchange gain or loss. The Board believes that all of the value changes in dollars described in this paragraph are the valid result of remeasuring foreign statements in dollars. What the Board did reject, for reasons given in the preceding paragraph, was translation at the current rate of items carried at cost in the foreign statements. In the Board's view, that procedure is not a valid valuation process and, further, it is unacceptable under the historical-cost-basis of accounting required by current generally accepted accounting principles.

.150 The key distinction in the situational approach to translation is between independent and dependent foreign operations, and the difference can result in significantly different accounting. Thus, if the purchase of land in the example in paragraph .148 was financed by locally incurred long-term debt due on December 31, 1974, the $2,350,000 equivalent of the payment to liquidate the debt is $450,000 less than the $2,800,000 equivalent proceeds of borrowing. If the foreign operation is considered to be independent by the advocates of the situational approach, both the land and the debt are translated at the current rate, and no exchange gain or loss is recognized when the rate changes because the amount of the debt equals the carrying basis (cost) of the asset, leaving no net investment subject to exchange risk. If,

however, the foreign operation is assumed to be dependent on its parent, advocates of the situational approach agree that the $450,000 should be recognized as gain on the debt in determining net income over the 10-year period (although they may disagree on the timing of recognition) and that no exchange loss because of the weakening of the pound sterling should be recognized on the land, which is translated at the historical rate.

.151 The Board can see no reason to base the calculation and recognition of exchange gains and losses solely on the dependence or independence of foreign operations. If the argument is sound that the net investment, rather than individual assets and liabilities, is subject to exchange exposure, it is as sound for dependent as for independent foreign operations. To hold that an independent foreign operation is fundamentally different from a dependent operation raises questions about the propriety of consolidation for independent operations that, as already noted, are beyond the scope of this Statement (paragraph .144). In summary, the Board recognized that foreign operations may be structured differently but could find no persuasive reasons to translate their financial statements differently for purposes of consolidation or combination with financial statements of a U.S. reporting enterprise.

.152 A modification of the situational approach to translation is the suggestion that to apply the current rate method to foreign operations located in highly inflationary economies (for example, some South American countries), the foreign statements first should be restated in terms of units of the general purchasing power of the local currency and then translated at the current rate because to do otherwise could produce unreasonable results in dollars. The Board believes that, even without the problem of identifying *highly inflationary* economies, restating part but not all of an enterprise's financial statements in units of general purchasing power mixes the units of measure used in the financial statements and results in an aggregation of numbers that cannot be meaningfully described except in terms of the procedures followed to obtain them. That is, adding units of general purchasing power (the unit of measure used in the restated foreign statements) translated at the current rate and units of money (the unit of measure used in conventional statements) produces a total that represents neither aggregate units of money nor aggregate units of general purchasing

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power. Moreover, to restate in units of general purchasing power only foreign statements in currencies that weaken against the dollar is to introduce a bias into the translated statements. According to its advocates, translation under the situational approach of all assets and liabilities at the current rate results in exchange losses on investments in countries with weakening currencies and exchange gains on investments in countries with strengthening currencies (paragraph .147). The proposed linking of translation at current rate and restatement in units of general purchasing power of foreign statements has the effect of reducing the exchange losses that normally result from translating net investments in countries with weakening currencies at the current rate while at the same time leaving undiminished the exchange gains that normally result from translating net investments in countries with strengthening currencies at the current rate.

Translation of Inventory

.153 Numerous respondents to the Discussion Memorandum and Exposure Draft recommended that inventory carried at cost be translated at the current rate. Many of those recommendations were from supporters of the current rate or current-noncurrent methods. The Board rejected those methods for reasons given in paragraphs .129-.139. Others argued or implied that inventory should be considered a monetary asset because it is but one step removed from accounts receivable and will soon bring cash into the enterprise. That view is rejected not only because inventory is a nonmonetary asset (paragraph .127) but also because the monetary-nonmonetary distinction is not an appropriate criterion in this Statement for choosing the applicable rate.

.154 Several respondents who generally supported the monetary-nonmonetary or temporal methods recommended that inventory carried at cost — other than on a last in, first out (LIFO) basis — should be translated at the current rate. (Some respondents would apply the current rate to LIFO inventory.) The reasons they gave for that major exception to methods they otherwise supported was the need to reflect economic reality or the impracticality of applying historical rates to inventories.

.155 Certain advocates of the exception described in the preceding paragraph argued that translating inventory at historical rates distorts the dollar gross profit during an

inventory turnover period after a rate change. Related arguments given for reflecting economic reality by using the current rate were that inventory is exposed to exchange risk the same as a receivable and that deducting cost of goods sold translated at historical rates from operating revenue translated at the current rate produces *inventory profits* or *paper profits* if the foreign currency strengthens.

.156 Translating inventory carried at cost at the current rate departs from historical-cost-based accounting (paragraph .134). A desire to approximate replacement cost of inventory may underlie some arguments for using the current rate, which are similar to those used to support replacement cost methods. However, even if the use of replacement cost were presently acceptable in principle, translating inventory cost in foreign currency at the current rate does not, except by coincidence, give a reasonable approximation of replacement cost for reasons given in paragraph .148. Nor does that translation method measure the exposure of inventory to rate changes because the basis of the exposure risk is unrecorded. The exchange exposure of inventory depends on its future selling price, not on its cost.

.157 Applying historical rates to inventory may result in a dollar gross profit on sales immediately after a rate change that differs from the dollar gross profit both on sales before the rate change and on sales after the inventory turnover period following the rate change. The Board believes that is the expected result of using the dollar as the unit of measure in concert with generally accepted accounting principles. That is, when selling prices change, matching historical cost of inventory with sales affects gross profit both in dollar statements of the parent company and in translated statements of foreign operations. For example, gross profit increases in the parent's statements if cost of inventory is deducted from sales after a selling price increase, resulting in so-called *inventory profits* from inflation. In other words, the phenomenon criticized is a feature of historical cost accounting; translation of inventory at historical rates does not introduce that feature.

.158 The Board rejected in principle the proposal to translate inventory at the current rate for the reasons given in the preceding paragraphs. However, the Board recognized the practical aspects of applying historical rates to detailed inventory records and provided for the use of averages and

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other reasonable approximations as long as the result is not materially different from the result of following the standards of this Statement (paragraph .029). Translating all or part of an inventory at the current rate may under certain circumstances give a reasonable approximation of translation at historical rates.

Translation of Revenue and Expense Accounts

.159 The Board believes that the transaction method, rather than the closing rate method, should be used to translate revenue and expense accounts because it satisfies an objective of translation adopted by the Board, namely, to measure all transactions in a single unit of measure (dollars).

.160 The closing rate method, in contrast, is linked to the view that the foreign currency should be retained as the unit of measure, requiring at least two units of measure in an enterprise's financial statements. Translating revenue and expenses at the closing rate retains the foreign currency as the unit of measure for transactions occurring during the year (including those previously reported for interim periods). If the rate changes, dollar translations of prior local currency transactions during the current year are restated (updated) to reflect the new dollar equivalents of the transactions, and no exchange gain or loss on the current year's transactions is separately recognized. Since the Board believes that the dollar, rather than the foreign currency, should be the unit of measure in translated statements, it rejected the closing rate method.

EXCHANGE GAINS AND LOSSES

Foreign Currency Transactions

.161 The Board concluded that an exchange gain or loss shall be recorded when a rate change occurs because (a) when the rate changes, certain assets and liabilities should be adjusted to reflect the new rate (paragraph .007(b)), (b) the resulting gain or loss is not an adjustment of the cost of an asset acquired in a foreign purchase or of the revenue recorded in a foreign sale (that is, the Board rejected the so-called *one-transaction* view), and (c) other methods of deferring recognition of the gain or loss are also unacceptable (paragraphs .163-.166).

.162 The Board also concluded that the accounting treatment specified in paragraph .017 offers more practical implementation than does a one-transaction view. Current recognition of an exchange gain or loss does not require, as does the one-transaction view, the tracing of exchange gains or losses on foreign currency payables or receivables to related assets, revenue, or expenses. Another implementation problem under the one-transaction view is that a purchase or sale of goods or services may take place in one accounting period and an exchange gain or loss on the related payable or receivable may occur in a subsequent period.

.163 Other alternative answers considered and rejected were (1) to record an exchange gain or loss when payables or receivables are settled, (2) to record an exchange gain or loss when the rate changes more than a specified percentage from the rate previously used, and (3) to record no gain or loss if the rate change is likely to reverse.

.164 The Board views an enterprise that holds foreign currency or has a receivable or a payable denominated in foreign currency as being in a special situation, namely, the enterprise is subject to a gain or loss solely as a result of a rate change. Accordingly, when the rate changes, an exchange gain or loss resulting from the adjustment of accounts denominated in foreign currency should be immediately included in the determination of net income to report properly the results of that situation at the time it occurs. Financial statement users are thus informed of the results of a rate change in the period of change rather than at conversion or settlement in a later period, which may be several years after the rate change for certain receivables and payables. Methods that involve amortizing exchange gains or losses also fail to recognize the effect of a rate change in the period of occurrence and are, therefore, also rejected (paragraphs .173-.182).

.165 The Board considered and rejected the possibility of recording exchange gains and losses only if the rate changes more than a specified percentage. The allowable percentage range chosen, within which rates might fluctuate without affecting the financial statements, would of necessity be arbitrary. A more serious weakness in the proposal is that, since even a relatively minor change in rate can sometimes have a material impact on the financial statements, depending on the size of an enterprise's exposed position in the foreign

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currency, the method may ignore material effects of rate changes. Therefore, the Board concluded that the rate at the balance sheet date should be used.

.166 The Board also considered and rejected the view that an exchange gain or loss should be deferred if the rate change that caused it is likely to reverse. The argument is that to recognize gains and losses from all rate changes in determining net income creates needless fluctuations in reported income by reporting exchange gains and losses that are cancelled by reversals of rate changes. The Board rejected the underlying argument and its implication for accounting (paragraphs .196-.199). The proposal is also incapable of practical application. First, it requires distinguishing rate changes that will reverse from those that will not. Second, it requires predicting the changes in an enterprise's exposure to rate changes between the time of a rate change and the time of its reversal. And third, it requires an arbitrary time limit to prevent rate changes from being ignored indefinitely. The proposal contains no objective basis for accounting measurement.

Foreign Statements

.167 In concept, exchange gains or losses from translating foreign statements are the direct effects, measured in dollars on existing assets and liabilities at the dates rates change, that are attributable solely to rate changes between the foreign currency and the dollar.

.168 In practice, however, the exchange gain or loss is usually determined at the close of a period by translating both the ending balance sheet and income statement accounts at the rates required by the translation method (that is, current or historical rates for assets and liabilities and weighted average rate for most revenue and expenses). When the translation is completed and the net income less dividends in dollars is added to the beginning dollar balance of retained earnings, the sum of those amounts will usually not equal the ending dollar retained earnings shown in the translated balance sheet. The difference is the exchange gain or loss from translating foreign statements.

.169 Applying the translation procedures for foreign statements (paragraphs .011-.014) results in an appropriate measure in dollars of the net income of a foreign operation consistent with the objective of translation. However, the

method in practice of calculating the exchange gain or loss from translating foreign statements, as described in paragraph .168, may sometimes include in exchange gains or losses other gains or losses from market price changes. For example, an enterprise that uses the dollar as its unit of measure acquires securities that it accounts for at current market price, and those securities' prices are stated in foreign currency. Since the cost of the securities acquired and subsequent changes in market price are recorded in dollars (not in foreign currency), following the procedures required by paragraphs .007(a) and .007(c), the accounting does not produce *exchange gains and losses* as described in paragraph .016. In the Board's view, it is unnecessary in measuring and recording transactions and events in dollars to distinguish between the effect of changes in the foreign market price of a security and changes in the market price of the foreign currency itself, even if that distinction can be made. To meet the objective of translation (paragraph .009), the same result should be obtained in translating similar securities presented in foreign statements. However, the averaging and approximations permitted by this Statement can result in exchange gains and losses that include gains and losses properly attributable to other revenue and expense accounts. The procedures that would be required to segregate those *other* gains and losses from exchange gains and losses for purposes of this Statement's disclosure requirements (paragraph .032) may not be practical. The Board accepted as reasonable the results determined by applying the requirements of paragraphs .011-.014 by the procedures described in paragraph .168.

.170 Some respondents to the Exposure Draft suggested that certain enterprises that carry investments in securities at current market price but do not include unrealized gains or losses on those investments *in the determination of net income* should be exempt from the requirement of paragraph .017 to include in the determination of net income *exchange* gains and losses relating to those investments.

.171 The Board concluded that if unrealized appreciation or depreciation on investments is measured in dollars, the translation procedures required by this Statement do not produce exchange gains or losses that pertain thereto. Accordingly, the Board concluded that *exemption* for those enterprises was not necessary.

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.172 The Board considered the following possible methods to account for exchange gains or losses in arriving at its conclusion stated in paragraph .017:

a) Adjust cost of, or amortize over life of, assets carried at cost in dollars (assets translated at historical rates);

b) Amortize over remaining term of long-term liabilities;

c) Adjust stockholders' equity;

d) Defer based on certain criteria;

e) Include immediately in the determination of net income.

Adjustment Related to Assets Carried at Cost

.173 One view to support accounting for exchange gains and losses as adjustments of the cost basis of assets is that the cost of an asset equals the total sacrifice required to discharge all related liabilities. Accordingly, if a foreign operation has an exposed net liability position at the time of a rate change, the exchange gain or loss is an element of the cost of the related assets. That view is similar to a one-transaction perspective and is rejected for reasons similar to those in paragraphs .114 and .115.

.174 Another view is that an exchange loss that results from the combination of the strengthening of a foreign currency and an exposed net liability position is considered *covered*, in whole or in part, by assets carried at cost in foreign currency. *Cover* is the amount by which the foreign currency cost of those assets translated at the current rate exceeds their cost translated at historical rates (their cost in dollars). According to the argument, the *covered* loss should be deferred rather than included in determining net income when the rate changes. The reduction in income over the lives of the assets from amortizing the deferred loss on the net exposed liability position is considered to be at least offset by the effect of depreciation based on lower historical translation rates (*lighter costs*) that will be deducted over the assets' lives from revenue (received in cash or receivables from sales) translated at the higher current rate.

.175 Likewise, an exchange gain that results from the combination of the weakening of a foreign currency and an

exposed net liability position should be deferred under the *cover* approach to the extent required to offset the unrecognized potential loss on the assets translated at the historical rate. The potential loss represents the difference between translating the foreign currency costs of the assets at the higher historical rates and translating them at the lower current rate. The cover approach views translating the assets at historical rates as speculation about the assets' ability to produce a product that will sell for an increased foreign currency selling price which, when translated at the lower current rate, will sufficiently cover the historical dollar cost of the assets. Amortization of the deferred gain over the life of the assets is, therefore, considered appropriate to offset the effect of depreciation based on higher historical rates (*heavier cost*) to be included in determining net income of later periods.

.176 The Board rejected the cover approach because it is essentially a procedure whereby a change that has occurred in the dollar measure of liabilities is deferred to be offset against a *potential* change in the future dollar value of assets carried at cost. That potential dollar value of the assets depends on foreign currency proceeds from sale or other disposition of the assets. Since changes in the values of assets carried at cost (for example, property, plant, and equipment) are not normally recognized under generally accepted accounting principles until the assets are sold, offsetting is accomplished under the cover approach by *not* including immediately in the determination of net income gains or losses on changes in the dollar measure of liabilities denominated in foreign currency. The argument for deferral is in effect that changes in the dollar measure of one item should not be recognized because changes in the dollar value of another item are not recognized. However, the Board believes that offsetting of that type is not proper under present generally accepted accounting principles that recognize certain gains and losses only at time of sale or other disposition. If offsetting is desirable at all, it should be accomplished by changing generally accepted accounting principles to recognize changes in the dollar value of items now carried at cost. However, to do so would require reconsideration of historical cost as a fundamental concept of accounting — a process that is beyond the scope of this Statement.

.177 The questionable result of offsetting recognizable gains and losses from changes in the dollar measurements of liabilities denominated in foreign currency against

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unrecognizable increases in the values of assets carried at cost in foreign currency is highlighted if the liability is paid but the asset remains unsold. For example, a rate change from FC1 = $1 to FC.80 = $1 occurs while a foreign operation has an exposed net liability position of FC80 and a depreciable asset with an undepreciated cost of FC100 and a remaining life of five years. The $20 loss on the exposed net liability position (FC80 ÷ .80 = $100; $100 - $80 = $20) is *covered* because the foreign currency cost of the asset translated at the current rate ($125) exceeds the cost translated at the historical rate ($100) by $25, which is $5 more than the loss on the liabilities. Thus, under the *cover* approach, the full $20 loss can be deferred and amortized over the remaining five-year life of the asset. Using straight-line depreciation and amortization, the expense for each of the succeeding five years is $24 ($20 depreciation based on cost translated at the historical rate plus $4 amortization of the deferred loss). The added expense ($4 amortization of the deferred loss) is said to be necessary to offset the effect of matching *light* depreciation expense translated at historical rates against foreign currency revenue translated at the higher rate after the rate change.

.178 If, however, all liabilities outstanding at the time of the rate change are settled by the end of the second year, the loss has occurred, even to the satisfaction of those who believe that exchange gains and losses are *unrealized* until payment of liabilities and collection of receivables (paragraph .188). However, the result that is said to justify the *cover* approach — matching of the increased expense from adding the annual amortization of the deferred loss against the increased revenue from translating current sales at the new higher rate — cannot be achieved unless the loss is deferred and amortized after it has been *realized.*

.179 The *cover* approach appears to be based on the presumption that a rate change may be expected to affect future earnings in a way that offsets an exchange gain or loss related to an exposed net liability position. The Board believes that future impacts of rate changes should be reflected in the future and not anticipated by deferring an exchange gain or loss.

.180 Another apparent assumption of the cover approach is that future revenue generated by the assets carried at cost will be in the same currency as the exposed net liability position. That may not be valid for many foreign operations.

Adjustment Related to Life of Long-Term Liabilities

.181 Another method that has been suggested would limit deferral of exchange gains or losses from an exposed net liability position to amounts associated with long-term liabilities denominated in foreign currency. The amount deferred would be amortized over the remaining term of the long-term liabilities, in effect accounting for the deferred exchange gain or loss as an adjustment of financing costs (interest expense). The Board rejected the method because of the Board's basic view (stated in paragraph .164) that the gain or loss results solely from the rate change and to recognize it in other periods obscures what has occurred. Furthermore, the method masks the economic difference in the source (denomination) of financing. That is, foreign currency denominated debt has an exchange exposure that dollar denominated debt or equity financing does not. Spreading the result of the exposure over the future rather than recognizing it in full when a rate changes fails to contrast an economic difference between financing denominated in foreign currency and dollar borrowings or equity financing.

.182 The Board considered the argument that management assesses the likelihood of rate changes and differences in interest rates between countries in deciding to borrow foreign currency rather than dollars or one foreign currency rather than another and that all or part of the effect on long-term debt of a rate change is, therefore, an added or reduced cost of borrowing a particular foreign currency. The Board does not deny that management may assess borrowing alternatives in that manner. To be consistent with that view, though, would require interest accruals over the life of the borrowing at the anticipated effective interest rate. However, the Board concluded that it is inappropriate to attempt to account currently for the expected effect of future rate changes on interest and principal payments. The Board also concluded that adjusting translated long-term debt by the amount of the related exchange gain or loss at the time of a rate change and spreading that gain or loss as an adjustment of interest expense subsequent to the rate change does not produce a result consistent with the expected effective interest rate at the date of the borrowing even if the expectations about rate changes at the time of borrowing are realized. Therefore, the Board rejected the proposal.

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Adjustment to Stockholders' Equity

.183 Certain respondents to the Discussion Memorandum and Exposure Draft suggested that exchange gains or losses be accounted for as adjustments of stockholders' equity. The Board rejected that method because it believes that a gain or loss resulting from an exposure to rate changes should be included in the determination of net income in accordance with the all-inclusive income statement presently required of most enterprises by generally accepted accounting principles. A foreign investment exposes a U.S. company to the effects of rate changes which can be economically beneficial or detrimental. The Board believes that those benefits or detriments should be reflected in the determination of net income at a time and in a manner that is consistent with generally accepted accounting principles.

Deferral Based on Certain Criteria

.184 The following criteria were suggested for deferring exchange gains or losses:

a) Realization;

b) Conservatism;

c) Likelihood of reversal of rate change;

d) The effect on future income of rate change.

.185 It was suggested that exchange gains or losses be deferred based on the criterion of realization. Realized gains and losses should be recognized immediately while unrealized gains and (possibly) losses should be deferred until realized. Chapter 12 of *ARB No. 43* [section 1081] permitted different accounting treatment for *realized* and *unrealized* exchange gains and losses but gave no guidance on how to distinguish them. In the Board's view, the distinction between *realized* and *unrealized* exchange gains and losses is a questionable concept for the purpose of translation as well as a difficult concept to implement.

.186 The concept of realization usually applied in accounting pertains to conversions of other assets into cash or receivables. It usually applies to conversion of inventory but is also applied to assets such as marketable securities, property, plant, equipment, and certain intangible assets. A

sale of an asset is the most common basis of realization in accounting.

.187 That meaning of realization is preserved if transmission of funds (for example, dividends) from a foreign operation to a domestic operation is the event that determines *realization* of exchange gains and losses from translating foreign statements, but that narrow view of realization is not particularly useful. First, it is questionable how transmission of funds causes an exchange gain or loss to be realized. For example, an exchange gain that results from translating a foreign operation's exposed net liability position cannot be reasonably associated with a dividend remittance. Likewise, an exchange gain that results from translating a foreign operation's exposed net asset position that primarily reflects accounts receivable cannot be reasonably associated with a dividend remittance if the foreign currency collected on settlement of the receivables is used to purchase other assets. Second, if remittance of dividends is the criterion for realization in translation of foreign statements, all of a foreign operation's unremitted earnings must be considered *unrealized.* That interpretation requires investments in foreign operations to be carried at cost and largely invalidates consolidation of foreign operations. It therefore is rejected.

.188 The suggestion by some respondents to the Discussion Memorandum and Exposure Draft that realization of exchange gains and losses should be based on spending cash, collecting receivables, and paying liabilities is the opposite of the usual concept of realization, namely, converting assets into cash or receivables. Converting cash into other assets is usually called a *purchase* and does not constitute realization in any accepted sense of the word. Moreover, it is generally impracticable to determine whether or not a given transaction converts a previously unrealized gain or loss into a realized gain or loss. Under the proposed realization test, not all collections of receivables or payments of liabilities are bases of realization but only collections or payments of receivables and payables that were in existence at the date of a rate change. Similarly, not all cash spent realizes previously unrealized exchange gains or losses but only the spending of cash held at the time of a rate change. The problem was complicated when rate changes were official devaluations or revaluations. Floating rates increase the complexity. The Board believes that attempting to base realization of exchange gains and losses on cash disbursements and collections and

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settlements of receivables and payables would involve unreasonable effort to make a distinction between realized and unrealized gains or losses for which the Board sees no theoretical justification.

.189 Another suggestion is that unrealized exchange gains should be deferred based on the criterion of conservatism. The Board believes that although the concept of conservatism may be appropriate in other areas of accounting, its application to exchange gains and losses is inappropriate.

.190 Conservatism is a way of dealing with uncertainty and is intended to avoid recognizing income on the basis of inadequate evidence that a gain has occurred. The Board believes that a rate change in a foreign exchange market provides sufficient objective evidence of the occurrence of a gain or loss to warrant changes in the dollar carrying amounts of cash, receivables, payables, and other assets and liabilities measured in foreign currency at current or future prices. To defer an exchange gain *solely because it is a gain* in effect denies that a rate change has occurred. Thus, the Board believes that even if it were feasible to identify unrealized gains, to defer recognition of unrealized exchange gains while recognizing unrealized exchange losses is an unwarranted inconsistency in translation.

.191 The inconsistency of deferring an exchange gain while recognizing an exchange loss is further illustrated by translation of two accounts receivable from the same customer, one from a sale just before a rate change and the other from a sale just afterwards. Both receivables are translated at the new rate after the rate change and are, therefore, treated as comparable. If the foreign currency weakens against the dollar, the *unrealized* exchange loss on the earlier receivable is recognized to be conservative. Otherwise, the deferral of the loss would have the effect of increasing the dollar measure of the receivable to the same amount as before the rate change. If, however, the foreign currency strengthens against the dollar, the *unrealized* exchange gain on the same receivable is deferred, again to be conservative. But the effect of deferring the gain is to reduce the dollar measure of the receivable to the same amount as before the rate change. Therefore, the earlier receivable is no longer treated as comparable to the later one.

Moreover, the inconsistency is unwarranted because the dollar measure of the earlier receivable is as objectively determinable as that of the later receivable.

.192 The Board rejected the recommendation that exchange gains or losses be deferred if rates are likely to reverse. That proposal is often a part of both the realization and conservatism proposals because those proposals are often based on arguments that gains should not be recognized because the related rate change might reverse *before the gain is realized.* But the proposal to defer if rates are likely to reverse raises separate issues because it depends on predicting rate changes in the future (paragraph .166). Given the high degree of unpredictability of exchange rates, the proposed method creates a situation in which operating results are misstated simply through errors in forecasting. A procedure of that type invariably causes divergent decisions about the movements of rates. In addition, to determine how much of an exchange gain or loss will be reversed when the rate change reverses necessitates a forecast of the financial position at the time of the later rate change, which may be another extremely uncertain variable. In the Board's judgment, the proposal is not practical.

.193 Another recommendation proposed is that accounting for exchange gains or losses vary depending on the likely effect of rate changes on future income. As pointed out in paragraph .107, the future effects of rate changes may vary widely, and the effects are uncertain. The Board believes it inappropriate to inject forecasting of future effects into the accounting for exchange gains or losses.

Additional Factors Considered

.194 An additional factor in the Board's decision to include exchange gains or losses in the determination of net income at the time of a rate change is that deferral approaches generally raise significant questions of implementation. For example, should amounts deferred be determined on a global basis, currency-by-currency, country-by-country, foreign-operation-by-foreign operation, or some other basis? If exchange gains or losses are aggregated on a global basis, most suggested amortization approaches become exceedingly complex, if not impractical, for a company with numerous foreign operations to apply. Not aggregating on a global basis can result in exchange gains being included in the

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determination of net income at the time of a rate change and exchange losses being deferred, or vice versa, depending on the deferral method employed.

.195 Another factor that supports including exchange gains or losses in the determination of net income at the time of a rate change is that after a rate change operating revenue (other than amortization of deferred income) as well as other cash receipts and disbursements are translated at the current rate. To recognize the effect of a rate change on current transactions (by reporting in the translated statements an increased or decreased dollar equivalent for the transactions) when they occur and yet defer the effect of a rate change on past unsettled transactions (for example, receivables from previously reported sales) places the enterprise in the anomalous position of having recognized the entire effect of the rate change on a recent transaction while holding in suspense its effect on a previous transaction.

Rate Changes and Earnings Fluctuations

.196 Many respondents to the Discussion Memorandum and Exposure Draft commented that to include exchange gains and losses in determining net income when rates change would distort reported net income or otherwise confuse readers of the financial statements. Some of those arguments were based on the assumption that rate changes would reverse. Some respondents to the Exposure Draft presented examples showing how application of the proposed standard would have caused reported income to fluctuate in recent years. Since many of the rate changes did reverse, those comments, based on hindsight, argued that the proposed standard would have caused unnecessary fluctuations in their reported net income.

.197 The Board's view has previously been indicated regarding the assumption that rate changes will reverse (paragraphs.166 and.192).

.198 In addition, the Board rejected the implication that a function of accounting is to minimize the reporting of fluctuations. Past rate changes are historical facts, and the Board believes that users of financial statements are best served by accounting for the changes as they occur. It is the deferring or spreading of those effects, not their recognition and disclosure, that is the artificial process (see *FASB*

Statement No. 2, "Accounting for Research and Development Costs," paragraph 54 [section 4211.54], and *FASB Statement No. 5*, "Accounting for Contingencies," paragraphs 64 and 65 [section 4311.64-.65]).

.199 In the Board's opinion, readers of financial statements will not be confused by fluctuations in reported earnings caused by rate changes. That view was supported by comments of financial analysts who said they preferred to have exchange gains and losses accounted for when rates change. Exchange rates fluctuate; accounting should not give the impression that rates are stable.

INCOME TAX CONSEQUENCES OF RATE CHANGES

.200 The Board concluded that if an exchange gain or loss related to a foreign currency transaction of a foreign operation is taxable in the foreign country, the related tax effect shall be included in the translated income statement when the rate change occurs. Inclusion is appropriate regardless of the fact that the foreign operation's exchange gain or loss may be partially or completely (for a dollar denominated asset or liability) eliminated upon translation, because the rate change is the event that causes the tax effect in the foreign operation's financial statements. The fact that the exchange gain or loss does not exist (or exists only partially) in dollars should in no way affect the accounting for the tax effect, which does exist in dollars.

.201 A method has been proposed for measuring exchange gains or losses resulting from translating foreign statements that in effect would correct what some might consider an erroneous relationship of translated tax expense to translated pretax income. Following the proposal, the exchange gain or loss would include the future tax effect in the translated financial statements of using the historical rate for translating inventory, plant, and equipment. The resulting deferred tax accounts would be amortized as an adjustment of tax expense as inventory and fixed assets are charged against operations.

.202 In the Board's opinion, the use of historical rates to translate certain income or expense items (for example, cost of goods sold and depreciation) does not require interperiod tax allocation. Timing differences, defined as "differences between the periods in which transactions affect taxable income and the periods in which they enter into the

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determination of pretax accounting income" (paragraph 13(e) of *APB Opinion No. 11* [section 4091.12(e)]), do not arise from translating assets or liabilities at historical rates. Accordingly, the effective tax rate in the translated dollar statements may differ from the effective tax rate in the foreign statements. Applying historical rates may also change various other relationships in the translated dollar statements from those in the foreign statements (for example, gross profit percentages). However, the Board believes that is the expected result of using the dollar as the unit of measure in concert with generally accepted accounting principles.

.203 The Board concluded that the existing authoritative literature (*APB Opinion Nos. 11, 23,* and *24* [sections 4091, 4095 and 4096]) provides sufficient guidance about whether deferred taxes should be recognized for exchange gains or losses that result from applying the requirements of this Statement. *APB Opinions No. 23* and *24* [sections 4095 and 4096] apply because exchange gains and losses from translation of foreign statements are an integral part of measuring in dollars the undistributed earnings of foreign subsidiaries and investees.

FORWARD EXCHANGE CONTRACTS

.204 A forward contract is an agreement to exchange at a specified future date currencies of different countries at a specified rate (the *forward rate*). The purpose of a forward contract may be to hedge either a foreign currency commitment or a foreign currency exposed net asset or net liability position or to speculate in anticipation of a gain.

Hedge of Foreign Currency Exposed Net Asset or Net Liability Position

.205 The Board concluded that if a forward contract is intended to hedge an exposed foreign currency position, the gain or loss on the forward contract (determined by the method specified in paragraph .025) shall be included in determining net income currently. To recognize the gain or loss only at maturity of the contract could result in benefiting (penalizing) one period's income by recognizing an exchange gain (loss) resulting from the translation process currently to the detriment (benefit) of a later period's income when a loss (gain) on the forward contract is recorded.

Speculative Contract

.206 An enterprise that uses a forward contract to speculate exposes itself to risks from movements in forward rates. Therefore, for reasons similar to those expressed in paragraphs .164-.166, the Board concluded that the gain or loss on the forward contract (determined by the method stated in paragraph .026) shall be included in determining net income currently as the value of the contract changes.

Hedge of Identifiable Foreign Currency Commitment

.207 Although the Board rejected the one-transaction approach as a general basis for translation of foreign currency transactions (paragraphs .114 and .115), it decided (for the reasons given in paragraphs .116-.118) that the dollar basis of a foreign currency transaction shall be established at the transaction date. By rejecting the commitment date as the date for making that determination, the Board implicitly accepted a one-transaction view for an unrecorded future foreign currency transaction (that is, a commitment in foreign currency) for the period from the commitment date to the transaction date. In other words, the effects of rate changes between commitment date and transaction date are not separately identified and accounted for as exchange gains or losses; rather, they are included in the dollar basis of the transaction.

.208 A number of respondents to the Exposure Draft opposed current recognition in income of the gain or loss on a forward contract intended to hedge a future foreign currency transaction. In their view, the exposure to rate changes during the commitment period could (or should) be hedged by a forward contract, even though the accounting does not separately recognize the exposure on the commitment. They believe that to include a gain or loss on a forward contract that hedges a commitment in determining net income when rates change rather than to include the gain or loss in the dollar basis of the related transaction could benefit (penalize) one period's income to the detriment (benefit) of a later period's income. For example, a U.S. enterprise contracts with a U.S. customer to sell for $1,000,000 certain equipment to be delivered in 18 months. At the same time the enterprise enters into a firm, uncancelable commitment with a foreign company to manufacture the specified equipment for FC900,000 (equal

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to $900,000 at the existing current rate). Simultaneously, the enterprise enters into a forward contract to receive FC900,000 in 18 months. By so doing, the enterprise is viewed as having fixed its gross profit on the transaction at $100,000 (ignoring premium or discount on the forward contract). If at a balance sheet date between the commitment date and the anticipated transaction date for receipt of the equipment, the spot rate has changed from FC1 = $1 to FC1 = $1.07, a gain of $63,000 exists on the forward contract. However, the dollar price of the equipment has also increased $63,000. If the gain on the forward contract is not deferred, the gross profit on the sale when recorded will be $37,000 rather than $100,000. Since the enterprise's intent on entering into the forward contract was not to speculate in the forward market but to fix the equipment's dollar cost at $900,000 and thus fix the gross profit at $100,000, those respondents argued that the gain on the contract should be deferred until the transaction date. On further consideration, the Board concluded that gains or losses on forward contracts that meet the conditions stated in paragraph .027 shall be deferred until the date the commitment is recorded (that is, the transaction date). The deferred gain or loss shall then be included in the dollar basis of the transaction.

.209 The requirements in this Statement for measuring gains or losses on forward contracts represent a modification of the requirements proposed in the Exposure Draft. That draft proposed accrual of the difference between the original market value of an unperformed forward contract (zero) and its current market value. Stated another way, the difference between the contracted forward rate (or the forward rate last used to measure a gain or loss on the contract) and the forward rate available for the remaining maturity of that forward contract multiplied by the amount of the forward contract is a gain or loss to be included in determining net income.

.210 Certain respondents to the Exposure Draft questioned valuing a forward contract at current market value if the intent is to hold the contract to maturity to hedge a foreign currency receivable or payable. In their view, it is inconsistent to value, for example, a two-year contract at a forward rate because it is a forward contract and translate at the current rate the two-year foreign currency payable that is hedged.

.211 The Board concluded that a gain or loss on a forward contract shall be determined on a basis consistent with management's intent for entering into the contract. That is, the results of a speculative forward contract should be determined by changes in its market value; the results of a forward contract intended to hedge an identifiable foreign currency commitment or exposed net asset or net liability position should be accounted for in a manner consistent with the accounting for the related exposure. Therefore, the Board specified the procedures in paragraphs .023-.026.

.212 An alternative approach for a forward contract intended to hedge a specific foreign currency transaction for the period between transaction date and settlement date is to use the rate in the forward contract rather than the spot rate at the transaction date to establish the related amounts payable or receivable. Although a forward contract may limit or eliminate exposure on a payable or receivable denominated in foreign currency, the Board views such a forward contract as an independent transaction that should be accounted for separately. It also believes that the original discount or premium on a forward contract normally reflects an interest rate differential between two countries which should be recognized over the life of the contract if the contract hedges a foreign currency exposed net asset or net liability position. Further, since specific identification of individual forward contracts with related unsettled foreign currency transactions may not be readily ascertainable, the procedures specified by paragraph .023 are a more practical approach.

DISCLOSURE

.213 In reaching its conclusion regarding disclosures, the Board considered disclosures required by *FASB Statement No. 1* as well as additional possible disclosures presented in the Discussion Memorandum.

.214 Since this Statement specifies a single accounting method for foreign currency translation, the Board concluded that the disclosure requirements as stated in *FASB Statement No. 1* are no longer appropriate.

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.215 Paragraph .032 herein requires disclosure of the aggregate exchange gain or loss included in the determination of net income for the period. An exchange gain or loss does not measure, nor is it necessarily an indicator of, the full economic effect of a rate change on an enterprise. The disclosure required by paragraph .032 provides information to users of financial statements about the effects of rate changes on certain assets and liabilities which may be useful in evaluating and comparing reported result of operations.

.216 A few respondents to the Exposure Draft suggested that some components of the aggregate exchange gain or loss (for example, gains and losses on unperformed forward exchange contracts) be separately disclosed. The Board concluded that since enterprises often manage and hedge their exchange exposure on an overall basis, separate disclosure of any of the components, particularly gains or losses on forward exchange contracts, should not be required.

.217 Disclosure of gains or losses on forward exchange contracts that are deferred in accordance with paragraph .027 is not required by paragraph .032. The Board reasoned that those gains or losses are, in effect, offset by unrecorded exchange losses or gains on the related foreign currency commitments; therefore, separate disclosure would be inappropriate.

.218 The Exposure Draft (paragraph .020) contained a proposed requirement that the aggregate amount of tax effects related to exchange gains or losses be disclosed. Some respondents to the Exposure Draft explained certain difficulties in determining the tax effects and pointed out that disclosure of tax effects might imply that the gain or loss was *extraordinary*—an implication contrary to the requirement of paragraph 23 of *APB Opinion No. 30* [section 2012.23] that exchange gains or losses not be reported as extraordinary items. Other respondents suggested that other accounting pronouncements already required explanations of unusual tax effects (for example, *APB Opinion No. 11* paragraph 63 [section 4091.62]). The Board concluded that those comments had merit, and, therefore, this Statement does not require disclosure of the tax effects of exchange gains or losses.

.219 Certain respondents to the Exposure Draft proposed an exemption from the disclosure requirements of paragraph .032

for certain enterprises whose principal business purpose is investing in foreign securities and that present those investments at current market price (determined by applying the current rate to the market price of securities traded and quoted in foreign currency). They argued that it is impracticable and of questionable usefulness for those enterprises to attempt to isolate the portion of the change in market price measured in dollars that arises from rate changes from the portion that arises from changes in foreign currency market prices.

.220 The Board concluded that *exemption* for those enterprises was not appropriate because the segregation described in paragraph .219 is not intended by paragraph .032 of this Statement (and was not intended in paragraph .020 of the Exposure Draft). Exchange gains and losses as described in paragraph .016 do not include the effects of rate changes on assets (other than those denominated in foreign currency) carried at current prices measured in dollars. However, those effects should be considered, if practicable, in providing the disclosures required by paragraph .033 (see paragraph .223).

.221 Some respondents to the Exposure Draft stated that disclosing the exchange gain or loss from an exposed net liability position when the foreign currency strengthens would give the wrong signal (a loss) because the rate change is expected to have future beneficial effects. In the Board's opinion, an exchange gain or loss neither is nor should be a signal of the direction of future operating results. An exchange gain or loss merely reflects the effect of a rate change on a given financial position at a specific time. Other respondents indicated that other effects of rate changes on reported results of operations should be disclosed in addition to the disclosure of exchange gains or losses.

.222 The Board acknowledges that more information than disclosure of exchange gains or losses is needed for an understanding of the effects of rate changes on the operating results of an enterprise. Therefore, it modified paragraph .021 of the Exposure Draft in paragraph .033 of this Statement.

.223 Paragraph .033 of this Statement requires that, if practicable, the effects of rate changes on reported revenue and earnings be described and quantified. The Board concluded that a practicability qualification was necessary. As indicated in paragraph .107, it may be difficult or impossible to quantify the economic effects of rate changes

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(for example, on selling prices, sales volume, and cost structures). In the Board's opinion, disclosing only the mathematical effects of translating revenue and expenses at rates different from those used in a preceding period could be misinterpreted if other significant direct and indirect economic effects of rate changes on operations are not considered and disclosed. Thus, the Board concluded that since the effect of rate changes on revenue and earnings cannot always be measured with sufficient precision, it could not require disclosures of that type in all financial statements. The Board noted, however, that some companies have disclosed certain information (not necessarily in financial statements) that might be interpreted as showing the effect of rate changes on revenue and earnings. The Board's intention is to encourage disclosures of that kind if, in the opinion of management, they provide useful information. The Board believes that if that information is disclosed in financial statements, a clear explanation of the methods and underlying assumptions used to determine the amounts is also essential, as required by paragraph .033 of this Statement.

.224 The Board believes that management can best decide how information about the effects of rate changes on revenue and earnings should be described or quantified. The nature and extent of foreign currency transactions or foreign operations of enterprises vary, and that which is possible or appropriate for one enterprise may not be possible or appropriate for others. The purpose of disclosure of the effect of rate changes in addition to exchange gains and losses is to assist financial statement users in understanding the financial effects of rate changes on the reported results of operations. Disclosing only exchange gains and losses if rate changes significantly affect reported revenue and earnings in a way or to an extent that can be determined would not, in the view of the Board, comply with the intent of paragraph .033 of this Statement. The disclosures urged by that paragraph are not forecasts, but rather descriptions and estimates of the effect on reported results of operations of rate changes that the Board believes will assist users in comparing recent results with those of prior periods.

.225 Some respondents requested clarification of the circumstances requiring an enterprise's financial statements to be *adjusted* for a change in rate subsequent to the date of the financial statements. The Board concluded that financial

statements should not be adjusted for rate changes after their date; however, disclosure may be necessary (paragraph .034). If the estimated effect of a rate change is disclosed, the disclosure should include consideration of changes in financial position from the date of the financial statements to the date the rate changed. The Board recognizes that in some cases it may not be practicable to determine the changes in financial position; if so, that fact should be stated.

.226 The disclosure of geographical, or otherwise segmented, information on foreign operations is discussed in FASB Statement No. 14 [section 2081], *Financial Reporting for Segments of a Business Enterprise.* [As modified, effective for financial statements for fiscal years beginning after December 15, 1976, and for interim periods within those fiscal years, by FASB Statement No. 14.] (See section 2081.)

EXCHANGE RATES

Multiple Rates

.227 The Board concluded that if multiple rates exist, the rate to be used to translate foreign statements should, in the absence of unusual circumstances, be the rate applicable to dividend remittances. Use of that rate expresses results of operations in dollars in a more meaningful way than any other rate because the earnings can be converted into dollars only at that rate. Further, in translating an asset carried at a current price, the dividend rate measures the dollar amount that might be realized from sale of the asset and remittance of the proceeds and thereby establishes the asset's value in dollars. In translating an asset carried at cost, the dividend rate at the time the asset was acquired measures the sacrifice made by the parent in foregoing a remission of the local-currency cost of the asset and thus establishes the asset's dollar cost.

.228 The dividend rate measures the dollar sacrifice in all situations, including those involving multiple rates in which the foreign operation purchased an imported asset at a preferential or penalty rate. Before being used to pay for the imported asset, the local currency cash with which payment is made is translated at the dividend rate. That rate thus measures the translated cost of the asset. If the preferential or penalty rate, whichever applies, were used to translate the local currency cost of the asset, its translated cost would not represent the dollar sacrifice made.

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Differing Balance Sheet Dates

.229 If foreign statements of an operation are as of a date different from that of the enterprise and are combined or consolidated with or accounted for by the equity method in the financial statements of the enterprise, the Board concluded that for purposes of applying the requirements of this Statement, the current rate is the rate in effect at the foreign operation's balance sheet date. The use of that rate is necessary to present dollar measurements as of that date.

.230 Some respondents to the Exposure Draft questioned that conclusion. In their view, use of a foreign operation's financial statements as of a date that differs from that of the enterprise's financial statements is justified only on the basis that those financial statements approximate financial statements as of the enterprise's year end. Accordingly, they argue, the current rate should be the rate in effect at the date of the enterprise's financial statements, not the rate at the date of the foreign operation's financial statements.

.231 Paragraph 4 of *ARB No. 51* [section 2051.05], "Consolidated Financial Statements," states:

> A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations.

Similarly, paragraph 19(g) of *APB Opinion No. 18* [section 5131.19(g)] states:

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

.232 Reconsideration of *ARB No. 51* [section 2051] and *APB Opinion No. 18* [section 5131] was not within the scope of the project that led to the issuance of this Statement. Accordingly, the

Board neither accepted nor rejected the view expressed in paragraph .230. However, the Board believes that if that view is appropriate, the determination that the operation's financial statements at other than the enterprise's year-end are reasonable approximations of its financial statements as of the enterprise's year-end should be based on dollar measurements (translated statements) and not local currency measurements (foreign statements). Using as the current rate a rate at a date other than the foreign operation's balance sheet date could produce translated financial statements that are not in accordance with the requirements of this Statement. For example, if between the date of the foreign operation's financial statements and the date of the enterprise's financial statements there have been changes in the foreign currency measure of the foreign operation's financial position (that is, total assets and total liabilities) or the components thereof (for example, cash and inventory), including changes that may have occurred in anticipation of a significant rate change, using the rate as of the enterprise's financial statements will not result in financial statements for the foreign operation that reflect dollar measures of financial position and results of operations as of either date.

.233 Certain respondents to the Exposure Draft expressed another view opposing the Board's conclusion. In their view, using as the current rate a rate at other than the enterprise's balance sheet date raises implemental issues in eliminating intercompany transactions if the rate has changed during the intervening period. The Board believes that those implemental problems are similar to other implemental problems caused by intercompany transactions within the intervening period and, therefore, apparently can be accommodated in the consolidation, combination, or equity accounting process.

.234 Another opposing view expressed in response to the Exposure Draft was that using as the current rate the rate in effect at the foreign operation's balance sheet date rather than the rate in effect on the date of the enterprise's balance sheet would be contrary to the principle underlying *FASB Statement No. 5* [section 4311], "Accounting for Contingencies," if an intervening rate change resulted in an exchange loss. According to that view, the rate change causes an asset to be impaired or liability incurred, and the amount of the loss is known as of the date of the enterprise's balance sheet. The Board believes that if foreign statements are as of a date other than the balance sheet date of the enterprise, the

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terminology "date of the financial statement" as used in paragraph 8(a) of *FASB Statement No. 5* [section 4311.08a] refers to the end of the most recent accounting period for which foreign statements are being combined, consolidated, or accounted for by the equity method.

.235 The Board believes that rate changes subsequent to the date of a foreign operation's balance sheet are similar to those subsequent to the date of an enterprise's balance sheet. Disclosure may be necessary, but the financial statements should not be adjusted (paragraph .034).

DEFERRED INCOME TAXES

.236 The procedures set forth in this Statement (paragraph .050) for determining the amount of deferred taxes in a translated balance sheet represent a modification of the procedures proposed in the Exposure Draft. That draft proposed that all deferred tax charges or credits be translated at historical rates.

.237 Certain respondents to the Exposure Draft questioned translation at historical rates if the *net change* method of deferred tax allocation is followed. In their view, use of historical rates requires that originating and reversing timing differences be distinguished for translation purposes—a requirement that is inconsistent with the *net change* method. Under the *net change* method, a single computation is made at the *current* tax rate for the net effect of both originating and reversing differences occurring during a period relating to a particular group of similar timing differences. The method results in a balance of deferred taxes that is a residual, that is, the difference between the deferred taxes originally recorded and subsequent reduction of deferred taxes at different tax rates as timing differences reverse.

.238 Other respondents to the Exposure Draft questioned translation at historical rates of deferred income tax charges or credits applicable to timing differences on items translated at the current rate. In their view, that approach does not result in proper dollar measures of deferred tax charges and credits relating to timing differences.

.239 The Board considered those views and the objective of translation (paragraph .006) and concluded that the procedures set forth in paragraph .050 should be followed. The Board

believes that those procedures result in deferred tax charges and credits in a translated balance sheet that are consistent with the requirements of *APB Opinion No. 11* [section 4091] and the objective of translation.

EFFECTIVE DATE AND TRANSITION

.240 The Board concluded that because of the various methods of translation or of recognition of exchange gains and losses now followed in practice and because of the complex nature of the translation process, a prospective method of transition is not feasible. The Board considered whether the transition should be by prior period restatement or by cumulative effect adjustment (the method specified in the Exposure Draft). The Board concluded that prior period restatement is the preferable method to provide useful information about foreign currency transactions and foreign operations for purposes of comparing financial data for periods after the effective date of this Statement with data presented for earlier periods.

.241 The Board recognizes, however, that the procedures called for by this Statement may sometimes differ significantly from procedures followed in previous periods. In addition, restatement requires the availability of records or information that an enterprise may no longer have or that its past procedures did not require. Therefore, if the effect of the restatement on all individual periods presented cannot be computed or reasonably estimated, the cumulative effect adjustment method shall be used in accordance with paragraph .036.

.242 On considering all circumstances, the Board judged the effective date specified in paragraph .035 to be advisable.

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Appendix E

GLOSSARY

.243 This Appendix defines certain terms used and not defined elsewhere in this Statement.

Attribute: The quantifiable characteristic of an item that is measured for accounting purposes. For example, historical cost and replacement cost are attributes of an asset.

Conversion: The exchange of one currency for another.

Enterprise: See Reporting Enterprise.

Exposed Net Asset Position: The excess of assets that are measured or denominated in foreign currency and translated at the current rate over liabilities that are measured or denominated in foreign currency and translated at the current rate.

Exposed Net Liability Position: The excess of liabilities that are measured or denominated in foreign currency and translated at the current rate over assets that are measured or denominated in foreign currency and translated at the current rate.

Foreign Currency: A currency other than the currency of the country being referred to; a currency other than the reporting currency of the enterprise being referred to; composites of currencies, such as the Special Drawing Rights on the International Monetary Fund (SDRs), used to set prices or denominate amounts of loans, etc., have the characteristics of foreign currency for purposes of applying this Statement.

Foreign Currency Financial Statements: Financial statements of a foreign operation that employ as the unit of measure a currency other than the reporting currency of the enterprise being referred to.

Foreign Currency Transactions: Transactions (for example, sales or purchases of goods or services or loans payable or receivable) whose terms are stated in a currency other than the local currency.

Foreign Currency Translation: The process of expressing amounts denominated or measured in one currency in terms of another currency by use of the exchange rate between the two currencies.

Foreign Operation: An operation whose financial statements are (a) combined or consolidated with or accounted for on an equity basis in the financial statements of the reporting enterprise and (b) prepared in a currency other than the reporting currency of the reporting enterprise.

Foreign Statements: See Foreign Currency Financial Statements.

Local Currency: Currency of a particular country being referred to; the reporting currency of a domestic or foreign operation being referred to.

Reporting Currency: The currency in which an enterprise prepares its financial statements.

Reporting Enterprise: An entity whose financial statements are being referred to; in this Statement, those financial statements reflect (a) the financial statements of one or more foreign operations by combination, consolidation, or equity accounting and/or (b) foreign currency transactions.

Settlement Date: The date at which a receivable is collected or a payable is paid.

Spot Rate: The exchange rate for immediate delivery of currencies exchanged.

Transaction Date: The date at which a transaction (for example, a sale or purchase of merchandise or services) is recorded in accounting records in conformity with generally accepted accounting principles.

Translation: See Foreign Currency Translation.

Unit of Measure: The currency in which assets, liabilities, revenue, and expenses are measured.

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AC Section 1083-1

Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company: An Interpretation of Section 1083

[Source: FASB Interpretation No. 15.]

September 1976

INTRODUCTION

.01 The FASB has been requested to clarify the application of *FASB Statement No. 8* [section 1083], "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," to the translation of the unamortized policy acquisition costs of a foreign stock life insurance company whose foreign currency financial statements are incorporated in the financial statements of an enterprise by consolidation, combination, or the equity method of accounting. Policy acquisition costs include commissions paid to agents for selling policies and other costs that vary with and are primarily related to the production of new business. The following three approaches have been suggested to the Board:

a. Unamortized policy acquisition costs are deferred charges and should be translated at historical rates. They represent expenses that have been incurred in past transactions that are deferred and amortized in proportion to the related anticipated premium revenue.

b. Unamortized policy acquisition costs are in the nature of long-term receivables and should be translated at the current rate. They represent past services paid for to receive future premium revenue and are recoverable from those future revenues.

c. Unamortized policy acquisition costs and the liability for future policy benefits are so interconnected that they both should be translated at the current rate. Unamortized policy acquisition costs are classified on the balance sheet among assets as an accounting convention for separate disclosure but this method of disclosure does not change their fundamental nature of being an integral part of the liability for future policy benefits.

In addition, if unamortized policy acquisition costs are translated at historical rates, the Board has been asked if Statement No. 8

[section 1083] requires that a "reserve deficiency computation" be made in dollars.

.02 The FASB has not considered the specialized accounting practices for life insurance companies. Those practices are specified for stock life insurance companies by the AICPA Industry Audit Guide, "Audits of Stock Life Insurance Companies." That Audit Guide requires that, because of their nature, unamortized policy acquisition costs should be classified as a deferred charge (page 74). The Guide also requires that unamortized policy acquisition costs be included in the computation of a deficiency, if any, in the reserve [1] applicable to a block of insurance policies; any deficiency is corrected "by a charge to earnings to increase reserves and/or reduce deferred acquisition expense" (page 87).

.03 *FASB Statement No. 8* [section 1083] requires that asset and liability balances representing cash and amounts receivable or payable that are denominated in a foreign currency shall be translated into dollars at the current rate. All other asset and liability accounts measured in a foreign currency shall generally be translated in a manner that retains their measurement bases; that is, accounts carried at prices in past exchanges shall be translated at historical rates and accounts carried at prices in current or future exchanges shall be translated at the current rate. The Statement also requires that existing U. S. generally accepted accounting principles be followed and specifies that translation should change only the unit of measure without changing the accounting principles.

INTERPRETATION

.04 According to the AICPA Industry Audit Guide, "Audits of Stock Life Insurance Companies," unamortized policy acquisition costs of a stock life insurance company are deferred charges under present generally accepted accounting principles. Because *FASB Statement No. 8* [section 1083] relies on generally accepted accounting principles, which for stock life insurance companies are set forth in the Audit Guide, those costs shall be translated at historical rates.

.05 Present generally accepted accounting principles require that a stock life insurance company recognize a loss represented by a reserve deficiency as a charge to current earnings (see para-

[1] The Audit Guide uses the term "reserve" to describe the actuarially determined liability for future benefits on insurance policies in force. Because that term has a special meaning in the insurance industry, it is also used in this Interpretation in referring to that *liability*.

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graph .02 above). *FASB Statement No. 8* [section 1083] requires that the dollar financial statements be in conformity with generally accepted accounting principles. Accordingly, computation of a reserve deficiency shall be made *in dollars* after translation of the unamortized policy acquisition costs at historical rates and the liability for future policy benefits at the current rate. Computation of a reserve deficiency *in dollars* may require a charge (or an increased charge) to current earnings in the dollar statements for a reserve deficiency even though no such charge is required in the foreign statements. It may also require a charge to current earnings in the foreign statements to be reversed in whole or in part in preparing the dollar statements if the translated charge to current earnings exceeds the reserve deficiency computed in dollars. (See paragraph 14 of Statement No. 8 [section 1083.014].)

EFFECTIVE DATE AND TRANSITION

.06 This Interpretation shall be effective for all unamortized policy acquisition costs reported in financial statements for annual and interim periods ending after December 15, 1976, except that it shall not be applied prior to initial application of *FASB Statement No. 8* [section 1083]. Earlier application is encouraged in financial statements for annual and interim periods ending before December 16, 1976 that have not been previously issued. If initially applied concurrently with the initial application of *FASB Statement No. 8* [section 1083], this Interpretation shall be applied in the same manner as the initial application of that Statement. Enterprises that have adopted Statement No. 8 [section 1083] prior to the effective date of this Interpretation and that have reported unamortized policy acquisition costs differently from the requirements of this Interpretation are encouraged to apply this Interpretation in the same manner as they initially applied Statement No. 8 (see paragraphs 35 and 36 of the Statement [sections 1083.035 and 1083.036]), but if they choose not to do so, those enterprises shall report the cumulative effect of applying this Interpretation in the year that it is adopted in the manner required by *APB Opinion No. 20* [section 1051], "Accounting Changes," and *FASB Statement No. 3* [section 2072], "Reporting Accounting Changes in Interim Financial Statements."

The next page is 7689.

AC Section 1083-2

Applying the Lower of Cost or Market Rule in Translated Financial Statements: An Interpretation of Section 1083

[Source: FASB Interpretation No. 17.]

February 1977

INTRODUCTION

.01 The FASB has been asked to clarify the determination of *market* when applying the rule of *cost or market, whichever is lower,* in translated financial statements. The FASB also has been requested to clarify the manner of reporting a write-down of inventory resulting from application of that rule in the translated financial statements.

.02 *FASB Statement No. 8* [section 1083], "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," relies on existing U. S. generally accepted accounting principles which for purposes of pricing inventories are set forth in Chapter 4, "Inventory Pricing," of *ARB No. 43* [section 5121]. Chapter 4 [section 5121] specifies that inventory should be stated at *cost or market, whichever is lower.* To ensure that inventory in the translated statements conforms to that rule, paragraph 14 of Statement No. 8 [section 1083.014] requires that the rule of *cost or market, whichever is lower,* be applied *in dollars.*[1]

.03 Appendix A of *FASB Statement No. 8* [section 1083] explains and illustrates how to apply the rule of *cost or market, whichever is lower,* in translated financial statements. Paragraph 46 of Statement No. 8 [section 1083.046] states that "to apply the rule of *cost or market, whichever is lower* (as described in Statement 6 of Chapter 4, 'Inventory Pricing,' of *ARB No. 43* [section 5121.08—.10]), *translated historical cost* shall be compared with *translated market.*"

.04 Statement 6 of Chapter 4 of *ARB No. 43* [section 5121.08—.10] is as follows:

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

[1] For convenience, both *FASB Statement No. 8* [section 1083] and this Interpretation assume that the translated financial statements are prepared using the U. S. dollar (dollar) as the unit of measure. See footnote 1 to *FASB Statement No. 8* [section 1083].

(1) Market should not exceed the net realizable value (i. e. estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and

(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Although the above is referred to as the rule of *cost or market, whichever is lower,* the discussion of Statement 6 in Chapter 4 of *ARB No. 43* [section 5121.08—.10] states that "because of the many variations of circumstances encountered in inventory pricing, Statement 6 is intended as a guide rather than a literal rule."

INTERPRETATION

.05 Because *FASB Statement No. 8* [section 1083] relies on U. S. generally accepted accounting principles, *translated market* for inventory shall be determined in accordance with the provisions of Chapter 4 of *ARB No. 43* [section 5121]. When applying the literal rule of *cost or market, whichever is lower,* in translated financial statements, *translated market* shall be current foreign currency replacement cost translated at the current rate,[2] except that:

a. *Translated market* shall not exceed foreign currency net realizable value translated at the current rate;[3] and

b. *Translated market* shall not be less than foreign currency net realizable value reduced by an allowance for an approximately normal profit margin translated at the current rate.[4]

.06 Literal application of the rule of *cost or market, whichever is lower,* will require an inventory write-down[5] in dollar financial statements for locally acquired inventory[6] if the value of the

---

[2] In the case of replacement by *reproduction,* certain elements of replacement cost (e. g., depreciation included in inventory) may need to be translated at historical rates to determine *translated market.*

[3] See footnote 2 above.

[4] In the case of replacement by *purchase,* if *normal profit margin* is viewed as being other than *gross profit margin,* translation entirely at the current rate may not be appropriate. In the case of replacement by *reproduction,* if *normal profit margin* is viewed as other than *gross profit margin,* certain elements, in addition to those referred to in footnote 2, may need to be translated at historical rates.

[5] As to interim periods, paragraph 14(c) of *APB Opinion No. 28* [section 2071.14], "Interim Financial Reporting," states:

> Inventory losses from market declines should not be deferred beyond the interim period in which the decline occurs. Recoveries of such losses on the same inventory in later interim periods of the same fiscal year through market price recoveries should be recognized as gains in the later interim period. Such gains should not exceed previously recognized losses. Some market declines at interim dates, however, can reasonably be expected to be restored in the fiscal year. Such *temporary* market declines need not be recognized at the interim date since no loss is expected to be incurred in the fiscal year.

[6] An inventory write-down may also be required for imported inventory.

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foreign currency has declined in relation to the dollar between the date the foreign operation acquired its inventory and the date of the foreign operation's balance sheet unless foreign currency replacement costs or selling prices have increased sufficiently so that translated market measured in dollars exceeds translated historical cost. Paragraphs .07—.09 illustrate literal application of the rule *in dollars.*

.07 Assume the following:

a. When the rate is FC 1 = $2.40, a foreign subsidiary of a U. S. company purchases a unit of inventory at a cost of FC 500 (measured in dollars, $1,200),

b. At the foreign subsidiary's balance sheet date, the current rate is FC 1 = $2.00 and the current replacement cost of the unit of inventory is FC 560 (measured in dollars, $1,120),

c. Net realizable value is FC 630 (measured in dollars, $1,260),

d. Net realizable value reduced by an allowance for an approximately normal profit margin is FC 550 (measured in dollars, $1,100).

Because current replacement cost measured in dollars ($1,120) is less than translated historical cost ($1,200), an inventory write-down of $80 is required in the dollar financial statements.

.08 Assume the same information as given in the preceding example except that current replacement cost at the foreign subsidiary's balance sheet date is FC 620. Because market measured in dollars (FC 620 × $2.00 = $1,240) exceeds translated historical cost (FC 500 × $2.40 = $1,200), an inventory write-down is not required in the dollar financial statements.

.09 As a further example, assume the same information given in paragraph .07 except that foreign currency selling prices have increased so that net realizable value is FC 720, and net realizable value reduced by an allowance for an approximately normal profit margin is FC 640. In this case, because replacement cost measured in dollars (FC 560 × $2.00 = $1,120) is less than net realizable value reduced by an allowance for an approximately normal profit margin measured in dollars (FC 640 × $2.00 = $1,280), translated market is $1,280. Because translated market ($1,280) exceeds translated historical cost (FC 500 × $2.40 = $1,200), an inventory write-down is not required in the dollar financial statements.

.10 Disclosure of inventory write-downs that result from applying the rule of *cost or market, whichever is lower,* is specified by *ARB No. 43,* Chapter 4, paragraph 14 [section 5121.14], as follows:

> When substantial and unusual losses result from the application of this rule it will frequently be desirable to disclose the amount of the loss in the income statement as a charge separately identified from the consumed inventory costs described as *cost of goods sold.*

Paragraph 16 of Statement No. 8 [section 1083.016] specifies that "exchange gains or losses are a consequence of translation . . ."; that is, "they result from the procedures specified in paragraphs 7(b) [section 1083.007(b)] and 11—13 [section 1083.011—.013]. . . ." Inventory write-downs are a consequence of applying the rule of *cost or market, whichever is lower,* in translated financial statements as required by paragraph 14 of Statement No. 8 [section 1083.014] and, accordingly, are not exchange losses. Therefore, such inventory write-downs in translated financial statements shall *not* be included in the aggregate exchange gain or loss required to be disclosed pursuant to paragraph 32 of Statement No. 8 [section 1083.032], but shall be reported in accordance with paragraph 14 of Chapter 4 of *ARB No. 43* [section 5121.14] and, in addition, included in the disclosures made pursuant to paragraph 33 of Statement No. 8 [section 1083.033].

EFFECTIVE DATE AND TRANSITION

.11 The provisions of this Interpretation shall be effective for financial statements for annual and interim periods ending after March 15, 1977. Earlier application is encouraged in financial statements for annual and interim periods ending before March 16, 1977 that have not been previously issued. This Interpretation shall not be applied retroactively for previously issued annual or interim financial statements unless it is being applied concurrently with initial application of *FASB Statement No. 8* [section 1083], in which case previously issued financial statements shall be restated in accordance with either paragraph 35 or 36 of Statement No. 8 [section 1083.035 or 1083.036].

The next page is 7711.

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AC Section 1084

Accounting for Forward Exchange Contracts

an amendment of section 1083
[Source: FASB Statement No. 20.]

December 1977

INTRODUCTION AND BACKGROUND INFORMATION

.01 Paragraph 27 of *FASB Statement No. 8* [section 1083.027], "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," specifies conditions that must be met to defer a gain or loss on a forward exchange contract (*forward contract*). Paragraph 27 [section 1083.027] states that:

> . . . a forward contract shall be considered a hedge of an identifiable foreign currency commitment . . ., provided *all* of the following conditions are met:
>
> a) The life of the forward contract extends from the foreign currency commitment date to the anticipated transaction date . . . or a later date. . . .
>
> b) The forward contract is denominated in the same currency as the foreign currency commitment and for an amount that is the same or less than the amount of the foreign currency commitment.
>
> c) The foreign currency commitment is firm and uncancelable.

With respect to the application of those conditions, the FASB has been asked:

a. Whether an enterprise may defer a gain or loss on a forward contract that is intended to hedge a commitment that was entered into before the effective date of *FASB Statement No. 8* [1] [section 1083] even though the life of the forward contract does not extend from the commitment date.

b. Whether an enterprise may defer a gain or loss on a portion of a forward contract in excess of the related commitment to the extent that the forward contract is intended to provide a hedge of the commitment on an after-tax basis, i. e., to assure that the gain or loss on the forward contract offsets the effects of an exchange rate change on the foreign currency exposure related to the commitment, after considering the net related tax effects.

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[1] For purposes of this Statement, the effective date of Statement No. 8 [section 1083] means the date that an enterprise first applied the provisions of Statement No. 8 [section 1083].

Hedging a Commitment Entered into before Section 1083 Became Effective

.02 By specifying that the life of a forward contract must extend from the foreign currency commitment date, paragraph 27(a) of *FASB Statement No. 8* [section 1083.027(a)] would appear to preclude the deferral of a gain or loss on any forward contract entered into after the commitment date. However, that was not the intent of the Board if a forward contract is intended to hedge a commitment entered into before the effective date of Statement No. 8 [section 1083]. Accordingly, the Board is specifying a transition period during which an enterprise may enter into a forward contract to hedge an existing commitment that was entered into before the effective date of Statement No. 8 [section 1083]. For purposes of determining compliance with the conditions for deferral of a gain or loss, such a forward contract will be considered to have met the condition of paragraph 27(a) [section 1083.027(a)] even though its life does not extend from the foreign currency commitment date.

Hedging on an After-Tax Basis

.03 Paragraph 24 of *FASB Statement No. 8* [section 1083.024] states, "a gain or loss shall be deferred and included in the measurement of the dollar basis of the related foreign currency transaction if the gain or loss pertains to a forward contract that is intended to be a hedge of an identifiable foreign currency commitment that meets the conditions described in paragraph 27 [section 1083.027]." The reason for that requirement is explained in paragraphs 207 and 208 of Statement No. 8 [sections 1083.207 and 1083.208].

.04 Paragraph 27 of *FASB Statement No. 8* [section 1083.027] limits the deferral of a gain or loss on a forward contract to the gain or loss pertaining to the portion of the forward contract that is not in excess of the related commitment. Thus, any gain or loss pertaining to a portion of a forward contract in excess of the related commitment is included in the determination of net income currently. After consideration of the question of hedging on an after-tax basis, the Board has decided that paragraph 27 of Statement No. 8 [section 1083.027] should be amended to require the deferral of a gain or loss on a portion of a forward contract *in excess of the related commitment* if certain conditions have been met. Those conditions are specified in paragraph .10 of this Statement.

.05 An Exposure Draft of a proposed Statement on "Accounting for Forward Exchange Contracts" was issued on November 7, 1977. The Board received 30 letters of comment in response to the Exposure Draft, virtually all of which expressed agreement.

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.06 Some respondents recommended that the final Statement should include other amendments of *FASB Statement No. 8* [section 1083] in addition to the provisions in the Exposure Draft, including an amendment to permit the gain or loss pertaining to a hedge of a net monetary position on an after-tax basis to be determined by the method specified in paragraph 25 of Statement No. 8 [section 1083.025]. The Board concluded that consideration of other possible amendments of Statement No. 8 [section 1083] should not delay the issuance of this Statement and noted that the determination of the gain or loss pertaining to a hedge of a net monetary position on an after-tax basis by the method specified in paragraph 25 is not now precluded by Statement No. 8 [section 1083.025].

.07 Some respondents questioned whether the requirement of the Exposure Draft to include the gain or loss pertaining to the portion of a forward contract that is intended to provide a hedge on an after-tax basis as an offset to the related tax effects is contrary to APB Opinion No. 11 [section 4091], "Accounting for Income Taxes." The Board concluded that such a requirement is not contrary to Opinion No. 11 [section 4091] and does not modify the disclosure requirements of paragraph 60 of that Opinion [section 4091.59]. However, the Board concluded that tax effects related to a hedge of a net monetary position should not be offset. The Board believes that with respect to a hedge of a commitment the requirement to offset a gain or loss against the related tax effects is consistent with paragraph 24 of *FASB Statement No. 8* [section 1083.024], which requires a deferred gain or loss pertaining to a forward contract that is intended to hedge an identifiable commitment to be included as an adjustment of the dollar basis of the foreign currency transaction. Further, the Board believes that with respect to a hedge of a net monetary position the requirement not to offset the related tax effects is consistent with the conclusion in paragraph 212 of Statement No. 8 [section 1083.212], which views such forward contracts as independent transactions.

.08 The Board has concluded that on the basis of existing data it can reach an informed decision without a public hearing and that the effective date and transition specified in paragraphs .14 and .15 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

.09 For purposes of applying paragraph 27 of *FASB Statement No. 8* [section 1083.027], a forward contract that is intended to hedge an identifiable foreign currency commitment entered into before the effective date of Statement No. 8 [section 1083] shall

be deemed to have met the conditions specified in paragraph 27(a) of Statement No. 8 [section 1083.027(a)] if the life of the forward contract extends from a date prior to March 31, 1978 to the anticipated transaction date [2] or a later date.[3]

.10 If the conditions of paragraph 27 of *FASB Statement No. 8* [section 1083.027] as amended are met, a gain or loss pertaining to a portion of a forward contract *in excess of the related commitment* shall be deferred to the extent that the forward contract is intended to provide a hedge on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the period in which such tax effects are recognized.[4] A gain or loss that has been offset against related tax effects shall not be included in the aggregate exchange gain or loss disclosure required by paragraph 32 of Statement No. 8 [section 1083.032].

.11 A gain or loss pertaining to the portion of a forward contract in excess of the amount that provides a hedge on an after-tax basis shall not be deferred. Likewise, a gain or loss pertaining to a period after the transaction date of the related commitment shall not be deferred.

Amendments to Section 1083

.12 Paragraph 35 of *FASB Statement No. 8* [section 1083.035] is amended to add the following as the last sentence:

> For purposes of applying the provisions of paragraph .027(a) of this Statement, *FASB Statement No. 20* [section 1084] provides a limited exception for forward contracts that are intended to hedge commitments entered into before the provisions of this Statement are initially applied.

.13 The words "and for an amount that is the same or less than the amount of the foreign currency commitment" in paragraph 27(b) of *FASB Statement No. 8* [section 1083.027(b)] are deleted. The last two sentences of paragraph 27 of Statement No. 8 [section 1083.027] are superseded by the following:

> The portion of a forward contract that shall be accounted for pursuant to paragraph .024 is limited to the amount of the related commitment. If a forward contract that meets conditions (a) through (c) above exceeds the amount of the related commitment, the gain

[2] See footnote 9 of Statement No. 8 [section 1083.027].

[3] See footnote 10 of Statement No. 8 [section 1083.027].

[4] The requirement to offset such gains or losses against the related tax effects does not modify the disclosure requirements of paragraph 60 of *APB Opinion No. 11* [section 4091.59].

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or loss pertaining to a portion of the forward contract in excess of the commitment shall be deferred to the extent that the forward contract is intended to provide a hedge on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the period in which such tax effects are recognized. A gain or loss that has been offset against related tax effects shall not be included in the aggregate exchange gain or loss disclosure required by paragraph .032. A gain or loss pertaining to the portion of a forward contract in excess of the amount that provides a hedge on an after-tax basis shall not be deferred. Likewise, a gain or loss pertaining to a period after the transaction date of the related commitment shall not be deferred.

Effective Date and Transition

.14 This Statement shall be effective prospectively beginning January 1, 1978. Earlier application is encouraged in financial statements for annual and interim periods ending before January 1, 1978 that have not been previously issued. Previously issued annual or interim financial statements shall not be restated to comply with the provisions of this Statement.

.15 An enterprise that has hedged a foreign currency commitment with a forward contract that meets the conditions of paragraph 27 of *FASB Statement No. 8* [section 1083.027] as amended, and, prior to March 31, 1978, has entered into a forward contract for an amount in excess of the related commitment shall defer the gain or loss on the amount of the excess that is intended to provide a hedge on an after-tax basis. Any gain or loss with respect to such excess that has been previously recognized in the determination of net income shall not be restated.

The provisions of this Statement need not be applied to immaterial items.

Appendix A

EXAMPLE OF APPLICATION OF THIS STATEMENT

.16 The following example provides guidance for applying paragraphs .10 and .11 of this Statement.

General Assumptions

.17 Assume the following:

a. ABC Company and XYZ Company, a wholly owned foreign subsidiary of ABC Company, both have fiscal years ending December 31.

b. On November 1, 1978, when the exchange rate is FC1 = $1, XYZ Company enters into a commitment to sell for FC2,120,000 on March 1, 1979 certain previously acquired and paid for assets having a cost of FC1,720,000 ($1,720,000).

c. Foreign income is subject to foreign taxes at the rate of 10 percent.

d. U.S. income is subject to U.S. taxes at the rate of 48 percent.

e. XYZ Company will invest its undistributed earnings indefinitely. Accordingly, under the provisions of *APB Opinion No. 23* [section 4095], "Accounting for Income Taxes—Special Areas," no U.S. income taxes are provided on XYZ Company's undistributed earnings in ABC Company's consolidated financial statements.

f. The forward rate is FC1 = $1. (This example assumes that there is no premium or discount.)

.18 Given the above assumptions, if the exchange rate does not change, ABC Company's reportable pre-tax profit in dollars from the transaction is $400,000 [$2,120,000 (FC2,120,000 x $1) selling price less $1,720,000 cost] and reportable after-tax profit in dollars is $360,000 [$400,000 pre-tax profit less $40,000 (FC40,000 x $1) foreign taxes].

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.19 Assume the same information as given in paragraph .17 and that the exchange rate changes on December 31, 1978 to FC1 = $.90 and that it remains unchanged through March 1, 1979. In this case, ABC Company's reportable pre-tax profit in dollars from the transaction is $188,000 [$1,908,000 (FC2,120,000 x $.90) selling price less $1,720,000 cost] and reportable after-tax profit is $152,000 [$188,000 pre-tax profit less $36,000 (FC40,000 x $.90) foreign taxes].

.20 Assume further that on November 1, 1978 ABC Company entered into a forward contract to sell forward FC5,000,000 for delivery on March 1, 1979 to hedge XYZ Company's commitment on an after-tax basis and to hedge a specific exposed monetary item of FC1,000,000 of ABC Company. The amount of a forward contract necessary to hedge the sales commitment in full on an after-tax basis is FC4,000,000, computed by dividing the net foreign currency exposure of FC2,080,000 by 52 percent (the complement of the U.S. income tax rate of 48 percent). In other words, a forward contract of FC4,000,000 assures that the effects of any exchange rate change on the foreign currency exposure related to the commitment will be offset by the gain or loss on the forward contract, after considering the net related tax effects. Accordingly, pursuant to paragraph .11 of this Statement, ABC Company cannot defer any gain or loss pertaining to the portion of the forward contract in excess of FC4,000,000. Given the above assumptions, an exchange rate change to FC1 = $.90 on December 31, 1978 results in the following:

Gain on forward contract (determined by the method specified in paragraph 25 of Statement No. 8 [section 1083.025]):

Total forward contract	FC	5,000,000
Exchange rate change	x	($1 - $.90)
Gain on forward contract	$	500,000

Portion of gain deferrable as a hedge of foreign currency sales commitment:

Forward contract	FC	2,120,000
Exchange rate change	x	($1 - $.90)
Gain deferrable as a hedge of foreign currency sales commitment	$	212,000

Portion of gain deferrable as a hedge of the net related tax effects (pursuant to paragraph .10 of this Statement):

Forward contract	FC	1,880,000
Exchange rate change	x	($1 - $.90)
Gain deferrable as hedge of net related tax effects	$	188,000

Portion of gain to be recognized in period in which exchange rate changes (pursuant to paragraph .11 of this Statement):

Forward contract	FC	1,000,000
Exchange rate change	x	($1 - $.90)
Gain to be recognized in period in which exchange rate changes	$	100,000

Calculation of net related tax effects:

Amount of forward contract intended to hedge the sales commitment on an after-tax basis	FC	4,000,000
Exchange rate change	x	($1 - $.90)
Gain on forward contract	$	400,000
U.S. income tax rate		48%
U.S. income taxes attributable to the gain on the forward contract		192,000
Reduction of foreign taxes in dollars resulting from exchange rate change (see below)		4,000
Net related tax effects	$	188,000

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Calculation of reduction of foreign taxes in dollars resulting from exchange rate change:

Selling price	FC	2,120,000
Cost		1,720,000
Pre-tax profit	FC	400,000
Foreign tax rate		10%
Foreign taxes	FC	40,000
Exchange rate change	x	($1 - $.90)
Reduction of foreign taxes in dollars resulting from exchange rate change	$	4,000

If the exchange rate remains at FC1 = $.90 through March 1, 1979, pursuant to paragraph 24 of *FASB Statement No. 8* [section 1083.024], the deferred gain of $212,000 would be included in the measurement of the dollar basis of the selling price of the assets on March 1, 1979. Also, pursuant to paragraph .10 of this Statement, the deferred gain of $188,000 would be included as an offset to the related tax effects in the period in which such tax effects are recognized.

The next page is 7731.

AC Section 1091

Accounting for Business Combinations

[Source: APB Opinion No. 16, as amended.]

Effective to account for business combinations initiated after October 31, 1970, unless otherwise indicated [1]

SUMMARY

Problem

.01 A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises.

.02 Two methods of accounting for business combinations—"purchase" and "pooling of interests"—have been accepted in practice and supported in pronouncements of the Board and its predecessor, the Committee on Accounting Procedure. The accounting treatment of a combination may affect significantly the reported financial position and net income of the combined corporation for prior, current, and future periods.

.03 The Director of Accounting Research of the American Institute of Certified Public Accountants has published two studies on accounting for business combinations and the related goodwill: Accounting Research Study No. 5, *A Critical Study of Accounting for Business Combinations,* by Arthur R. Wyatt and Accounting Research Study No. 10, *Accounting for Goodwill,* by George R. Catlett and Norman O. Olson.[2] The two studies describe the origin and development of the purchase and pooling of interests methods of accounting for business combinations. The studies also cite the supporting authoritative pronouncements and their influences on accounting practices and evaluate the effects of practices on financial reporting.

Scope and Effect of Section

.04 The Board has considered the conclusions and recommendations of Accounting Research Studies Nos. 5

[1] See paragraphs .97—.99.

[2] Accounting research studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.

and 10, the discussions of the need for and appropriateness of the two accepted methods of accounting for business combinations, and proposals for alternative accounting methods. It has also observed the present treatments of combinations in various forms and under differing conditions. The Board expresses in this section its conclusions on accounting for business combinations.

.05 This section covers the combination of a corporation and one or more incorporated or unincorporated businesses; both incorporated and unincorporated enterprises are referred to in this section as companies. The conclusions of this section apply equally to business combinations in which one or more companies become subsidiary corporations, one company transfers its net assets to another, and each company transfers its net assets to a newly formed corporation. The acquisition of some or all of the stock held by minority stockholders of a subsidiary is not a business combination, but paragraph .43 of this section specifies the applicable method of accounting. The term business combination in this section excludes a transfer by a corporation of its net assets to a newly formed substitute corporate entity chartered by the existing corporation and a transfer of net assets or exchange of shares between companies under common control (control is described in section 2051.03), such as between a parent corporation and its subsidiary or between two subsidiary corporations of the same parent. This section does not specifically discuss the combination of a corporation and one or more unincorporated businesses or of two or more unincorporated businesses, but its provisions should be applied as a general guide.

.06 This section applies to regulated companies in accordance with the provisions of section 6011, *Accounting Principles for Regulated Industries.*

.07 The conclusions of this section modify previous views of the Board and its predecessor committee.

Conclusions

.08 The Board concludes that the purchase method and the pooling of interests method are both acceptable in accounting for business combinations, although not as alter-

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natives in accounting for the same business combination. A business combination which meets specified conditions requires accounting by the pooling of interests method. A new basis of accounting is not permitted for a combination that meets the specified conditions, and the assets and liabilities of the combining companies are combined at their recorded amounts. All other business combinations should be accounted for as an acquisition of one or more companies by a corporation. The cost to an acquiring corporation of an entire acquired company should be determined by the principles of accounting for the acquisition of an asset. That cost should then be allocated to the identifiable individual assets acquired and liabilities assumed based on their fair values; the unallocated cost should be recorded as goodwill.

BACKGROUND

Present Accounting and Its Development

Development of Two Methods

.09 Most business combinations before World War II were classified either as a "merger," the acquisition of one company by another, or as a "consolidation," the formation of a new corporation. Accounting for both types of combinations generally followed traditional principles for the acquisition of assets or issuance of shares of stock. The accounting adopted by some new corporations was viewed as a precedent for the combining of retained earnings and of amounts of net assets recorded by predecessor corporations as retained earnings and net assets of a new entity.

.10 Emphasis shifted after World War II from the legal form of the combination to distinctions between "a continuance of the former ownership or a new ownership" (ARB No. 40, paragraph 1). New ownership was accounted for as a purchase; continuing ownership was accounted for as a pooling of interests. Carrying forward the stockholders' equity, including retained earnings, of the constituents became an integral part of the pooling of interests method. Significant differences between the purchase and pooling of interests methods accepted today are in the amounts ascribed to assets and liabilities at the time of combination and income reported for the combined enterprise.

Purchase Method [3]

.11 The purchase method accounts for a business combination as the acquisition of one company by another. The acquiring corporation records at its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill. The reported income of an acquiring corporation includes the operations of the acquired company after acquisition, based on the cost to the acquiring corporation.

Pooling of Interests Method [4]

.12 The pooling of interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained. The recorded assets and liabilities of the constituents are carried forward to the combined corporation at their recorded amounts. Income of the combined corporation includes income of the constituents for the entire fiscal period in which the combination occurs. The reported income of the constituents for prior periods is combined and restated as income of the combined corporation.

.13 The original concept of pooling of interests as a fusion of equity interests was modified in practice as use of the method expanded.[4] The method was first applied in accounting for combinations of affiliated corporations and then extended to some combinations of unrelated corporate

[3] This section refers to the "purchase method of accounting" for a business combination because the term is widely used and generally understood. However, the more inclusive terms "acquire" (to come into possession of) and "acquisition" are generally used to describe transactions rather than the more narrow term "purchase" (to acquire by the payment of money or its equivalent). The broader terms clearly encompass obtaining assets by issuing stock as well as by disbursing cash and thus avoid the confusion that results from describing a stock transaction as a "purchase." This section does not describe a business combination accounted for by the pooling of interests method as an "acquisition" because the meaning of the word is inconsistent with the method of accounting.

[4] The origin, development, and application of the pooling of interests method of accounting are traced in Accounting Research Study No. 5 and summarized in Accounting Research Study No. 10.

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ownership interests of comparable size. The method was later accepted for most business combinations in which common stock was issued. New and complex securities have been issued in recent business combinations and some combination agreements provide for additional securities to be issued later depending on specified events or circumstances. Most of the resulting combinations are accounted for as poolings of interests. Some combinations effected by both disbursing cash and issuing securities are now accounted for as a "part purchase, part pooling."

.14 Some accountants believe that the pooling of interests method is the only acceptable method for a combination which meets the requirements for pooling. Others interpret the existing pronouncements on accounting for business combinations to mean that a combination which meets the criteria for a pooling of interests may alternatively be accounted for as a purchase.

Appraisal of Accepted Methods of Accounting

.15 The pooling of interests method of accounting is applied only to business combinations effected by an exchange of stock and not to those involving primarily cash, other assets, or liabilities. Applying the purchase method of accounting to business combinations effected by paying cash, distributing other assets, or incurring liabilities is not challenged. Thus, those business combinations effected primarily by an exchange of equity securities present a question of choice between the two accounting methods.

.16 The significantly different results of applying the purchase and pooling of interests methods of accounting to a combination effected by an exchange of stock stem from distinct views of the nature of the transaction itself. Those who endorse the pooling of interests method believe that an exchange of stock to effect a business combination is in substance a transaction between the combining stockholder groups and does not involve the corporate entities. The transaction therefore neither requires nor justifies establishing a new basis of accountability for the assets of the combined corporation. Those who endorse the purchase method believe that the transaction is an issue of stock by a corporation for consideration received from those who become stockholders by the transaction. The consideration

received is established by bargaining between independent parties, and the acquiring corporation accounts for the additional assets at their bargained—that is, current—values.

Purchase Method

.17 The more important arguments expressing the advantages and disadvantages of the purchase method and some of the practical difficulties experienced in implementing it are summarized in paragraphs .18 to .26.

.18 *An acquisition.* Those who favor the purchase method of accounting believe that one corporation acquires another company in almost every business combination. The acquisition of one company by another and the identities of the acquiring and acquired companies are usually obvious. Generally, one company in a business combination is clearly the dominant and continuing entity and one or more other companies cease to control their own assets and operations because control passes to the acquiring corporation.

.19 *A bargained transaction.* Proponents of purchase accounting hold that a business combination is a significant economic event which results from bargaining between independent parties. Each party bargains on the basis of his assessment of the current status and future prospects of each constituent as a separate enterprise and as a contributor to the proposed combined enterprise. The agreed terms of combination recognize primarily the bargained values and only secondarily the costs of assets and liabilities carried by the constituents. In fact, the recorded costs are not always known by the other bargaining party.

.20 Accounting by the purchase method is essentially the same whether the business combination is effected by distributing assets, incurring liabilities, or issuing stock because issuing stock is considered an economic event as significant as distributing assets or incurring liabilities. A corporation must ascertain that the consideration it receives for stock issued is fair, just as it must ascertain that fair value is received for cash disbursed. Recipients of the stock similarly appraise the fairness of the transaction. Thus, a business combination is a bargained transaction regardless of the nature of the consideration.

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.21 *Reporting economic substance.* The purchase method adheres to traditional principles of accounting for the acquisition of assets. Those who support the purchase method of accounting for business combinations effected by issuing stock believe that an acquiring corporation accounts for the economic substance of the transaction by applying those principles and by recording:

a. All assets and liabilities which comprise the bargained cost of an acquired company, not merely those items previously shown in the financial statements of an acquired company.

b. The bargained costs of assets acquired less liabilities assumed, not the costs to a previous owner.

c. The fair value of the consideration received for stock issued, not the equity shown in the financial statements of an acquired company.

d. Retained earnings from its operations, not a fusion of its retained earnings and previous earnings of an acquired company.

e. Expenses and net income after an acquisition computed on the bargained cost of acquired assets less liabilities, not on the costs to a previous owner.

.22 *Defects attributed to purchase method.* Applying the purchase method to business combinations effected primarily by issuing stock may entail difficulties in measuring the cost of an acquired company if neither the fair value of the consideration given nor the fair value of the property acquired is clearly evident. Measuring fair values of assets acquired is complicated by the presence of intangible assets or other assets which do not have discernible market prices. Goodwill and other unidentifiable intangible assets are difficult to value directly, and measuring assets acquired for stock is easier if the fair value of the stock issued is determinable. The excess of the value of stock issued over the sum of the fair values of the tangible and identifiable intangible assets acquired less liabilities assumed indicates the value of acquired unidentified intangible assets (usually called goodwill).

.23 However, the fair value of stock issued is not always objectively determinable. A market price may not

be available for a newly issued security or for securities of a closely held corporation. Even an available quoted market price may not always be a reliable indicator of fair value of consideration received because the number of shares issued is relatively large, the market for the security is thin, the stock price is volatile, or other uncertainties influence the quoted price. Further, the determinable value of one security may not necessarily indicate the fair value of another similar, but not identical, security because their differences affect the value—for example, the absence of registration or an agreement which restricts a holder's ability to sell a security may significantly affect its value.

.24 Those who oppose applying the purchase method to some or most business combinations effected by stock also challenge the theoretical merits of the method. They contend that the goodwill acquired is stated only by coincidence at the value which would be determined by direct valuation. The weakness is attributed not to measurement difficulties (direct valuation of goodwill is assumed) but to the basis underlying an exchange of shares of stock. Bargaining in that type of transaction is normally based on the market prices of the equity securities. Market prices of the securities exchanged are more likely to be influenced by anticipated earnings capacities of the companies than by evaluations of individual assets. The number of shares of stock issued in a business combination is thus influenced by values attributed to goodwill of the acquirer as well as goodwill of the acquired company. Since the terms are based on the market prices of both stocks exchanged, measuring the cost of an acquired company by the market price of the stock issued may result in recording acquired goodwill at more or less than its value determined directly.

.25 A related argument is that the purchase method is improper accounting for a business combination in which a relatively large number of shares of stock is issued because it records the goodwill and fair values of only the acquired company. Critics of purchase accounting say that each group of stockholders of two publicly held and actively traded companies evaluates the other stock, and the exchange ratio for stock issued is often predicated on relative market values. The stockholders and management of each company evaluate the goodwill and fair values of the other.

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Purchase accounting is thus viewed as illogical because it records goodwill and values of only one side of the transaction. Those who support this view prefer that assets and liabilities of both companies be combined at existing recorded amounts, but if one side is to be stated at fair values, they believe that both sides should be recorded at fair values.

.26 Criticism of the purchase method is directed not only to the theoretical and practical problems of measuring goodwill in combinations effected primarily by stock but also to accounting after the combination for goodwill recorded by the purchase method. Present accounting for goodwill, which often has an indeterminate useful life, is cited as an example of lack of uniformity because selecting among alternative methods of accounting is discretionary.

Pooling of Interests Method

.27 The more important arguments expressing the advantages and disadvantages of the pooling of interests method and some of the practical difficulties experienced in implementing it are summarized in paragraphs .28 to .41.

.28 *Validity of the concept.* Those who support the pooling of interests method believe that a business combination effected by issuing common stock is different from a purchase in that no corporate assets are disbursed to stockholders and the net assets of the issuing corporation are enlarged by the net assets of the corporation whose stockholders accept common stock of the combined corporation. There is no newly invested capital nor have owners withdrawn assets from the group since the stock of a corporation is not one of its assets. Accordingly, the net assets of the constituents remain intact but combined; the stockholder groups remain intact but combined. Aggregate income is not changed since the total resources are not changed. Consequently, the historical costs and earnings of the separate corporations are appropriately combined. In a business combination effected by exchanging stock, groups of stockholders combine their resources, talents, and risks to form a new entity to carry on in combination the previous businesses and to continue their earnings streams. The sharing of risks by the constituent stockholder groups

is an important element in a business combination effected by exchanging stock. By pooling equity interests, each group continues to maintain risk elements of its former investment and they mutually exchange risks and benefits.

.29 A pooling of interests transaction is regarded as in substance an arrangement among stockholder groups. The fractional interests in the common enterprise are reallocated—risks are rearranged among the stockholder groups outside the corporate entity. A fundamental concept of entity accounting is that a corporation is separate and distinct from its stockholders. Elected managements represent the stockholders in bargaining to effect a combination, but the groups of stockholders usually decide whether the proposed terms are acceptable by voting to approve or disapprove a combination. Stockholders sometimes disapprove a combination proposed by management, and tender offers sometimes succeed despite the opposition of management.

.30 Each stockholder group in a pooling of interests gives up its interests in assets formerly held but receives an interest in a portion of the assets formerly held in addition to an interest in the assets of the other. The clearest example of this type of combination is one in which both groups surrender their stock and receive in exchange stock of a new corporation. The fact that one of the corporations usually issues its stock in exchange for that of the other does not alter the substance of the transaction.

.31 *Consistency with other concepts.* Proponents of pooling of interests accounting point out that the pooling concept was developed within the boundaries of the historical-cost system and is compatible with it. Accounting by the pooling of interests method for business combinations arranged through the issuance of common stock is based on existing accounting concepts and is not an occasion for revising historical costs. Both constituents usually have elements of appreciation and of goodwill which are recognized and offset, at least to some extent, in setting a ratio of exchange of stock. The bargaining which occurs usually reflects the relative earning capacities (measured by historical-cost accounts) of the constituents and frequently recognizes the relative market values of the two

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stocks, which in turn reflect earning capacity, goodwill, or other values. Accounting recognizes the bargaining by means of the new number of shares outstanding distributed in accordance with the bargained ratio, which has a direct effect on earnings per share after the combination.

.32 *Usefulness of the concept.* Those who favor the pooling of interests method of accounting believe that the economic substance of a combination is best reflected by reporting operations up to the date of the exchange of stock based on the same historical-cost information used to develop the separate operating results of each constituent. Also, informative comparison with periods prior to the business combination is facilitated by maintaining historical costs as the basis of reporting combined operations subsequent to the combination.

.33 *Application of the concept.* It has been observed that criteria for distinguishing between a pooling and a purchase have eroded over the years and that present interpretations of criteria have led to abuse. However, most accountants who support the pooling concept believe that criteria can be redefined satisfactorily to eliminate abuses. It is their view that the pooling of interests method of accounting for business combinations is justifiable on conceptual grounds and is a useful technique and therefore should be retained.

.34 Some proponents of pooling of interests accounting support a restriction on the difference in size of combining interests because a significant sharing of risk cannot occur if one combining interest is minor or because a meaningful mutual exchange does not occur if the combination involves a relatively small number of shares. Most, however, believe that there is no conceptual basis for a size restriction and that establishing a size restriction would seriously impair pooling of interests accounting.

.35 *Defects attributed to pooling of interests method.* Those who oppose the pooling of interests method of accounting doubt that the method is supported by a concept. In their view it has become essentially a method of accounting for an acquisition of a company without recognizing the current costs of the assets, including goodwill, underlying the transaction. The concept of a pooling of interests

was described in general terms in the past—for example, as a continuity of equity interests or as a combination of two or more interests of comparable size. The descriptions tend to be contradictory. For example, accountants do not agree on whether or not relative size is part of the pooling of interests concept. Attempts to define the concept in terms of broad criteria for applying the method have also been unsuccessful.

.36 Indeed, many opponents of the pooling of interests method of accounting believe that effective criteria cannot be found. The concept of a uniting or fusing of stockholder groups on which pooling of interests accounting is based implies a broad application of the method because every combination effected by issuing stock rather than by disbursing cash or incurring debt is potentially a pooling of interests unless the combination significantly changes the relative equity interests. However, so broad an application without effective criteria results in applying the pooling of interests method to numerous business combinations which are clearly in economic substance the acquisition of one company by another.

.37 Some critics point out that the method was first applied to combining interests of comparable size and that pronouncements on business combinations have never sanctioned applying pooling of interests accounting to all or almost all business combinations effected by exchanging stock. All pronouncements have indicated that a large disparity in the size of the combining interests is evidence that one corporation is acquiring another.

.38 Other criteria restricting application of pooling of interests accounting, such as those prohibiting future disposals of stock received and providing for continuity of management, were added to the size restriction. Those criteria have, however, tended to strengthen the view that one corporation acquires another because they are unilateral, that is, they are applied only to the stockholders and management of the "acquired" company.

.39 The most serious defect attributed to pooling of interests accounting by those who oppose it is that it does not accurately reflect the economic substance of the business combination transaction. They believe that the method

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ignores the bargaining which results in the combination by accounting only for the amounts previously shown in accounts of the combining companies. The acquiring corporation does not record assets and values which usually influence the final terms of the combination agreement with consequent effects on subsequent balance sheets and income statements. The combined earnings streams, which are said to continue after a pooling of interests, can continue unchanged only if the cost of the assets producing those earnings is identical for the acquiring corporation and the acquired company. That coincidence rarely occurs because the bargaining is based on current values and not past costs.

.40 Pooling of interests accounting is also challenged because the amount of assets acquired less liabilities assumed is recorded without regard to the number of shares of stock issued. The result does not reflect the presumption that a corporation issues stock only for value received and, in general, the greater the number of shares issued, the larger the consideration to be recorded.

.41 Traditional principles of accounting for acquisitions of assets encompass all business combinations because every combination is effected by distributing assets, incurring liabilities, issuing stock, or some blend of the three. Those who oppose the pooling of interests method believe that a departure from the traditional principles is justified only if evidence shows that financial statements prepared according to other principles better reflect the economic significance of a combination. In their opinion, the characteristics of a business combination do not justify departing from traditional principles of accounting to accommodate the pooling of interests method.

OPINION

Applicability of Accounting Methods

.42 The Board finds merit in both the purchase and pooling of interests methods of accounting for business combinations and accepts neither method to the exclusion of the other. The arguments in favor of the purchase method of accounting are more persuasive if cash or other assets are distributed or liabilities are incurred to effect a combination, but arguments in favor of the pooling of in-

terests method of accounting are more persuasive if voting common stock is issued to effect a combination of common stock interests. Therefore, the Board concludes that some business combinations should be accounted for by the purchase method and other combinations should be accounted for by the pooling of interests method.

.43 The Board also concludes that the two methods are not alternatives in accounting for the same business combination. A single method should be applied to an entire combination; the practice now known as part-purchase, part-pooling is not acceptable. The acquisition after the effective date of this section of some or all of the stock held by minority stockholders of a subsidiary—whether acquired by the parent, the subsidiary itself, or another affiliate—should be accounted for by the purchase method rather than by the pooling of interests method.

.44 The Board believes that accounting for business combinations will be improved significantly by specifying the circumstances in which each method should be applied and the procedures which should be followed in applying each method. The *distinctive conditions* which require pooling of interests accounting are described in paragraphs .45 to .48, and combinations involving all of those conditions should be accounted for as described in paragraphs .50 to .65. All other business combinations should be treated as the acquisition of one company by another and accounted for by the purchase method as described in paragraphs .66 to .96.

Conditions for Pooling of Interests Method

.45 The pooling of interests method of accounting is intended to present as a single interest two or more common stockholder interests which were previously independent and the combined rights and risks represented by those interests. That method shows that stockholder groups neither withdraw nor invest assets but in effect exchange voting common stock in a ratio that determines their respective interests in the combined corporation. Some business combinations have those features. A business combination which meets *all* of the conditions specified and explained in paragraphs .46 to .48 should be accounted for by the pooling of interests method. The conditions are classified

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by (1) attributes of the combining companies, (2) manner of combining interests, and (3) absence of planned transactions.

.46 *Combining companies.* Certain attributes of combining companies indicate that independent ownership interests are combined in their entirety to continue previously separate operations. Combining virtually all of existing common stock interests avoids combining only selected assets, operations, or ownership interests, any of which is more akin to disposing of and acquiring interests than to sharing risks and rights. It also avoids combining interests that are already related by substantial intercorporate investments.

The two conditions in this paragraph define essential attributes of combining companies.

a. Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.

A plan of combination is initiated on the earlier of (1) the date that the major terms of a plan, including the ratio of exchange of stock, are announced publicly or otherwise formally made known to the stockholders of any one of the combining companies or (2) the date that stockholders of a combining company are notified in writing of an exchange offer. Therefore, a plan of combination is often initiated even though consummation is subject to the approval of stockholders and others.

A new company incorporated within the preceding two years meets this condition unless the company is successor to a part of a company or to a company that is otherwise not autonomous for this condition. A wholly owned subsidiary company which distributes voting common stock of its parent corporation to effect the combination is also considered an autonomous company provided the parent corporation would have met all conditions in paragraphs .46 to .48 had the parent corporation issued its stock directly to effect the combination.

Divestiture of assets to comply with an order of a governmental authority or judicial body results in an exception to the terms of this condition. Either a subsidiary divested

under an order or a new company which acquires assets disposed of under an order is therefore autonomous for this condition.

b. Each of the combining companies is independent of the other combining companies.

This condition means that at the dates the plan of combination is initiated and consummated the combining companies hold as intercorporate investments no more than 10 percent in total of the outstanding voting common stock of any combining company.[5] For the percentage computation, intercorporate investments exclude voting common stock that is acquired after the date the plan of combination is initiated in exchange for the voting common stock issued to effect the combination. Investments of 10 percent or less are explained in paragraph .47-b.

.47 *Combining of interests.* The combining of existing voting common stock interests by the exchange of stock is the essence of a business combination accounted for by the pooling of interests method. The separate stockholder interests lose their identities and all share mutually in the combined risks and rights. Exchanges of common stock that alter relative voting rights, that result in preferential claims to distributions of profits or assets for some common stockholder groups, or that leave significant minority interests in combining companies are incompatible with the idea of mutual sharing. Similarly, acquisitions of common stock for assets or debt, reacquisitions of outstanding stock for the purpose of exchanging it in a business combination, and other transactions that reduce the common stock interests are contrary to the idea of combining existing stockholder interests. The seven conditions in this paragraph relate to the exchange to effect the combination.

a. The combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.

Altering the terms of exchange of stock constitutes initiation of a new plan of combination unless earlier exchanges of stock are adjusted to the new terms.[6]

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[5] An exception for common stock held on October 31, 1970 is explained in paragraph .99.

[6] However, an adjustment after the effective date of this section in the terms of exchange in a plan of combination initiated before and consum-

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A business combination completed in more than one year from the date the plan is initiated meets this condition if the delay is beyond the control of the combining companies because proceedings of a governmental authority or litigation prevents completing the combination.

b. A corporation offers and issues only common stock with rights identical to those of the majority of its outstanding voting common stock[7] in exchange for substantially all of the voting common stock interest of another company at the date the plan of combination is consummated.

The plan to issue voting common stock in exchange for voting common stock may include, within limits, provisions to distribute cash or other consideration for fractional shares, for shares held by dissenting stockholders, and the like but may not include a pro rata distribution of cash or other consideration.

Substantially all of the voting common stock means 90 percent or more for this condition. That is, after the date the plan of combination is initiated, one of the combining companies (issuing corporation) issues voting common stock in exchange for at least 90 percent of the voting common stock of another combining company that is outstanding at the date the combination is consummated. The number of shares exchanged therefore excludes those shares of the combining company (1) acquired before and held by the issuing corporation and its subsidiaries at the date the plan of combination is initiated, regardless of the form of consideration,[8] (2) acquired by the issuing corporation and its subsidiaries after the date the plan of combination is initiated other than by issuing its own voting common stock, and (3) outstanding after the date the combination is consummated.

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mated after the effective date always constitutes initiation of a new plan. The one year specified in this condition is measured, therefore, from the date of adjustment of terms and all other conditions are evaluated for the new plan. (Paragraph .97 describes the application of this section to a plan of combination initiated before the effective date of this section and consummated later in accordance with the terms of exchange prevailing on the effective date.)

[7] A class of stock that has voting control of a corporation is the majority class.

[8] An exception for common stock held on October 31, 1970 is explained in paragraph .99.

An investment in stock of the issuing corporation held by a combining company may prevent a combination from meeting this condition even though the investment of the combining company is not more than 10 percent of the outstanding stock of the issuing corporation (paragraph .46-b). An investment in stock of the issuing corporation by another combining company is the same in a mutual exchange as an investment by the issuing corporation in stock of the other combining company—the choice of issuing corporation is essentially a matter of convenience. An investment in stock of the issuing corporation must be expressed as an equivalent number of shares of the investor combining company because the measure of percent of shares exchanged is in terms of shares of stock of the investor company. An investment in 10 percent or less of the outstanding voting common stock of the issuing corporation affects the measure of percent of shares exchanged in the combination as follows:

> The number of shares of voting common stock of the issuing corporation held by the investor combining company at the date the plan is initiated plus shares it acquired after that date are restated as an equivalent number of shares of voting common stock of the investor combining company based on the ratio of exchange of stock in the combination.
>
> The equivalent number of shares is deducted from the number of shares of voting common stock of the investor combining company exchanged for voting common stock of the issuing corporation as part of the plan of combination.
>
> The reduced number of shares is considered the number exchanged and is compared with 90 percent of the outstanding voting common stock of the investor combining company at the date the plan is consummated to determine whether the terms of condition .47-b are met.

Since the number of shares of voting common stock exchanged is reduced for an intercorporate investment in voting common stock of the issuing corporation, the terms of condition .47-b may not be met even though 90 percent or more of the outstanding common stock of a combining company is exchanged to effect a combination.

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A combination of more than two companies is evaluated essentially the same as a combination of two companies. The percent of voting common stock exchanged is measured separately for each combining company, and condition .47-b is met if 90 percent or more of the voting common stock of each of the several combining companies is exchanged for voting common stock of the issuing corporation. The number of shares exchanged for stock of the issuing corporation includes only shares exchanged by stockholders other than the several combining companies themselves. Thus, intercorporate investments in combining companies are included in the number of shares of stock outstanding but are excluded from the number of shares of stock exchanged to effect the combination.

A new corporation formed to issue its stock to effect the combination of two or more companies meets condition .47-b if (1) the number of shares of each company exchanged to effect the combination is not less than 90 percent of its voting common stock outstanding at the date the combination is consummated and (2) condition .47-b would have been met had any one of the combining companies issued its stock to effect the combination on essentially the same basis.

Condition .47-b relates to issuing common stock for the common stock interests in another company. Hence, a corporation issuing stock to effect the combination may assume the debt securities of the other company or may exchange substantially identical securities or voting common stock for other outstanding equity and debt securities of the other combining company. An issuing corporation may also distribute cash to holders of debt and equity securities that either are callable or redeemable and may retire those securities. However, the issuing corporation may exchange only voting common stock for outstanding equity and debt securities of the other combining company that have been issued in exchange for voting common stock of that company during a period beginning two years preceding the date the combination is initiated.

A transfer of the net assets of a combining company to effect a business combination satisfies condition .47-b provided all net assets of the company at the date the plan is consummated are transferred in exchange for stock of

the issuing corporation. However, the combining company may retain temporarily cash, receivables, or marketable securities to settle liabilities, contingencies, or items in dispute if the plan provides that the assets remaining after settlement are to be transferred to the corporation issuing the stock to effect the combination. Only voting common stock may be issued to effect the combination unless both voting common stock and other stock of the other combining company are outstanding at the date the plan is consummated. The combination may then be effected by issuing all voting common stock or by issuing voting common and other stock in the same proportions as the outstanding voting common and other stock of the other combining company. An investment in 10 percent or less of the outstanding voting common stock of a combining company held by another combining company requires special computations to evaluate condition .47-b. The computations and comparisons are in terms of the voting common stock of the issuing corporation and involve:

Stock issued for common stock interest. The total number of shares of voting common stock issued for all of the assets[9] is divided between those applicable to outstanding voting common stock and those applicable to other outstanding stock, if any, of the combining company which transfers assets (transferor company).

Reduction for intercorporate investments. The number of issued shares of voting common stock applicable to the voting common stock interests of the transferor combining company is reduced by the sum of (1) the number of shares of voting common stock of the issuing corporation held by the transferor combining company at the date the plan of combination is initiated plus shares it acquired after that date and (2) the number of shares of voting common stock of the transferor combining company held by the issuing corporation at the date the plan of combination is initiated plus shares it acquired after that date. The shares of the transferor combining company are restated as the equivalent number of shares of voting common stock of the issuing corporation for this purpose. Restate-

[9] Including (for this computation) stock of the issuing corporation held by the transferor combining company.

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ment is based on the ratio of the number of shares of voting common stock of the transferor combining company which are outstanding at the date the plan is consummated to the number of issued shares of voting common stock applicable to the voting common stock interests.

Comparison with 90 percent. The reduced number of shares of stock issued is compared with 90 percent of the issued number of shares of voting common stock applicable to voting common stock interests to determine if the transfer of assets meets the terms of condition .47-b.

c. None of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated or between the dates the combination is initiated and consummated; changes in contemplation of effecting the combination may include distributions to stockholders and additional issuances, exchanges, and retirements of securities.

Distributions to stockholders which are no greater than normal dividends are not changes for this condition. Normality of dividends is determined in relation to earnings during the period and to the previous dividend policy and record. Dividend distributions on stock of a combining company that are equivalent to normal dividends on the stock to be issued in exchange in the combination are considered normal for this condition.

d. Each of the combining companies reacquires shares of voting common stock only for purposes other than business combinations, and no company reacquires more than a normal number of shares between the dates the plan of combination is initiated and consummated.

Treasury stock acquired for purposes other than business combinations includes shares for stock option and compensation plans and other recurring distributions provided a systematic pattern of reacquisitions is established at least two years before the plan of combination is initiated. A

systematic pattern of reacquisitions may be established for less than two years if it coincides with the adoption of a new stock option or compensation plan. The normal number of shares of voting common stock reacquired is determined by the pattern of reacquisitions of stock before the plan of combination is initiated.

Acquisitions by other combining companies of voting common stock of the issuing corporation after the date the plan of combination is initiated are essentially the same as if the issuing corporation reacquired its own common stock.

e. The ratio of the interest of an individual common stockholder to those of other common stockholders in a combining company remains the same as a result of the exchange of stock to effect the combination.

This condition means that each individual common stockholder who exchanges his stock receives a voting common stock interest exactly in proportion to his relative voting common stock interest before the combination is effected. Thus no common stockholder is denied or surrenders his potential share of a voting common stock interest in a combined corporation.

f. The voting rights to which the common stock ownership interests in the resulting combined corporation are entitled are exercisable by the stockholders; the stockholders are neither deprived of nor restricted in exercising those rights for a period.

This condition is not met, for example, if shares of common stock issued to effect the combination are transferred to a voting trust.

g. The combination is resolved at the date the plan is consummated and no provisions of the plan relating to the issue of securities or other consideration are pending.

This condition means that (1) the combined corporation does not agree to contingently issue additional shares of stock or distribute other consideration at a later date to the former stockholders of a combining company or (2) the combined corporation does not issue or distribute to an escrow agent common stock or other consideration which

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is to be either transferred to common stockholders or returned to the corporation at the time the contingency is resolved.

An agreement may provide, however, that the number of shares of common stock issued to effect the combination may be revised for the later settlement of a contingency at a different amount than that recorded by a combining company.

.48 *Absence of planned transactions.* Some transactions after a combination is consummated are inconsistent with the combining of entire existing interests of common stockholders. Including those transactions in the negotiations and terms of the combination, either explicitly or by intent, counteracts the effect of combining stockholder interests. The three conditions in this paragraph relate to certain future transactions.

a. The combined corporation does not agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination.

b. The combined corporation does not enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guaranty of loans secured by stock issued in the combination, which in effect negates the exchange of equity securities.

c. The combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination other than disposals in the ordinary course of business of the formerly separate companies and to eliminate duplicate facilities or excess capacity.

Subsidiary Corporation

.49 Dissolution of a combining company is not a condition for applying the pooling of interests method of accounting for a business combination. One or more combining companies may be subsidiaries of the issuing corporation after the combination is consummated if the other conditions are met.

Application of Pooling of Interests Method

.50 A business combination which meets all of the conditions in paragraphs .45 to .48 should be accounted for by the pooling of interests method. Appropriate procedures are described in paragraphs .51 to .65.

Assets and Liabilities Combined

.51 The recorded assets and liabilities of the separate companies generally become the recorded assets and liabilities of the combined corporation. The combined corporation therefore recognizes those assets and liabilities recorded in conformity with generally accepted accounting principles by the separate companies at the date the combination is consummated.

.52 The combined corporation records the historical-cost based amounts of the assets and liabilities of the separate companies because the existing basis of accounting continues. However, the separate companies may have recorded assets and liabilities under differing methods of accounting and the amounts may be adjusted to the same basis of accounting if the change would otherwise have been appropriate for the separate company. A change in accounting method to conform the individual methods should be applied retroactively, and financial statements presented for prior periods should be restated. (See sections 1051.34-.35, *Accounting Changes.*)

Stockholders' Equity Combined

.53 The stockholders' equities of the separate companies are also combined as a part of the pooling of interests method of accounting. The combined corporation records as capital the capital stock and capital in excess of par or stated value of outstanding stock of the separate companies. Similarly, retained earnings or deficits of the separate companies are combined and recognized as retained earnings of the combined corporation (paragraph .56). The amount of outstanding shares of stock of the combined corporation at par or stated value may exceed the total amount of capital stock of the separate combining companies; the excess should be deducted first from the combined other contributed capital and then from the combined retained earnings. The combined retained earnings

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could be misleading if shortly before or as a part of the combination transaction one or more of the combining companies adjusted the elements of stockholders' equity to eliminate a deficit; therefore, the elements of equity before the adjustment should be combined.

.54 A corporation which effects a combination accounted for by the pooling of interests method by distributing stock previously acquired as treasury stock (paragraph .47-d) should first account for those shares of stock as though retired. The issuance of the shares for the common stock interests of the combining company is then accounted for the same as the issuance of previously unissued shares.

.55 Accounting for common stock of one of the combining companies which is held by another combining company at the date a combination is consummated depends on whether the stock is the same as that which is issued to effect the combination or is the same as the stock which is exchanged in the combination. An investment of a combining company in the common stock of the issuing corporation is in effect returned to the resulting combined corporation in the combination. The combined corporation should account for the investment as treasury stock. In contrast, an investment in the common stock of other combining companies (not the one issuing stock in the combination) is an investment in stock that is exchanged in the combination for the common stock issued. The stock in that type of intercorporate investment is in effect eliminated in the combination. The combined corporation should account for that investment as stock retired as part of the combination.

Reporting Combined Operations

.56 A corporation which applies the pooling of interests method of accounting to a combination should report results of operations for the period in which the combination occurs as though the companies had been combined as of the beginning of the period. Results of operations for that period thus comprise those of the separate companies combined from the beginning of the period to the date the combination is consummated and those of the combined operations from that date to the end of the period. Elimi-

nating the effects of intercompany transactions from operations before the date of combination reports operations before and after the date of combination on substantially the same basis. The effects of intercompany transactions on current assets, current liabilities, revenue, and cost of sales for periods presented and on retained earnings at the beginning of the periods presented should be eliminated to the extent possible. The nature of and effects on earnings per share of nonrecurring intercompany transactions involving long-term assets and liabilities need not be eliminated but should be disclosed. A combined corporation should disclose in notes to financial statements the revenue, extraordinary items, and net income of each of the separate companies from the beginning of the period to the date the combination is consummated (paragraph .64-d). The information relating to the separate companies may be as of the end of the interim period nearest the date that the combination is consummated.

.57 Similarly, balance sheets and other financial information of the separate companies as of the beginning of the period should be presented as though the companies had been combined at that date. Financial statements and financial information of the separate companies presented for prior years should also be restated on a combined basis to furnish comparative information. All restated financial statements and financial summaries should indicate clearly that financial data of the previously separate companies are combined.

Expenses Related to Combination

.58 The pooling of interests method records neither the acquiring of assets nor the obtaining of capital. Therefore, costs incurred to effect a combination accounted for by that method and to integrate the continuing operations are expenses of the combined corporation rather than additions to assets or direct reductions of stockholders' equity. Accordingly, all expenses related to effecting a business combination accounted for by the pooling of interests method should be deducted in determining the net income of the resulting combined corporation for the period in which the expenses are incurred. Those expenses include, for example, registration fees, costs of furnishing informa-

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tion to stockholders, fees of finders and consultants, salaries and other expenses related to services of employees, and costs and losses of combining operations of the previously separate companies and instituting efficiencies.

Disposition of Assets After Combination

.59 A combined corporation may dispose of those assets of the separate companies which are duplicate facilities or excess capacity in the combined operations. Losses or estimated losses on disposal of specifically identified duplicate or excess facilities should be deducted in determining the net income of the resulting combined corporation. However, a loss estimated and recorded while a facility remains in service should not include the portion of the cost that is properly allocable to anticipated future service of the facility.

.60 Profit or loss on other dispositions of assets of the previously separate companies may require special disclosure unless the disposals are part of customary business activities of the combined corporation. Specific treatment of a profit or loss on those dispositions is warranted because the pooling of interests method of accounting would have been inappropriate (paragraph .48-c) if the combined corporation were committed or planned to dispose of a significant part of the assets of one of the combining companies. The Board concludes that a combined corporation should disclose separately a profit or loss resulting from the disposal of a significant part of the assets or a separable segment of the previously separate companies, provided

the profit or loss is material in relation to the net income of the combined corporation, and

the disposition is within two years after the combination is consummated.

The disclosed profit or loss, less applicable income tax effect, should be classified as an extraordinary item.

Date of Recording Combination

.61 A business combination accounted for by the pooling of interests method should be recorded as of the date the combination is consummated. Therefore, even though a business combination is consummated before one or more

of the combining companies first issues its financial statements as of an earlier date, the financial statements issued should be those of the combining company and not those of the resulting combined corporation. A combining company should, however, disclose as supplemental information, in notes to financial statements or otherwise, the substance of a combination consummated before financial statements are issued and the effects of the combination on reported financial position and results of operations (paragraph .65). Comparative financial statements presented in reports of the resulting combined corporation after a combination is consummated should combine earlier financial statements of the separate companies.

.62 A corporation may be reasonably assured that a business combination which has been initiated but not consummated as of the date of financial statements will meet the conditions requiring the pooling of interests method of accounting. The corporation should record as an investment common stock of the other combining company acquired before the statement date. Common stock acquired by disbursing cash or other assets or by incurring liabilities should be recorded at cost. Stock acquired in exchange for common stock of the issuing corporation should, however, be recorded at the proportionate share of underlying net assets at the date acquired as recorded by the other company. Until the pooling of interests method of accounting for the combination is known to be appropriate, the investment and net income of the investor corporation should include the proportionate share of earnings or losses of the other company after the date of acquisition of the stock. The investor corporation should also disclose results of operations for all prior periods presented as well as the entire current period as they will be reported if the combination is later accounted for by the pooling of interests method. After the combination is consummated and the applicable method of accounting is known, financial statements issued previously should be restated as necessary to include the other combining company.

Disclosure of a Combination

.63 A combined corporation should disclose in its financial statements that a combination which is accounted

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for by the pooling of interests method has occurred during the period. The basis of current presentation and restatements of prior periods may be disclosed in the financial statements by captions or by references to notes.

.64 Notes to financial statements of a combined corporation should disclose the following for the period in which a business combination occurs and is accounted for by the pooling of interests method.

a. Name and brief description of the companies combined, except a corporation whose name is carried forward to the combined corporation.

b. Method of accounting for the combination—that is, by the pooling of interests method.

c. Description and number of shares of stock issued in the business combination.

d. Details of the results of operations of the previously separate companies for the period before the combination is consummated that are included in the current combined net income (paragraph .56). The details should include revenue, extraordinary items, net income, other changes in stockholders' equity, and amount of and manner of accounting for intercompany transactions.

e. Descriptions of the nature of adjustments of net assets of the combining companies to adopt the same accounting practices and of the effects of the changes on net income reported previously by the separate companies and now presented in comparative financial statements (paragraph .52).

f. Details of an increase or decrease in retained earnings from changing the fiscal year of a combining company. The details should include at least revenue, expenses, extraordinary items, net income, and other changes in stockholders' equity for the period excluded from the reported results of operations.

g. Reconciliations of amounts of revenue and earnings previously reported by the corporation that issues the stock to effect the combination with the combined amounts currently presented in financial

statements and summaries. A new corporation formed to effect a combination may instead disclose the earnings of the separate companies which comprise combined earnings for prior periods.

The information disclosed in notes to financial statements should also be furnished on a pro forma basis in information on a proposed business combination which is given to stockholders of combining companies.

.65 Notes to the financial statements should disclose details of the effects of a business combination consummated before the financial statements are issued but which is either incomplete as of the date of the financial statements or initiated after that date (paragraph .61). The details should include revenue, net income, earnings per share, and the effects of anticipated changes in accounting methods as if the combination had been consummated at the date of the financial statements (paragraph .52).

Application of Purchase Method

Principles of Historical-Cost Accounting

.66 Accounting for a business combination by the purchase method follows principles normally applicable under historical-cost accounting to recording acquisitions of assets and issuances of stock and to accounting for assets and liabilities after acquisition.

.67 *Acquiring assets.* The general principles to apply the historical-cost basis of accounting to an acquisition of an asset depend on the nature of the transaction:

a. An asset acquired by exchanging cash or other assets is recorded at cost—that is, at the amount of cash disbursed or the fair value of other assets distributed.

b. An asset acquired by incurring liabilities is recorded at cost—that is, at the present value of the amounts to be paid.

c. An asset acquired by issuing shares of stock of the acquiring corporation is recorded at the fair value of the asset[10]—that is, shares of stock issued are

[10] An asset acquired may be an entire entity which may have intangible assets, including goodwill.

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recorded at the fair value of the consideration received for the stock.

The general principles must be supplemented to apply them in certain transactions. For example, the fair value of an asset received for stock issued may not be reliably determinable, or the fair value of an asset acquired in an exchange may be more reliably determinable than the fair value of a noncash asset given up. Restraints on measurement have led to the practical rule that assets acquired for other than cash, including shares of stock issued, should be stated at "cost" when they are acquired and "cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident."[11] "Cost" in accounting often means the amount at which an entity records an asset at the date it is acquired whatever its manner of acquisition, and that "cost" forms the basis for historical-cost accounting.

.68 *Allocating cost.* Acquiring assets in groups requires not only ascertaining the cost of the assets as a group but also allocating the cost to the individual assets which comprise the group. The cost of a group is determined by the principles described in paragraph .67. A portion of the total cost is then assigned to each individual asset acquired on the basis of its fair value. A difference between the sum of the assigned costs of the tangible and identifiable intangible assets acquired less liabilities assumed and the cost of the group is evidence of unspecified intangible values.

.69 *Accounting after acquisition.* The nature of an asset and not the manner of its acquisition determines an acquirer's subsequent accounting for the cost of that asset. The basis for measuring the cost of an asset—whether amount of cash paid, fair value of an asset received or given up, amount of a liability incurred, or fair value of stock issued—has no effect on the subsequent accounting for that cost, which is retained as an asset, depreciated, amortized, or otherwise matched with revenue.

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[11] ARB No. 24; the substance was retained in slightly different words in Chapter 5, ARB No. 43 and ARB No. 48.

Acquiring Corporation

.70 A corporation which distributes cash or other assets or incurs liabilities to obtain the assets or stock of another company is clearly the acquirer. The identities of the acquirer and the acquired company are usually evident in a business combination effected by the issue of stock. The acquiring corporation normally issues the stock and commonly is the larger company. The acquired company may, however, survive as the corporate entity, and the nature of the negotiations sometimes clearly indicates that a smaller corporation acquires a larger company. The Board concludes that presumptive evidence of the acquiring corporation in combinations effected by an exchange of stock is obtained by identifying the former common stockholder interests of a combining company which either retain or receive the larger portion of the voting rights in the combined corporation. That corporation should be treated as the acquirer unless other evidence clearly indicates that another corporation is the acquirer. For example, a substantial investment of one company in common stock of another before the combination may be evidence that the investor is the acquiring corporation.

.71 If a new corporation is formed to issue stock to effect a business combination to be accounted for by the purchase method, one of the existing combining companies should be considered the acquirer on the basis of the evidence available.

Determining Cost of an Acquired Company

.72 The same accounting principles apply to determining the cost of assets acquired individually, those acquired in a group, and those acquired in a business combination. A cash payment by a corporation measures the cost of acquired assets less liabilities assumed. Similarly, the fair values of other assets distributed, such as marketable securities or properties, and the fair value of liabilities incurred by an acquiring corporation measure the cost of an acquired company. The present value of a debt security represents the fair value of the liability, and a premium or discount should be recorded for a debt security issued with an interest rate fixed materially above or below the effective rate or current yield for an otherwise comparable security. (See section 4111.)

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.73 The distinctive attributes of preferred stocks make some issues similar to a debt security while others possess common stock characteristics, with many gradations between the extremes. Determining cost of an acquired company may be affected by those characteristics. For example, the fair value of a nonvoting, nonconvertible preferred stock which lacks characteristics of common stock may be determined by comparing the specified dividend and redemption terms with comparable securities and by assessing market factors. Thus although the principle of recording the fair value of consideration received for stock issued applies to all equity securities, senior as well as common stock, the cost of a company acquired by issuing senior equity securities may be determined in practice on the same basis as for debt securities.

.74 The fair value of securities traded in the market is normally more clearly evident than the fair value of an acquired company (paragraph .67). Thus, the quoted market price of an equity security issued to effect a business combination may usually be used to approximate the fair value of an acquired company after recognizing possible effects of price fluctuations, quantities traded, issue costs, and the like (paragraph .23). The market price for a reasonable period before and after the date the terms of the acquisition are agreed to and announced should be considered in determining the fair value of securities issued.

.75 If the quoted market price is not the fair value of stock, either preferred or common, the consideration received should be estimated even though measuring directly the fair values of assets received is difficult. Both the consideration received, including goodwill, and the extent of the adjustment of the quoted market price of the stock issued should be weighed to determine the amount to be recorded. All aspects of the acquisition, including the negotiations, should be studied, and independent appraisals may be used as an aid in determining the fair value of securities issued. Consideration other than stock distributed to effect an acquisition may provide evidence of the total fair value received.

.76 *Costs of acquisition.* The cost of a company acquired in a business combination accounted for by the

purchase method includes the direct costs of acquisition. Costs of registering and issuing equity securities are a reduction of the otherwise determinable fair value of the securities. However, indirect and general expenses related to acquisitions are deducted as incurred in determining net income.

Contingent Consideration

.77 A business combination agreement may provide for the issuance of additional shares of a security or the transfer of cash or other consideration contingent on specified events or transactions in the future. Some agreements provide that a portion of the consideration be placed in escrow to be distributed or to be returned to the transferor when specified events occur. Either debt or equity securities may be placed in escrow, and amounts equal to interest or dividends on the securities during the contingency period may be paid to the escrow agent or to the potential security holder.

.78 The Board concludes that cash and other assets distributed and securities issued unconditionally and amounts of contingent consideration which are determinable at the date of acquisition should be included in determining the cost of an acquired company and recorded at that date. Consideration which is issued or issuable at the expiration of the contingency period or which is held in escrow pending the outcome of the contingency should be disclosed but not recorded as a liability or shown as outstanding securities unless the outcome of the contingency is determinable beyond reasonable doubt.

.79 Contingent consideration should usually be recorded when the contingency is resolved and consideration is issued or becomes issuable. In general, the issue of additional securities or distribution of other consideration at resolution of contingencies based on earnings should result in an additional element of cost of an acquired company. In contrast, the issue of additional securities or distribution of other consideration at resolution of contingencies based on security prices should not change the recorded cost of an acquired company.

.80 *Contingency based on earnings.* Additional consideration may be contingent on maintaining or achieving

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specified earnings levels in future periods. When the contingency is resolved and additional consideration is distributable, the acquiring corporation should record the current fair value of the consideration issued or issuable as additional cost of the acquired company. The additional costs of affected assets, usually goodwill, should be amortized over the remaining life of the asset.

.81 *Contingency based on security prices.* Additional consideration may be contingent on the market price of a specified security issued to effect a business combination. Unless the price of the security at least equals the specified amount on a specified date or dates, the acquiring corporation is required to issue additional equity or debt securities or transfer cash or other assets sufficient to make the current value of the total consideration equal to the specified amount. The securities issued unconditionally at the date the combination is consummated should be recorded at that date at the specified amount.

.82 The cost of an acquired company recorded at the date of acquisition represents the entire payment, including contingent consideration. Therefore, the issuance of additional securities or distribution of other consideration does not affect the cost of the acquired company, regardless of whether the amount specified is a security price to be maintained or a higher security price to be achieved. On a later date when the contingency is resolved and additional consideration is distributable, the acquiring corporation should record the current fair value of the additional consideration issued or issuable. However, the amount previously recorded for securities issued at the date of acquisition should simultaneously be reduced to the lower current value of those securities. Reducing the value of debt securities previously issued to their later fair value results in recording a discount on debt securities. The discount should be amortized from the date the additional securities are issued.

.83 Accounting for contingent consideration based on conditions other than those described should be inferred from the procedures outlined. For example, if the consideration contingently issuable depends on both future earnings and future security prices, additional cost of the

acquired company should be recorded for the additional consideration contingent on earnings, and previously recorded consideration should be reduced to current value of the consideration contingent on security prices. Similarly, if the consideration contingently issuable depends on later settlement of a contingency, an increase in the cost of acquired assets, if any, should be amortized over the remaining life of the assets.

.84 *Interest or dividends during contingency period.* Amounts paid to an escrow agent representing interest and dividends on securities held in escrow should be accounted for according to the accounting for the securities. That is, until the disposition of the securities in escrow is resolved, payments to the escrow agent should not be recorded as interest expense or dividend distributions. An amount equal to interest and dividends later distributed by the escrow agent to the former stockholders should be added to the cost of the acquired assets at the date distributed and amortized over the remaining life of the assets.

.85 *Tax effect of imputed interest.* A tax reduction resulting from imputed interest on contingently issuable stock reduces the fair value recorded for contingent consideration based on earnings and increases additional capital recorded for contingent consideration based on security prices.

.86 *Compensation in contingent agreements.* The substance of some agreements for contingent consideration is to provide compensation for services or use of property or profit sharing, and the additional consideration given should be accounted for as expenses of the appropriate periods.

Recording Assets Acquired and Liabilities Assumed

.87 An acquiring corporation should allocate the cost of an acquired company to the assets acquired and liabilities assumed. Allocation should follow the principles described in paragraph .68.

> First, all identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company, should be assigned

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a portion of the cost of the acquired company, normally equal to their fair values at date of acquisition.

Second, the excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill. The sum of the market or appraisal values of identifiable assets acquired less liabilities assumed may sometimes exceed the cost of the acquired company. If so, the values otherwise assignable to noncurrent assets acquired (except long-term investments in marketable securities) should be reduced by a proportionate part of the excess to determine the assigned values. A deferred credit for an excess of assigned value of identifiable assets over cost of an acquired company (sometimes called "negative goodwill") should not be recorded unless those assets are reduced to zero value.

Independent appraisals may be used as an aid in determining the fair values of some assets and liabilities. Subsequent sales of assets may also provide evidence of values. The effect of taxes may be a factor in assigning amounts to identifiable assets and liabilities (paragraph .89).

.88 General guides for assigning amounts to the individual assets acquired and liabilities assumed, except goodwill, are:

a. Marketable securities at current net realizable values.

b. Receivables at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary.

c. Inventories:

  (1) Finished goods and merchandise at estimated selling prices less the sum of (a) costs of disposal and (b) a reasonable profit allowance for the selling effort of the acquiring corporation.

  (2) Work in process at estimated selling prices of finished goods less the sum of (a) costs to complete, (b) costs of disposal, and (c) a reasonable

profit allowance for the completing and selling effort of the acquiring corporation based on profit for similar finished goods.

(3) Raw materials at current replacement costs.

d. Plant and equipment: (1) to be used, at current replacement costs for similar capacity [12] unless the expected future use of the assets indicates a lower value to the acquirer, (2) to be sold or held for later sale rather than used, at current net realizable value, and (3) to be used temporarily, at current net realizable value recognizing future depreciation for the expected period of use.

e. Intangible assets which can be identified and named, including contracts, patents, franchises, customer and supplier lists, and favorable leases, at appraised values.[13]

f. Other assets, including land, natural resources, and nonmarketable securities, at appraised values.

g. Accounts and notes payable, long-term debt, and other claims payable at present values of amounts to be paid determined at appropriate current interest rates.

h. Liabilities and accruals—for example, accruals for pension cost,[14] warranties, vacation pay, deferred compensation—at present values of amounts to be paid determined at appropriate current interest rates.

i. Other liabilities and commitments, including unfavorable leases, contracts, and commitments and plant closing expense incident to the acquisition, at present values of amounts to be paid determined at appropriate current interest rates.

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[12] Replacement cost may be determined directly if a used asset market exists for the assets acquired. Otherwise, the replacement cost should be approximated from replacement cost new less estimated accumulated depreciation.

[13] Fair values should be ascribed to specific assets; identifiable assets should not be included in goodwill.

[14] An accrual for pension cost should be the greater of (1) accrued pension cost computed in conformity with the accounting policies of the acquiring corporation for one or more of its pension plans or (2) the excess, if any, of the actuarially computed value of vested benefits over the amount of the pension fund.

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An aquiring corporation should record periodically as a part of income the accrual of interest on assets and liabilities recorded at acquisition date at the discounted values of amounts to be received or paid. An acquiring corporation should not record as a separate asset the goodwill previously recorded by an acquired company and should not record deferred income taxes recorded by an acquired company before its acquisition. An acquiring corporation should reduce the acquired goodwill retroactively for the realized tax benefits of loss carry-forwards of an acquired company not previously recorded by the acquiring corporation.

.89 The market or appraisal values of specific assets and liabilities determined in paragraph .88 may differ from the income tax bases of those items. Estimated future tax effects of differences between the tax bases and amounts otherwise appropriate to assign to an asset or a liability are one of the variables in estimating fair value. Amounts assigned to identifiable assets and liabilities should, for example, recognize that the fair value of an asset to an acquirer is less than its market or appraisal value if all or a portion of the market or appraisal value is not deductible for income taxes. The impact of tax effects on amounts assigned to individual assets and liabilities depends on numerous factors, including imminence or delay of realization of the asset value and the possible timing of tax consequences. Since differences between amounts assigned and tax bases are not timing differences (section 4091.12), the acquiring corporation should not record deferred tax accounts at the date of acquisition.

Amortization of Goodwill

.90 Goodwill recorded in a business combination accounted for by the purchase method should be amortized in accordance with the provisions in section 5141.27-.31.

Excess of Acquired Net Assets Over Cost

.91 The value assigned to net assets acquired should not exceed the cost of an acquired company because the general presumption in historical-cost based accounting is that net assets acquired should be recorded at not more than cost. The total market or appraisal values of identifiable

assets acquired less liabilities assumed in a few business combinations may exceed the cost of the acquired company. An excess over cost should be allocated to reduce proportionately the values assigned to noncurrent assets (except long-term investments in marketable securities) in determining their fair values (paragraph .87). If the allocation reduces the noncurrent assets to zero value, the remainder of the excess over cost should be classified as a deferred credit and should be amortized systematically to income over the period estimated to be benefited but not in excess of forty years. The method and period of amortization should be disclosed.

.92 No part of the excess of acquired net assets over cost should be added directly to stockholders' equity at the date of acquisition.

Acquisition Date

.93 The Board believes that the date of acquisition of a company should ordinarily be the date assets are received and other assets are given or securities are issued. However, the parties may for convenience designate as the effective date the end of an accounting period between the dates a business combination is initiated and consummated. The designated date should ordinarily be the date of acquisition for accounting purposes if a written agreement provides that effective control of the acquired company is transferred to the acquiring corporation on that date without restrictions except those required to protect the stockholders or other owners of the acquired company—for example, restrictions on significant changes in the operations, permission to pay dividends equal to those regularly paid before the effective date, and the like. Designating an effective date other than the date assets or securities are transferred requires adjusting the cost of an acquired company and net income otherwise reported to compensate for recognizing income before consideration is transferred. The cost of an acquired company and net income should therefore be reduced by imputed interest at an appropriate current rate on assets given, liabilities incurred, or preferred stock distributed as of the transfer date to acquire the company.

.94 The cost of an acquired company and the values assigned to assets acquired and liabilities assumed should

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be determined as of the date of acquisition. The statement of income of an acquiring corporation for the period in which a business combination occurs should include income of the acquired company after the date of acquisition by including the revenue and expenses of the acquired operations based on the cost to the acquiring corporation.

Disclosure in Financial Statements

.95 Notes to the financial statements of an acquiring corporation should disclose the following for the period in which a business combination occurs and is accounted for by the purchase method.

a. Name and a brief description of the acquired company.

b. Method of accounting for the combination—that is, by the purchase method.

c. Period for which results of operations of the acquired company are included in the income statement of the acquiring corporation.

d. Cost of the acquired company and, if applicable, the number of shares of stock issued or issuable and the amount assigned to the issued and issuable shares.

e. Description of the plan for amortization of acquired goodwill, the amortization method, and period (section 5141.27-.31).

f. Contingent payments, options, or commitments specified in the acquisition agreement and their proposed accounting treatment.

Information relating to several relatively minor acquisitions may be combined for disclosure.

.96 Notes to the financial statements of the acquiring corporation for the period in which a business combination occurs and is accounted for by the purchase method should include as supplemental information the following results of operations on a pro forma basis:

a. Results of operations for the current period as though the companies had combined at the beginning of the period, unless the acquisition was at or near the beginning of the period.

b. Results of operations for the immediately preceding period as though the companies had combined at the beginning of that period if comparative financial statements are presented.

The supplemental pro forma information should as a minimum show revenue, income before extraordinary items, net income, and earnings per share. To present pro forma information, income taxes, interest expense, preferred stock dividends, depreciation and amortization of assets, including goodwill, should be adjusted to their accounting bases recognized in recording the combination. Pro forma presentation of results of operations of periods prior to the combination transaction should be limited to the immediately preceding period.

EFFECTIVE DATE

.97 The provisions of this section shall be effective to account for business combinations initiated [15] after October 31, 1970. Business combinations initiated before November 1, 1970 and consummated on or after that date under the terms prevailing on October 31, 1970 (paragraph .47-a) may be accounted for in accordance with this section or the applicable previous pronouncements of the Board and its predecessor committee.

.98 The provisions of this section should not be applied retroactively for business combinations consummated before November 1, 1970.

.99 If a corporation holds as an investment on October 31, 1970 a minority interest in or exactly 50 percent of the common stock of another company and the corporation initiates after October 31, 1970 a plan of combination with that company, the resulting business combination may be accounted for by the pooling of interests method provided the combination meets all conditions specified in paragraphs .45 to .48, except that

(i) the minority interest in the voting common stock of the combining company held on October 31, 1970 may exceed 10 percent of the outstanding voting common stock of the combining company (paragraph .46-b), and

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[15] Initiated is defined in paragraph .46-a whether the combination is accounted for by the pooling of interests method or by the purchase method.

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(ii) the corporation which effects the combination issues voting common stock for at least 90 percent of the outstanding voting common stock interest, as described in paragraph .47-b, of the other combining company not already held on October 31, 1970 (rather than 90 percent of all of the common stock interest of the combining company).

The investment in common stock held on October 31, 1970 should not be accounted for as treasury stock or retired stock at the date of the combination. Instead, the excess of cost over the investor corporation's proportionate equity in the net assets of the combining company at or near the date the stock investment was acquired should be allocated to identifiable assets of the combining company at the date the combination is consummated on the basis of the fair values of those assets at the combination date. The unallocated portion of the excess should be assigned to an unidentified intangible asset (goodwill) and should be accounted for according to applicable previous pronouncements of the Board and its predecessor committee. The cost of goodwill should not be amortized retroactively but may be amortized prospectively under the provision of section 5141.35. If the cost of the investment is less than the investor's equity in the net assets of the combining company, that difference should reduce proportionately the recorded amounts of noncurrent assets (except long-term investments in marketable securities) of the combining company. [As amended, effective November 1, 1975, by FASB Statement No. 10.] (See section 1092.)

The next page is 7791.

AC Section 1091-1

Applying Sections 1091 and 5141 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method: An Interpretation of Sections 1091 and 5141

[Source: FASB Interpretation No. 9.]

February 1976

INTRODUCTION

.01 The FASB has been asked to explain how the provisions of *APB Opinions No. 16* [section 1091], "Business Combinations," and *No. 17* [section 5141], "Intangible Assets," should be applied to account for the acquisition of a savings and loan association [1] in a business combination accounted for by the purchase method. In this regard, the FASB has been asked (1) whether the *net-spread* method or the *separate-valuation* method is appropriate for determining the amounts assigned to the assets and liabilities of the acquired savings and loan association and (2) whether any cost not assigned to the identifiable assets acquired less liabilities assumed may be amortized using an accelerated method of amortization rather than the straight-line method of amortization.

.02 Under the net-spread method, the acquisition of a savings and loan association is viewed as the acquisition of a leveraged whole rather than the acquisition of the separate assets and liabilities of the association. Therefore, if the spread between the rates of interest received on mortgage loans and the rates of interest (often called *dividends* in the industry) paid on savings accounts is normal for the particular market area, the acquired savings and loan association's principal assets and liabilities, i. e., its mortgage loan portfolio and savings accounts, are brought forward at the carrying amounts shown in the financial statements of the acquired association.

.03 Under the separate-valuation method, each of the identifiable assets and liabilities of the acquired savings and loan association is accounted for in the consolidated financial statements at an

[1] This Interpretation applies not only in the case of the acquisition of a savings and loan association but also in the case of the acquisition of a savings and loan association holding company, a savings and loan branch, or other financial institution having similar types of assets and liabilities.

amount based on fair value at the date of acquisition, either individually or by types of assets and types of liabilities.

INTERPRETATION

.04 Paragraph 87 of *APB Opinion No. 16* [section 1091.87] states the general principle that "all identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination . . . should be assigned a portion of the cost of the acquired company, normally equal to their fair values at date of acquisition." Because the net-spread method ignores fair value of individual assets and liabilities or types of assets and liabilities, that method is inappropriate under *APB Opinion No. 16* [section 1091].

.05 Paragraph 88 of *APB Opinion No. 16* [section 1091.88] provides "general guides for assigning amounts to the individual assets acquired and liabilities assumed, except goodwill." In paragraph 88(b) [section 1091.88(b)], the general guide for receivables is "present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary." Ascertaining appropriate current interest rates (and the periods over which the receivables are to be discounted) requires an analysis of the many factors that determine the fair value of the portfolio of loans acquired.

.06 In paragraph 88(e) [section 1091.88(e)], the general guide for "intangible assets which can be identified and named, including contracts, patents, franchises, customer and supplier lists, and favorable leases" is "appraised values." A footnote to that paragraph states that "fair values should be ascribed to specific assets; identifiable assets should not be included in goodwill."

.07 In paragraph 88(g) [section 1091.88(g)], the general guide for "accounts and notes payable, long-term debt, and other claims payable" is "present values of amounts to be paid determined at appropriate current interest rates." That present value for savings deposits due on demand is their face amount plus interest accrued or accruable as of the date of acquisition. That present value for other liabilities assumed, e. g., time savings deposits, borrowings from a Federal Home Loan Bank, or other borrowings, shall be determined by using prevailing interest rates for similar liabilities at the acquisition date.

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.08 The purchase price paid for a savings and loan association may include an amount for one or more factors, such as the following:

a) Capacity of existing savings accounts and loan accounts to generate future income,

b) Capacity of existing savings accounts and loan accounts to generate additional business or new business, and

c) Nature of territory served.

If the amount paid for any such factor can be determined, that amount shall not be included in goodwill. Rather, the amount paid for that separately identified intangible shall be recorded as the cost of the intangible and amortized over its estimated life as specified by *APB Opinion No. 17* [section 5141]. Any portion of the purchase price that cannot be assigned to specifically identifiable tangible and intangible assets acquired (see paragraph .06 above) less liabilities assumed shall be assigned to goodwill.

.09 Paragraph 30 of *APB Opinion No. 17* [section 5141.30] requires that goodwill be amortized using the straight-line method "unless a company demonstrates that another systematic method is more appropriate." An accelerated method would be appropriate and may be used to amortize goodwill when a company demonstrates that (a) the amount assigned to goodwill represents an amount paid for factors such as those listed in paragraph .08 but there is not a satisfactory basis for determining appraised values for the individual factors, and (b) the benefits expected to be received from the factors decline over the expected life of those factors. Unless both (a) and (b) are demonstrated, straight-line amortization shall be used.

EFFECTIVE DATE AND TRANSITION

.10 This Interpretation shall be effective for business combinations initiated on or after March 1, 1976. Application to business combinations initiated before March 1, 1976 but consummated on or after that date is encouraged but not required. Application to a business combination consummated prior to March 1, 1976 is permitted if the annual financial statements for the fiscal year in which the business combination was consummated have not yet been issued; if applied to such a combination, financial statements for interim periods of that fiscal year shall be restated if subsequently presented. Previously issued annual financial statements shall not be restated.

The next page is 7851.

AC Section 1092

Extension of "Grandfather" Provisions for Business Combinations

an amendment of Section 1091

[Source: FASB Statement No. 10.]

October 1975

INTRODUCTION AND BACKGROUND INFORMATION

.01 *APB Opinion No. 16* [section 1091], "Business Combinations," which became effective for business combinations initiated after October 31, 1970, establishes conditions that must be met for a business combination to be accounted for by the pooling of interests method. Paragraph 99 of that Opinion [section 1091.99], however, provides an exemption from certain of those conditions for a business combination between two companies with certain intercorporate investments at October 31, 1970 if "the combination is completed within five years after October 31, 1970." That exemption has been referred to as a "grandfather clause." AICPA Accounting Interpretations Nos. 15, 16, 17, and 26 of *APB Opinion No. 16* relate to that grandfather clause. [Sections U1091.050—.060 and U1091.099—.102.]

.02 In addition, AICPA Accounting Interpretation No. 24 of *APB Opinion No. 16* [section U1091.086—.089] contains a grandfather provision related to paragraph 46(a) of that Opinion [section 1091.46(a)] and permits certain subsidiaries to account for business combinations by the pooling of interests method. In part, the Interpretation states:

> Subsidiaries which had a *significant* outstanding minority interest at October 31, 1970 may take part in a pooling combination completed within five years after that date providing the significant minority also exists at the initiation of the combination. In addition, the combination must meet all of the other pooling conditions specified in paragraphs 46 through 48 [sections 1091.46 through 1091.48] . . .
>
> For purposes of this Interpretation, a significant minority means that at least 20 percent of the voting common stock of the subsidiary is owned by persons not affiliated with the parent company.
>
> This "grandfathering" is consistent with paragraph 99 of the Opinion [section 1091.99] and applies both to combinations where the subsidiary with a significant minority interest is the issuing corporation and those where it is the other combining company. However, it does not permit a pooling between a subsidiary and its parent.

.03 The FASB presently has on its technical agenda a project entitled "Accounting for Business Combinations and Purchased Intangibles," which involves a reconsideration of *APB Opinion No. 16* [section 1091]. Consequently, accounting practices that would change if the grandfather provisions of that Opinion expire on October 31, 1975 might, once again, be changed as a result of the FASB's reconsideration of the Opinion. The Board believes that because it is reconsidering *APB Opinion No. 16* [section 1091] the grandfather provisions of the Opinion and related AICPA Accounting Interpretations should continue in effect so as to maintain the status quo during the Board's reconsideration of that Opinion.

.04 An Exposure Draft of a proposed Statement on "Extension of 'Grandfather' Provisions for Business Combinations" was issued on September 8, 1975. Twenty-two letters were received in response to that Exposure Draft. No substantive changes were suggested by respondents, and this Statement contains no substantive changes from the Exposure Draft.

.05 The Board concluded that on the basis of existing data it could make an informed decision on the matter addressed in this Statement without a public hearing and that the effective date set forth in paragraph .08 is advisable.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

.06 The five-year limitation in the grandfather provisions contained in paragraph 99 of *APB Opinion No. 16* [section 1091.99] and in the AICPA Accounting Interpretations cited in paragraphs .01—.02 of this Statement is eliminated.

Amendment to Existing Pronouncement

.07 The wording "the combination is completed within five years after October 31, 1970 and" in paragraph 99 of *APB Opinion No. 16* [section 1091.99] and similar wording in the AICPA Accounting Interpretations cited in paragraphs .01—.02 of this Statement, imposing an October 31, 1975 expiration date for the grandfather provisions, are deleted.

Effective Date

.08 This Statement shall be effective on November 1, 1975.

The provisions of this Statement need not be applied to immaterial items.

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AC Section 2000

FINANCIAL STATEMENT PRESENTATION

. . . reporting the results of operations . . . earnings per share . . . gains and losses from extinguishment of debt . . . prior period adjustments . . . statements of funds . . . working capital . . . form of statements . . . consolidation of financial statements . . . development stage enterprises . . . interim financial statements . . . reportable segments

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AC Section 2010

Reporting the Results of Operations

[Source: APB Opinion No. 9, as amended.]

Effective for fiscal periods beginning after December 31, 1966, unless otherwise indicated

INTRODUCTION

.01 The American Institute of Certified Public Accountants, through its boards and committees, reviews from time to time the form and content of financial statements to determine how their usefulness may be improved. This section is the result of a review of present practice in the reporting of the results of operations of business entities.

.02 This section concludes that net income should reflect all items of profit and loss recognized during the period except for prior period adjustments, with extraordinary items to be shown separately as an element of net income of the period. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.) [As amended, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.] (See section 2014.)

.03 This section also specifies the method of treating extraordinary items and prior period adjustments in comparative statements for two or more periods, specifies the disclosures required when previously issued statements of income are restated and recommends methods of presentation of historical, statistical-type financial summaries which include extraordinary items or are affected by prior period adjustments. [As amended, effective for fiscal periods beginning after December 31, 1968, by APB Opinion No. 15.]

.04 For convenience, the term *net income* is used herein to refer to either net income or net loss. [As amended,

effective for fiscal periods beginning after December 31, 1968, by APB Opinion No. 15.]

APPLICABILITY

.05 This section applies to general purpose statements which purport to present results of operations in conformity with generally accepted accounting principles. Investment companies, insurance companies and certain nonprofit organizations have developed income statements with formats different from those of the typical commercial entity described herein, designed to highlight the peculiar nature and sources of their income or operating results. The portion of this section which requires that net income be presented as one amount does not apply to such entities. [As amended, effective for fiscal periods beginning after December 31, 1968, by APB Opinion No. 13.]

NET INCOME AND THE TREATMENT OF PRIOR PERIOD ADJUSTMENTS

DISCUSSION

General

.06 Business entities have developed a reporting pattern under which periodic financial statements are prepared from their accounting records to reflect the financial position of the entity at a particular date and the financial results of its activities for a specified period or periods. The statement of income and the statement of retained earnings (separately or combined) are designed to reflect, in a broad sense, the "results of operations."

.07 A problem in reporting the results of operations of a business entity for one or more periods is the treatment of prior period adjustments. The section also discusses the various types of adjustment which might be considered to be proper adjustments of the recorded results of operations of prior periods. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.) [As amended, effective for financial statements for fiscal years beginning after October 15, 1977 by FASB Statement No. 16.] (See section 2014.)

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Historical Background

General

.08 There is considerable diversity of views as to whether extraordinary items and prior period adjustments should enter into the determination of net income of the period in which they are recognized. When Accounting Research Bulletin No. 32 was issued in December 1947, as well as when it was reissued in June 1953 as Chapter 8 of Accounting Research Bulletin No. 43, two conflicting viewpoints had attracted considerable support. The paragraphs which follow summarize the discussion of these two viewpoints contained in Chapter 8.

Current Operating Performance

.09 Under one viewpoint, designated *current operating performance,* the principal emphasis is upon the ordinary, normal, recurring operations of the entity during the current period. If extraordinary or prior period transactions have occurred, their inclusion might impair the significance of net income to such an extent that misleading inferences might be drawn from the amount so designated.

.10 Advocates of this position believe that users of financial statements attach a particular business significance to the statement of income and the "net income" reported therein. They point out that, while some users are able to analyze a statement of income and to eliminate from it those prior period adjustments and extraordinary items which may tend to impair its usefulness for their purposes, many users are not trained to do this. They believe that management (subject to the attestation of the independent auditors) is in a better position to do this, and to eliminate the effect of such items from the amount designated as net income.

.11 Advocates of this position also point out that many companies, in order to give more useful information concerning their earnings performance, restate the earnings or losses of affected periods to reflect the proper allocation of prior period adjustments. They believe therefore that items of this type may best be handled as direct adjustments of retained earnings or as "special items" excluded from net income of the current period. They

feel that extraordinary items of *all* types may often best be disclosed as direct adjustments of retained earnings, since this eliminates any distortive effect on reported earnings.

All Inclusive

.12 Under the other viewpoint, designated *all inclusive,* net income is presumed to include all transactions affecting the net increase or decrease in proprietorship equity during the current period, except dividend distributions and transactions of a capital nature.

.13 Proponents of this position believe that the aggregate of such periodic net incomes, over the life of an enterprise, constitutes total net income, and that this is the only fair and complete method of reporting the results of operations of the entity. They believe that extraordinary items and prior period adjustments are part of the earnings history of an entity and that omission of such items from periodic statements of income increases the possibility that these items will be overlooked in a review of operating results for a period of years. They also stress the dangers of possible manipulation of annual earnings figures if such items may be omitted from the determination of net income. They believe that a statement of income including all such items is easy to understand and less subject to variations resulting from different judgments. They feel that, when judgment is allowed to determine whether to include or exclude particular items or adjustments, significant differences develop in the treatment of borderline cases and that there is a danger that the use of ''extraordinary'' as a criterion may be a means of equalizing income. Advocates of this theory believe that full disclosure in the income statement of the nature of any extraordinary items or prior period adjustments during each period will enable the user of a statement of income to make his own assessment of the importance of the items and their effects on operating results.

Decisions of Committee on Accounting Procedure—Subsequent Developments

.14 The committee on accounting procedure (predecessor of the Accounting Principles Board) did not em-

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brace either of these viewpoints in its entirety in issuing its first Accounting Research Bulletin on this subject in December 1947. Instead, the committee stated ". . . it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period. Thus, only extraordinary items such as the following may be excluded from the determination of net income for the year, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom: . . . ."[1] The list of items which followed consisted of material charges or credits, other than ordinary adjustments of a recurring nature, (a) specifically related to operations of prior years, (b) resulting from unusual sales of assets not acquired for resale and not of the type in which the company usually deals, (c) resulting from losses of a type not usually insured against, (d) resulting from the write-off of a material amount of intangibles or a material amount of unamortized bond discount or premium and expense. The language quoted above was continued substantially unchanged in the 1953 *Restatement and Revision of Accounting Research Bulletins,* becoming Chapter 8 of ARB No. 43.

.15 Since the issuance of these guidelines for the determination of net income, developments in the business and investment environment have increased the emphasis on, and interest in, the financial reporting format of business entities and the nature of the amount shown as net income therein. As a result of the widespread and increasing dissemination of financial data, often in highly condensed form, to investors and potential investors, suggestions have been made that the criteria for the determination of the amount to be reported as net income, insofar as it is affected by extraordinary items and prior period adjustments, should be re-examined.

[1] Accounting Research Bulletin No. 32, *Income and Earned Surplus.*

OPINION

Summary

.16 The Board has considered various methods of reporting the effects of extraordinary events and transactions and of prior period adjustments which are recorded in the accounts during a particular accounting period. The Board has concluded that net income should reflect all items of profit and loss recognized during the period with the sole exception of the prior period adjustments described below. *Extraordinary items* should, however, be segregated from the results of ordinary operations and shown separately in the income statement, with disclosure of the nature and amounts thereof. The criteria for determination of extraordinary items and their presentation are described in section 2012.19-.24. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.]

.17 Those items that are reported as prior period adjustments shall, in single period statements, be reflected as adjustments of the opening balance of retained earnings. When comparative statements are presented, corresponding adjustments should be made of the amounts of net income (and the components thereof) and retained earnings balances (as well as of other affected balances) for all of the periods reported therein, to reflect the retroactive application of the prior period adjustments. (See paragraph .25 for required disclosures of prior period adjustments.) [As amended, effective for fiscal periods beginning after July 31, 1971 by APB Opinion No. 20]. [As amended, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.] (See section 2014.)

.18 The Board has concluded that the above approach to the reporting of the results of operations of business entities will result in the most meaningful and useful type of financial presentation. The principal advantages are: (a) inclusion of all operating items related to the current period, with segregation and disclosure of the extraordinary items, (b) a reporting of current income from operations free from distortions resulting from material items directly related to prior periods and (c) proper retroactive

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reflection in comparative financial statements of material adjustments relating directly to prior periods. In reaching its conclusion, the Board recognizes that this approach may involve (a) occasional revision of previously-reported net income for prior periods to reflect subsequently recorded material items directly related thereto, (b) difficulty in segregating extraordinary items and items related to prior periods and (c) the possibility that disclosures regarding adjustments of opening balances in retained earnings or of net income of prior periods will be overlooked by the reader.

[.19-.21] [Superseded, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

[.22-.23] [Superseded, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.] (See section 2014.)

[.24] [Superseded, effective for fiscal periods beginning after July 31, 1971 by APB Opinion No. 20.] (See section 1051.)

Disclosure of Prior Period Adjustments and Restatements of Reported Net Income

.25 When prior period adjustments are recorded, the resulting effects (both gross and net of applicable income tax) on the net income of prior periods should be disclosed in the annual report for the year in which the adjustments are made.[2] When financial statements for a single period only are presented, this disclosure should indicate the ef-

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[2] The Board recommends disclosure, in addition, in interim reports issued during that year subsequent to the date of recording the adjustments.

fects of such restatement on the balance of retained earnings at the beginning of the period and on the net income of the immediately preceding period. When financial statements for more than one period are presented, which is ordinarily the preferable procedure,[3] the disclosure should include the effects for each of the periods included in the statements. Such disclosures should include the amounts of income tax applicable to the prior period adjustments. Disclosure of restatements in annual reports issued subsequent to the first such post-revision disclosure would ordinarily not be required.

Historical Summaries of Financial Data

.26 It has become customary for business entities to present historical, statistical-type summaries of financial data for a number of periods—commonly five or ten years. The Board recommends that the format for reporting extraordinary items described in section 2012 be used in such summaries. The Board further recommends that, whenever prior period adjustments have been recorded during any of the periods included therein, the reported amounts of net income (and the components thereof), as well as other affected items, be appropriately restated, with disclosure in the first summary published after the adjustments. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

Capital Transactions

.27 The Board reaffirms the conclusion of the former committee on accounting procedure that the following should be excluded from the determination of net income or the results of operations under all circumstances: (a) adjustments or charges or credits resulting from transactions in the company's own capital stock,[4] (b) transfers to and from accounts properly designated as appropriated retained earnings (such as general purpose contingency reserves or provisions for replacement costs of fixed assets) and (c) adjustments made pursuant to a quasi-reorganization.

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[3] See section 2041, *Comparative Financial Statements.*

[4] See section 5542, *Profits or Losses on Treasury Stock.*

Income Statements

.28 Income statements may be prepared in either "single-step" or "multi-step" form. Regardless of the form used, the income statement should disclose revenues (sales), and the elements mentioned in section 2012.11 should be clearly disclosed in the order there indicated. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

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AC Section 2011

Earnings per Share*

[Source: APB Opinion No. 15, as amended.]

Effective for fiscal periods beginning after December 31, 1968, unless otherwise indicated [1]

INTRODUCTION

.01 Earnings per share data are used in evaluating the past operating performance of a business, in forming an opinion as to its potential and in making investment decisions. They are commonly presented in prospectuses, proxy material and reports to stockholders. They are used in the compilation of business earnings data for the press, statistical services and other publications. When presented with formal financial statements, they assist the investor in weighing the significance of a corporation's current net income and of changes in its net income from period to period in relation to the shares he holds or may acquire.

.02 In view of the widespread use of earnings per share data, it is important that such data be computed on a consistent basis and presented in the most meaningful manner. The Board and its predecessor committee have previously expressed their views on general standards designed to achieve these objectives, most recently in Part II of APB Opinion No. 9, *Reporting the Results of Operations.*[2]

.03 In this section the Board expresses its views on some of the more specific aspects of the subject, including the guidelines that should be applied uniformly in the computation and presentation of earnings per share data in financial statements.

.04 Computational guidelines for the implementation of this section are contained in section 2011A. Certain views differing from those adopted in this section are summarized in section 2011B. Illustrations of the presentations described in this section are included in the Exhibits

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* See section 2083, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises.*

[1] See paragraphs .45 and .46.

[2] Editor's Note: Footnote reference eliminated.

contained in section 2011C. Definitions of certain terms as used in this section are contained in section 2011D.

APPLICABILITY

.05 This section applies to financial presentations which purport to present results of operations of corporations in conformity with generally accepted accounting principles and to summaries of those presentations, except as excluded in paragraph .06. Thus, it applies to corporations whose capital structures include only common stock or common stock and senior securities and to those whose capital structures also include securities that should be considered the equivalent of common stock [3] in computing earnings per share data.

.06 This section does not apply to mutual companies that do not have outstanding common stock or common stock equivalents (for example, mutual savings banks, cooperatives, credit unions, and similar entities); to registered investment companies; to government-owned corporations; or to nonprofit corporations. This section also does not apply to parent company statements accompanied by consolidated financial statements, to statements of wholly-owned subsidiaries, or to special purpose statements.

HISTORICAL BACKGROUND

.07 Prior to the issuance of APB Opinion No. 9, earnings per share were generally computed by dividing net income (after deducting preferred stock dividends, if any) by the number of common shares outstanding. The divisor used in the computation usually was a weighted average of the number of common shares outstanding during the period, but sometimes was simply the number of common shares outstanding at the end of the period.

.08 ARB No. 49, *Earnings per Share,* referred to "common stock or other residual security;" however, the concept that a security other than a common stock could be the substantial equivalent of common stock and should,

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[3] APB Opinion No. 9 referred to certain securities as *residual* securities, the determination of which was generally based upon the market value of the security as it related to investment value. In this section, the Board now uses the term *common stock equivalents* as being more descriptive of those securities other than common stock that should be dealt with as common stock in the determination of earnings per share.

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therefore, enter into the computation of earnings per share was seldom followed prior to the issuance of APB Opinion No. 9. Paragraph 33 of APB Opinion No. 9 stated that earnings per share should be computed by reference to common stock and other residual securities and defined a residual security as follows:

> ''When more than one class of common stock is outstanding, or when an outstanding security has participating dividend rights with the common stock, or when an outstanding security clearly derives a major portion of its value from its conversion rights or its common stock characteristics, such securities should be considered 'residual securities' and not 'senior securities' for purposes of computing earnings per share.''

.09 APB Opinon No. 9 also stated in part (paragraph 43) that:

> ''Under certain circumstances, earnings per share may be subject to dilution in the future if existing contingencies permitting issuance of common shares eventuate. Such circumstances include contingent changes resulting from the existence of (a) outstanding senior stock or debt which is convertible into common shares, (b) outstanding stock options, warrants or similar agreements and (c) agreements for the issuance of common shares for little or no consideration upon the satisfaction of certain conditions (e.g., the attainment of specified levels of earnings following a business combination). If such potential dilution is material, supplementary pro forma computations of earnings per share should be furnished, showing what the earnings would be if the conversions or contingent issuances took place.''

Before the issuance of APB Opinion No. 9 corporations had rarely presented pro forma earnings per share data of this type except in prospectuses and proxy statements.

.10 Under the definition of a residual security contained in paragraph 33 of APB Opinion No. 9, residual status of convertible securities has been determined using the ''major-portion-of-value'' test at the time of the issuance of the security and from time to time thereafter when-

ever earnings per share data were presented. In practice this test has been applied by comparing a convertible security's market value with its investment value, and the security has been considered to be residual whenever more than half its market value was attributable to its common stock characteristics at time of issuance. Practice has varied in applying this test subsequent to issuance with a higher measure used in many cases. Thus, a convertible security's status as a residual security has been affected by equity and debt market conditions at and after the security's issuance.

.11 Application of the residual security concept as set forth in paragraph 33 of APB Opinion No. 9 has raised questions as to the validity of the concept and as to the guidelines developed for its application in practice. The Board has reviewed the concept of residual securities as it relates to earnings per share and, as a result of its own study and the constructive comments on the matter received from interested parties, has concluded that modification of the residual concept is desirable. The Board has also considered the disclosure and presentation requirements of earnings per share data contained in APB Opinion No. 9 and has concluded that these should be revised.

OPINION

Presentation on Face of Income Statement

.12 The Board believes that the significance attached by investors and others to earnings per share data, together with the importance of evaluating the data in conjunction with the financial statements, requires that such data be presented prominently in the financial statements. The Board has therefore concluded that earnings per share or net loss per share data should be shown on the face of the income statement. The extent of the data to be presented and the captions used will vary with the complexity of the company's capital structure, as discussed in the following paragraphs.

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.13 The reporting of earnings per share data should be consistent with the income statement presentation called for by section 2012. Earnings per share amounts should therefore be presented for (a) income before extraordinary items and (b) net income. It may also be desirable to present earnings per share amounts for extraordinary items. if any. When accounting changes and corrections of errors in previously issued financial statements occur, refer to section 1051, *Accounting Changes.* [As amended, effective for fiscal periods beginning after July 31, 1971 by APB Opinion No. 20.] [As amended, effective for events and transactions occurring after September 30, 1973, by APB Opinion No. 30.] (See section 2012.)

Simple Capital Structures

.14 The capital structures of many corporations are relatively simple—that is, they either consist of only common stock or include no potentially dilutive convertible securities, options, warrants or other rights that upon conversion or exercise could in the aggregate dilute [4] earnings per common share. In these cases, a single presentation expressed in terms such as *Earnings per common share* on the face of the income statement (based on common shares outstanding and computed in accordance with the provisions of section 2011A.02-.05) is the appropriate presentation of earnings per share data.

Complex Capital Structures

.15 Corporations with capital structures other than those described in the preceding paragraph should present two types of earnings per share data (dual presentation) with equal prominence on the face of the income statement. The first presentation is based on the outstanding common shares and those securities that are in substance equivalent to common shares and have a dilutive [4] effect. The second is a pro-forma presentation which reflects the dilution [4] of

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[4] Any reduction of less than 3% in the aggregate need not be considered as dilution in the computation and presentation of earnings per share data as discussed throughout this section. In applying this test only issues which reduce earnings per share should be considered. In establishing this guideline the Board does not imply that a similar measure should be applied in any circumstances other than the computation and presentation of earnings per share data under this section.

earnings per share that would have occurred if *all* contingent issuances of common stock that would individually reduce earnings per share had taken place at the beginning of the period (or time of issuance of the convertible security, etc., if later). For convenience in this section, these two presentations are referred to as "primary earnings per share" and "fully diluted earnings per share,"[5] respectively, and would in certain circumstances discussed elsewhere in this section be supplemented by other disclosures and other earnings per share data. (See paragraphs .19-.23.)

Dual Presentation

.16 When dual presentation of earnings per share data is required, the primary and fully diluted earnings per share amounts should be presented with equal prominence on the face of the income statement. The difference between the primary and fully diluted earnings per share

[5] APB Opinion No. 9 referred to the latter presentation as "supplementary pro forma earnings per share."

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amounts shows the maximum extent of potential dilution of current earnings which conversions of securities that are not common stock equivalents could create. If the capital structure contains no common stock equivalents, the first may be designated *Earnings per common share—assuming no dilution* and the second *Earnings per common share—assuming full dilution.* When common stock equivalents are present and dilutive, the primary amount may be designated *Earnings per common and common equivalent share.* The Board recognizes that precise designations should not be prescribed; corporations should be free to designate these dual presentations in a manner which best fits the circumstances provided they are in accord with the substance of this section. The term *Earnings per common share* should not be used without appropriate qualification except under the conditions discussed in paragraph .14.

Periods Presented

.17 Earnings per share data should be presented for all periods covered by the statement of income or summary of earnings. If potential dilution exists in any of the periods presented, the dual presentation of primary earnings per share and fully diluted earnings per share data should be made for all periods presented. This information together with other disclosures required (see paragraphs .19-.23) will give the reader an understanding of the extent and trend of the potential dilution.

.18 When results of operations of a prior period included in the statement of income or summary of earnings have been restated as a result of a prior period adjustment, earnings per share data given for the prior period should be restated. The effect of the restatement, expressed in per share terms, should be disclosed in the year of restatement.

Additional Disclosures

Capital Structure

.19 The use of complex securities complicates earnings per share computations and makes additional disclosures necessary. The Board has concluded that financial

statements should include a description, in summary form, sufficient to explain the pertinent rights and privileges of the various securities outstanding. Examples of information which should be disclosed are dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking fund requirements, unusual voting rights, etc.

Dual Earnings per Share Data

.20 A schedule or note relating to the earnings per share data should explain the bases upon which both primary and fully diluted earnings per share are calculated. This information should include identification of any issues regarded as common stock equivalents in the computation of primary earnings per share and the securities included in the computation of fully diluted earnings per share. It should describe all assumptions and any resulting adjustments used in deriving the earnings per share data.[6] There should also be disclosed the number of shares issued upon conversion, exercise or satisfaction of required conditions, etc., during at least the most recent annual fiscal period and any subsequent interim period presented.[7]

.21 Computations and/or reconciliations may sometimes be desirable to provide a clear understanding of the manner in which the earnings per share amounts were obtained. This information may include data on each issue of securities entering into the computation of the primary and fully diluted earnings per share. It should not, however, be shown on the face of the income statement or otherwise furnished in a manner implying that an earnings per share amount which ignores the effect of common stock equivalents (that is, earnings per share based on outstanding common shares only) constitutes an acceptable presentation of primary earnings per share.

Supplementary Earnings per Share Data

.22 Primary earnings per share should be related to the capital structures existing during each of the various

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[6] These computations should give effect to all adjustments which would result from conversion: for example, dividends paid on convertible preferred stocks should not be deducted from net income; interest and related expenses on convertible debt, less applicable income tax, should be added to net income, and any other adjustments affecting net income because of these assumptions should also be made. (See section 2011A.06.)

[7] See also section 2042 and section 2071.

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periods presented.[8] Although conversions ordinarily do not alter substantially the amount of capital employed in the business, they can significantly affect the trend in earnings per share data. Therefore, if conversions during the current period would have affected (either dilutively or incrementally) primary earnings per share if they had taken place at the beginning of the period, supplementary information should be furnished (preferably in a note) for the latest period showing what primary earnings per share would have been if such conversions had taken place at the beginning of that period (or date of issuance of the security, if within the period). Similar supplementary per share earnings should be furnished if conversions occur after the close of the period but before completion of the financial report. It may also be desirable to furnish supplementary per share data for each period presented, giving the cumulative retroactive effect of all such conversions or changes. However, primary earnings per share data should not be adjusted retroactively for conversions.

.23 Occasionally a sale of common stock or common stock equivalents for cash occurs during the latest period presented or shortly after its close but before completion of the financial report. When a portion or all of the proceeds of such a sale has been used to retire preferred stock or debt, or is to be used for that purpose, supplementary earnings per share data should be furnished (preferably in a note) to show what the earnings would have been for the latest fiscal year and any subsequent interim period presented if the retirement had taken place at the beginning of the respective period (or date of issuance of the retired security, if later). The number of shares of common stock whose proceeds are to be used to retire the preferred stock or debt should be included in this computation. The bases of these supplementary computations should be disclosed.[9]

Primary Earnings per Share

.24 If a corporation's capital structure is complex and either does not include common stock equivalents or includes common stock equivalents which do not have a dilutive effect, the primary earnings per share figures should be

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[8] See sections 2011A.03-.04 and 2011A.17-.19 for exceptions to this general rule.

[9] There may be other forms of recapitalization which should be reflected in a similar manner.

based on the weighted average number of shares of common stock outstanding during the period. In such cases, potential dilutive effects of contingent issuances would be reflected in the fully diluted earnings per share amounts. Certain securities, however, are considered to be the equivalent of outstanding common stock and should be recognized in the computation of primary earnings per share if they have a dilutive effect.

Nature of Common Stock Equivalents

.25 The concept that a security may be the equivalent of common stock has evolved to meet the reporting needs of investors in corporations that have issued certain types of convertible and other complex securities. A common stock equivalent is a security which is not, in form, a common stock but which usually contains provisions to enable its holder to become a common stockholder and which, because of its terms and the circumstances under which it was issued, is in substance equivalent to a common stock. The holders of these securities can expect to participate in the appreciation of the value of the common stock resulting principally from the earnings and earnings potential of the issuing corporation. This participation is essentially the same as that of a common stockholder except that the security may carry a specified dividend or interest rate yielding a return different from that received by a common stockholder. The attractiveness of this type of security to investors is often based principally on this potential right to share in increases in the earnings potential of the issuing corporation rather than on its fixed return or other senior security characteristics. With respect to a convertible security, any difference in yield between it and the underlying common stock as well as any other senior characteristics of the convertible security become secondary. The value of a common stock equivalent is derived in large part from the value of the common stock to which it is related, and changes in its value tend to reflect changes in the value of the common stock. Neither conversion nor the imminence of conversion is necessary to cause a security to be a common stock equivalent.

.26 The Board has concluded that outstanding convertible securities which have the foregoing characteristics and which meet the criteria set forth in this section for the

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determination of common stock equivalents at the time they are issued should be considered the equivalent of common stock in computing primary earnings per share if the effect is dilutive. The recognition of common stock equivalents in the computation of primary earnings per share avoids the misleading implication which would otherwise result from the use of common stock only; use of the latter basis would place form over substance.

.27 In addition to convertible debt and convertible preferred stocks, the following types of securities are or may be considered as common stock equivalents:

Stock options and warrants (and their equivalents) and stock purchase contracts—should always be considered common stock equivalents (see paragraphs .35-.38).

Participating securities and two-class common stocks—if their participation features enable their holders to share in the earnings potential of the issuing corporation on substantially the same basis as common stock even though the securities may not give the holder the right to exchange his shares for common stock (see section 2011A.14-.15).

Contingent shares—if shares are to be issued in the future upon the mere passage of time (or are held in escrow pending the satisfaction of conditions unrelated to earnings or market value) they should be considered as outstanding for the computation of earnings per share. If additional shares of stock are issuable for little or no consideration upon the satisfaction of certain conditions they should be considered as outstanding when the conditions are met (see section 2011A.16-.19).

Determination of Common Stock Equivalents at Issuance

.28 The Board has concluded that determination of whether a convertible security is a common stock equivalent should be made only at the time of issuance and should not be changed thereafter so long as the security remains outstanding. However, convertible securities outstanding or subsequently issued with the same terms as those of a common stock equivalent also should be classified as common stock equivalents. After full consideration of whether a convertible security may change its status as a common

stock equivalent subsequent to issuance, including the differing views which are set forth in section 2011B hereto, the Board has concluded that the dilutive effect of any convertible securities that were not common stock equivalents at time of their issuance should be included only in the fully diluted earnings per share amount. This conclusion is based upon the belief (a) that only the conditions which existed at the time of issuance of the convertible security should govern the determination of status as a common stock equivalent, and (b) that the presentation of fully diluted earnings per share data adequately discloses the potential dilution which may exist because of changes in conditions subsequent to time of issuance.

.29 Various factors should be considered in determining the appropriate "time of issuance" in evaluating whether a security is substantially equivalent to a common stock. The time of issuance generally is the date when agreement as to terms has been reached and announced, even though subject to certain further actions, such as directors' or stockholders' approval.

No Anti-Dilution

.30 Computations of primary earnings per share should not give effect to common stock equivalents or other contingent issuance for any period in which their inclusion would have the effect of increasing the earnings per share amount or decreasing the loss per share amount otherwise computed.[10] Consequently, while a security once determined to be a common stock equivalent retains that status, it may enter into the computation of primary earnings per share in one period and not in another.

Test of Common Stock Equivalent Status

.31 *Convertible securities.* A convertible security which at the time of issuance has terms that make it for all practical purposes substantially equivalent to a common

[10] The presence of a common stock equivalent or other dilutive securities together with income from continuing operations and extraordinary items may result in diluting one of the per share amounts which are required to be disclosed on the face of the income statement—i. e., income from continuing operations, income before extraordinary items and before the cumulative effect of accounting changes, if any, and net income—while increasing another. In such a case, the common stock equivalent or other dilutive securities should be recognized for all computations even though they have an anti-dilutive effect on one of the per share amounts. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

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stock should be regarded as a common stock equivalent. The complexity of convertible securities makes it impractical to establish definitive guidelines to encompass all the varying terms which might bear on this determination. Consideration has been given, however, to various characteristics of a convertible security which might affect its status as a common stock equivalent, such as cash yield at issuance, increasing or decreasing conversion rates, liquidation and redemption amounts, and the conversion price in relation to the market price of the common stock. In addition, consideration has been given to the pattern of various nonconvertible security yields in recent years, during which period most of the existing convertible securities have been issued, as well as over a longer period of time. Many of the characteristics noted above, which in various degrees may indicate status as a common stock equivalent, are also closely related to the interest or dividend rate of the security and to its market price at the time of issuance.

.32 The Board has also studied the use of market price in relation to investment value (value of a convertible security without the conversion option) and market parity (relationship of conversion value of a convertible security to its market price) as means of determining if a convertible security is equivalent to a common stock. (See discussion of investment value and market parity tests in section 2011B.) It has concluded, however, that these tests are too subjective or not sufficiently practicable.

.33 The Board believes that convertible securities should be considered common stock equivalents if the cash yield to the holder at time of issuance is significantly below what would be a comparable rate for a similar security of the issuer without the conversion option. Recognizing that it may frequently be difficult or impossible to ascertain such comparable rates, and in the interest of simplicity and objectivity, the Board has concluded that a convertible security should be considered as a common stock equivalent at the time of issuance if, based on its market price,[11] it has a cash yield of less than 66⅔% of the then current bank prime interest rate.[12] For any convertible security which

[11] If no market price is available, this test should be based on the fair value of the security.

[12] If convertible securities are sold or issued outside the United States, the most comparable interest rate in the foreign country should be used for this test.

has a change in its cash interest rate or cash dividend rate scheduled within the first five years after issuance, the lowest scheduled rate during such five years should be used in determining the cash yield of the security at issuance.

.34 The Board believes that the current bank prime interest rate in general use for short-term loans represents a practical, simple and readily available basis on which to establish the criteria for determining a common stock equivalent, as set forth in the preceding paragraph. The Board recognizes that there are other rates and averages of interest rates relating to various grades of long-term debt securities and preferred stocks which might be appropriate or that a more complex approach could be adopted. However, after giving consideration to various approaches and interest rates in this regard, the Board has concluded that since there is a high degree of correlation between such indices and the bank prime interest rate, the latter is the most practical rate available for this particular purpose.

.35 *Options and warrants (and their equivalents).* Options, warrants and similar arrangements usually have no cash yield and derive their value from their right to obtain common stock at specified prices for an extended period. Therefore, these securities should be regarded as common stock equivalents at all times. Other securities, usually having a low cash yield (see definition of ''cash yield'', section 2011D.03), require the payment of cash upon conversion and should be considered the equivalents of warrants for the purposes of this section. Accordingly, they should also be regarded as common stock equivalents at all times. Primary earnings per share should reflect the dilution that would result from exercise or conversion of these securities and use of the funds, if any, obtained. Options and warrants (and their equivalents) should, therefore, be treated as if they had been exercised and earnings per share data should be computed as described in the following paragraphs. The computation of earnings per share should not, however, reflect exercise or conversion of any such security [13] if its effect on earnings per share is anti-dilutive (see paragraph .30) except as indicated in paragraph .38.

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[13] Reasonable grouping of like securities may be appropriate.

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.36 Except as indicated in this paragraph and in paragraphs .37 and .38, the amount of dilution to be reflected in earnings per share data should be computed by application of the "treasury stock" method. Under this method, earnings per share data are computed as if the options and warrants were exercised at the beginning of the period (or at time of issuance, if later) and as if the funds obtained thereby were used to purchase common stock at the average market price during the period.[14] As a practical matter, the Board recommends that assumption of exercise not be reflected in earnings per share data until the market price of the common stock obtainable has been in excess of the exercise price for substantially all of three consecutive months ending with the last month of the period to which earnings per share data relate. Under the treasury stock method, options and warrants have a dilutive effect (and are, therefore, reflected in earnings per share computations) only when the average market price of the common stock obtainable upon exercise during the period exceeds the exercise price of the options or warrants. Previously reported earnings per share amounts should not be retroactively adjusted, in the case of options and warrants, as a result of changes in market prices of common stock. The Board recognizes that the funds obtained by issuers from the exercise of options and warrants are used in many ways with a wide variety of results that cannot be anticipated. Application of the treasury stock method in earnings per share computations is not based on an assumption that the funds will or could actually be used in that manner. In the usual case, it represents a practical approach to reflecting the dilutive effect that would result from the issuance of common stock under option and warrant agreements at an effective price below the current market price. The Board has concluded, however, that the treasury stock method is inappropriate, or should be modified, in certain cases described in paragraphs .37 and .38.

[14] For example, if a corporation has 10,000 warrants outstanding, exercisable at $54 and the average market price of the common stock during the reporting period is $60, the $540,000 which would be realized from exercise of the warrants and issuance of 10,000 shares would be an amount sufficient to acquire 9,000 shares; thus 1,000 shares would be added to the outstanding common shares in computing primary earnings per share for the period.

.37 Some warrants contain provisions which permit, or require, the tendering of debt (usually at face amount) or other securities of the issuer in payment for all or a portion of the exercise price. The terms of some debt securities issued with warrants require that the proceeds of the exercise of the related warrants be applied toward retirement of the debt. As indicated in paragraph .35, some convertible securities require cash payments upon conversion and are, therefore, considered to be the equivalent of warrants. In all of these cases, the "if converted" method (see section 2011A.06) should be applied as if retirement or conversion of the securities had occurred and as if the excess proceeds, if any, had been applied to the purchase of common stock under the treasury stock method. However, exercise of the options and warrants should not be reflected in the computation unless for the period specified in paragraph .36 either (a) the market price of the related common stock exceeds the exercise price or (b) the security which may be (or must be) tendered is selling at a price below that at which it may be tendered under the option or warrant agreement and the resulting discount is sufficient to establish an effective exercise price below the market price of the common stock that can be obtained upon exercise. Similar treatment should be followed for preferred stock bearing similar provisions or other securities having conversion options permitting payment of cash for a more favorable conversion rate from the standpoint of the investor.

.38 The treasury stock method of reflecting use of proceeds from options and warrants may not adequately reflect potential dilution when options or warrants to acquire a substantial number of common shares are outstanding. Accordingly, the Board has concluded that, if the number of shares of common stock obtainable upon exercise of outstanding options and warrants in the aggregate exceeds 20% of the number of common shares outstanding at the end of the period for which the computation is being made, the treasury stock method should be modified in determining the dilutive effect of the options and warrants upon earnings per share data. In these circumstances all the options and warrants should be assumed to have been exercised and the aggregate proceeds therefrom to have been applied in two steps:

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a. As if the funds obtained were first applied to the repurchase of outstanding common shares at the average market price during the period (treasury stock method) but not to exceed 20% of the outstanding shares; and then

b. As if the balance of the funds were applied first to reduce any short-term or long-term borrowings and any remaining funds were invested in U. S. government securities or commercial paper, with appropriate recognition of any income tax effect.

The results of steps (a) and (b) of the computation (whether dilutive or anti-dilutive) should be aggregated and, if the net effect is dilutive, should enter into the earnings per share computation.[15]

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[15] The following are examples of the application of Paragraph .38:

Assumptions:	*Case 1*	*Case 2*
Net income for year	$ 4,000,000	$ 2,000,000
Common shares outstanding	3,000,000	3,000,000
Options and warrants outstanding to purchase equivalent shares	1,000,000	1,000,000
20% limitation on assumed repurchase	600,000	600,000
Exercise price per share	$15	$15
Average and year-end market value per common share to be used (see paragraph 42)	$20	$12
Computations:		
Application of assumed proceeds ($15,000,000):		
Toward repurchase of outstanding common shares at applicable market value	$12,000,000	$ 7,200,000
Reduction of debt	3,000,000	7,800,000
	$15,000,000	$15,000,000
Adjustment of net income:		
Actual net income	$ 4,000,000	$ 2,000,000
Interest reduction (6%) less 50% tax effect	90,000	234,000
Adjusted net income (A)	$ 4,090,000	$ 2,234,000
Adjustment of shares outstanding:		
Actual outstanding	3,000,000	3,000,000
Net additional shares issuable (1,000,000—600,000)	400,000	400,000
Adjusted shares outstanding (B)	3,400,000	3,400,000
Earnings per share:		
Before adjustment	$1.33	$ .67
After adjustment (A ÷ B)	$1.20	$ .66

Non-Recognition of Common Stock Equivalents in Financial Statements

.39 The designation of securities as common stock equivalents in this section is solely for the purpose of determining primary earnings per share. No changes from present practices are recommended in the accounting for such securities, in their presentation within the financial statements or in the manner of determining net assets per common share. Information is available in the financial statements and elsewhere for readers to make judgments as to the present and potential status of the various securities outstanding.

Fully Diluted Earnings Per Share

No Anti-Dilution

.40 The purpose of the fully diluted earnings per share presentation is to show the maximum potential dilution of current earnings per share on a prospective basis. Consequently, computations of fully diluted earnings per share for each period should exclude those securities whose conversion, exercise or other contingent issuance would have the effect of increasing the earnings per share amount or decreasing the loss per share amount [16] for such period.

When Required

.41 Fully diluted earnings per share data should be presented on the face of the statement of income for each period presented if shares of common stock (a) were issued during the period on conversions, exercise, etc., or (b) were contingently issuable at the close of any period presented and if primary earnings per share for such period would have been affected (either dilutively or incrementally) had such actual issuances taken place at the beginning of the period or would have been reduced had such contingent issuances taken place at the beginning of the period. The above contingencies may result from the existence of (a) senior stock or debt which is convertible into common shares but is not a common stock equivalent, (b) options or warrants, or (c) agreements for the issuance of common shares upon the satisfaction of certain conditions (for example, the attainment of specified higher levels of earnings following a business combination). The computation should be based on the assumption that all such issued and issuable

[16] See footnote 10.

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shares were outstanding from the beginning of the period (or from the time the contingency arose, if after the beginning of the period). Previously reported fully diluted earnings per share amounts should not be retroactively adjusted for subsequent conversions or subsequent changes in the market prices of the common stock.

.42 The methods described in paragraphs .36-.38 should be used to compute fully diluted earnings per share if dilution results from outstanding options and warrants; however, in order to reflect maximum potential dilution, the market price at the close of the period reported upon should be used to determine the number of shares which would be assumed to be repurchased (under the treasury stock method) if such market price is higher than the average price used in computing primary earnings per share (see paragraph .30). Common shares issued on exercise of options or warrants during each period should be included in fully diluted earnings per share from the beginning of the period or date of issuance of the options or warrants if later; the computation for the portion of the period prior to the date of exercise should be based on market prices of the common stock when exercised.

Situations Not Covered in Section

.43 The Board recognizes that it is impracticable to cover all possible conditions and circumstances that may be encountered in computing earnings per share. When situations not expressly covered in this section occur, however, they should be dealt with in accordance with their substance, giving cognizance to the guidelines and criteria outlined herein.

Computational Guidelines

.44 The determination of earnings per share data required under this section reflects the complexities of the capital structures of some businesses. The calculations should give effect to matters such as stock dividends and splits, business combinations, changes in conversion rates, etc. Guidelines which should be used in dealing with some of the more common computational matters are set forth in section 2011A.

EFFECTIVE DATE

.45 This section shall be effective for fiscal periods beginning after December 31, 1968 for all earnings per share data (primary, fully diluted and supplementary) regardless of when the securities entering into computations of earnings per share were issued, except as described in paragraph .46 as it relates to primary earnings per share.* The Board recommends that (a) computations for periods beginning before January 1, 1969 be made for all securities in conformity with the provisions of this section and (b) in comparative statements in which the data for some periods are subject to this section and others are not, the provisions of the section be applied to all periods—in either case based on the conditions existing in the prior periods.

[As amended, effective April 30, 1978, by FASB Statement No. 21.] (See section 2083).

.46 In the case of securities whose time of issuance is prior to June 1, 1969 the following election should be made as of May 31, 1969 (and not subsequently changed) with respect to all such securities for the purpose of computing primary earnings per share:

a. determine the classifications of all such securities under the provisions of this section, or

b. classify as common stock equivalents only those securities which are classified as residual securities under APB Opinion No. 9 regardless of how they would be classified under this section.

If the former election is made, the provisions of this section should be applied in the computation of both primary and fully diluted earnings per share data for all periods presented.

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* The provisions of this section were suspended by *FASB Statement No. 21* [section 2083] and need not be applied by a nonpublic enterprise as defined in that Statement pending further action by the FASB.

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AC Section 2011A

Earnings per Share—Appendix A

COMPUTATIONAL GUIDELINES

.01 The Board has adopted the following general guidelines which should be used in the computation of earnings per share data.

.02 *Weighted average.* Computations of earnings per share data should be based on the weighted average number of common shares and common share equivalents outstanding during each period presented. Use of a weighted average is necessary so that the effect of increases or decreases in outstanding shares on earnings per share data is related to the portion of the period during which the related consideration affected operations. Reacquired shares should be excluded from date of their acquisition. (See definition in section 2011D.28.)

.03 *Stock dividends or splits.* If the number of common shares outstanding increases as a result of a stock dividend or stock split[1] or decreases as a result of a reverse split, the computations should give retroactive recognition to an appropriate equivalent change in capital structure for all periods presented. If changes in common stock resulting from stock dividends or stock splits or reverse splits have been consummated after the close of the period but before completion of the financial report, the per share computations should be based on the new number of shares because the readers' primary interest is presumed to be related to the current capitalization. When per share computations reflect such changes in the number of shares after the close of the period, this fact should be disclosed.

.04 *Business combinations and reorganizations.* When shares are issued to acquire a business in a transaction accounted for as a purchase, the computation of earnings per share should give recognition to the existence of the new shares only from the date the acquisition took place. When a business combination is accounted for as a pooling of interests, the computation should be based on the aggregate of the weighted average outstanding shares of the constituent businesses, adjusted to equivalent shares of

[1] See section 5561, *Stock Dividends and Stock Split Ups.*

the surviving business for all periods presented. This difference in treatment reflects the fact that in a purchase the results of operations of the acquired business are included in the statement of income only from the date of acquisition, whereas in a pooling of interests the results of operations are combined for all periods presented. In reorganizations, the computations should be based on analysis of the particular transaction according to the criteria contained in section 2011.

.05 *Claims of senior securities.* The claims of senior securities on earnings of a period should be deducted from net income (and also from income before extraordinary items if an amount therefor appears in the statement) before computing earnings per share. Dividends on cumulative preferred senior securities, whether or not earned, should be deducted from net income.[2] If there is a net loss, the amount of the loss should be increased by any cumulative dividends for the period on these preferred stocks. If interest or preferred dividends are cumulative only if earned, no adjustment of this type is required, except to the extent of income available therefor. If interest or preferred dividends are not cumulative, only the interest accruable or dividends declared should be deducted. In all cases, the effect that has been given to rights of senior securities in arriving at the earnings per share should be disclosed.

.06 *Use of "if converted" method of computation.* If convertible securities are deemed to be common stock equivalents for the purpose of computing primary earnings per share, or are assumed to have been converted for the purpose of computing fully diluted earnings per share, the securities should be assumed to have been converted at the beginning of the earliest period reported (or at time of issuance, if later). Interest charges applicable to convertible securities and non-discretionary adjustments that would have been made to items based on net income or income before taxes—such as profit sharing expense, certain royalties, and investment credit—or preferred dividends applicable to the convertible securities should be taken into account in determining the balance of income

[2] The per share and aggregate amounts of cumulative preferred dividends in arrears should be disclosed.

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applicable to common stock. As to primary earnings per share this amount should be divided by the total of the average outstanding common shares and the number of shares which would have been issued on conversion or exercise of common stock equivalents.[3] As to fully diluted earnings per share this amount should be divided by the total of the average outstanding common shares plus the number of shares applicable to conversions during the period from the beginning of the period to the date of conversion and the number of shares which would have been issued upon conversion or exercise of any other security which might dilute earnings.

.07 The if converted method recognizes the fact that the holders of convertible securities cannot share in distributions of earnings applicable to the common stock unless they relinquish their right to senior distributions. Conversion is assumed and earnings applicable to common stock and common stock equivalents are determined before distributions to holders of these securities.

.08 The if converted method also recognizes the fact that a convertible issue can participate in earnings, through dividends or interest, either as a senior security or as a common stock, but not both. The two-class method (see paragraph .10) does not recognize this limitation and may attribute to common stock an amount of earnings per share less than if the convertible security had actually been converted. The amount of earnings per share on common stock as computed under the two-class method is affected by the amount of dividends declared on the common stock.

.09 *Use of "two-class" method of computation.* Although the two-class method is considered inappropriate with respect to the securities described in paragraph .06, its use may be necessary in the case of participating securities and two-class common stock. (See paragraphs .14-.15 for discussion of these securities.) This is the case, for example, when these securities are not convertible into common stock.

.10 Under the two-class method, common stock equivalents are treated as common stock with a dividend rate

[3] Determined as to options and warrants by application of the method described in section 2011.36-.38.

different from the dividend rate on the common stock and, therefore, conversion of convertible securities is not assumed. No use of proceeds is assumed. Distributions to holders of senior securities, common stock equivalents and common stock are first deducted from net income. The remaining amount (the undistributed earnings) is divided by the total of common shares and common share equivalents. Per share distributions to the common stockholders are added to this per share amount to arrive at primary earnings per share.

.11 *Delayed effectiveness and changing conversion rates or exercise prices.* In some cases, a conversion option does not become effective until a future date; in others conversion becomes more (or less) advantageous to the security holder at some later date as the conversion rate increases (or decreases), generally over an extended period. For example, an issue may be convertible into one share of common stock in the first year, 1.10 shares in the second year, 1.20 shares in the third year, etc. Frequently, these securities receive little or no cash dividends. Hence, under these circumstances, their value is derived principally from their conversion or exercise option and they would be deemed to be common stock equivalents under the yield test previously described. (See section 2011.33.)[4] Similarly, the right to exercise options or warrants may be deferred or the exercise price may increase or decrease.

.12 *Conversion rate or exercise price to be used—primary earnings per share.* The conversion rate or exercise price of a common stock equivalent in effect during each period presented should be used in computing primary earnings per share, with the exceptions stated hereinafter in this paragraph. Prior period primary earnings per share should not be restated for changes in the conversion ratio or exercise price. If options, warrants or other common stock equivalents are not immediately exercisable or convertible, the earliest effective exercise price or conversion rate if any during the succeeding five years should be used. If a convertible security having an increasing conversion rate is issued in exchange for another class of security of the issuing company and is convertible back into the same or a similar security, and if a conversion rate equal to or

[4] An increasing conversion rate should not be accounted for as a stock dividend.

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greater than the original exchange rate becomes effective during the period of convertibility, the conversion rate used in the computation should not result in a reduction in the number of common shares (or common share equivalents) existing before the original exchange took place until a greater rate becomes effective.

.13 *Conversion rate or exercise price to be used—fully diluted earnings per share.* Fully diluted earnings per share computations should be based on the most advantageous (from the standpoint of the security holder) conversion or exercise rights that become effective within ten years following the closing date of the period being reported upon.[5] Conversion or exercise options that are not effective until after ten or more years may be expected to be of limited significance because (a) investors' decisions are not likely to be influenced substantially by events beyond ten years, and (b) it is questionable whether they are relevant to current operating results.

.14 *Participating securities and two-class common.* The capital structures of some companies include:

a. Securities which may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to but not beyond a specified amount per share).

b. A class of common stock with different dividend rates or voting rights from those of another class of common stock, but without prior or senior rights.

Additionally, some of these securities are convertible into common stock. Earnings per share computations relating to certain types of participating securities may require the use of the two-class method. (See paragraphs .09-.10.)

.15 Because of the variety of features which these securities possess, frequently representing combinations of the features referred to above, it is not practicable to set out specific guidelines as to when they should be considered

[5] The conversion rate should also reflect the cumulative effect of any stock dividends on the preferred stock which the company has contracted or otherwise committed itself to issue within the next ten years.

common stock equivalents. Dividend participation does not *per se* make a security a common stock equivalent. A determination of the status of one of these securities should be based on an analysis of all the characteristics of the security, including the ability to share in the earnings potential of the issuing corporation on substantially the same basis as the common stock.

.16 *Issuance contingent on certain conditions.* At times, agreements call for the issuance of additional shares contingent upon certain conditions being met. Frequently these conditions are either:

a. the maintenance of current earnings levels, or

b. the attainment of specified increased earnings.

Alternatively, agreements sometimes provide for immediate issuance of the maximum number of shares issuable in the transaction with some to be placed in escrow and later returned to the issuer if specified conditions are not met. For purposes of computing earnings per share, contingently returnable shares placed in escrow should be treated in the same manner as contingently issuable shares.

.17 If attainment or maintenance of a level of earnings is the condition, and if that level is currently being attained, the additional shares should be considered as outstanding for the purpose of computing both primary and fully diluted earnings per share. If attainment of increased earnings reasonably above the present level or maintenance of increased earnings above the present level over a period of years is the condition, the additional shares should be considered as outstanding only for the purpose of computing fully diluted earnings per share (but only if dilution is the result); for this computation, earnings should be adjusted to give effect to the increase in earnings specified by the particular agreements (if different levels of earnings are specified, the level that would result in the largest potential dilution should be used). Previously reported earnings per share data should not be restated to give retroactive effect to shares subsequently issued as a result of attainment of specified increased earnings levels. If upon expiration of the term of the agreement providing for contingent issuance of additional shares the conditions have not been met, the shares should not be considered

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outstanding in that year. Previously reported earnings per share data should then be restated to give retroactive effect to the removal of the contingency.

.18 The number of shares contingently issuable may depend on the market price of the stock at a future date. In such a case, computations of earnings per share should reflect the number of shares which would be issuable based on the market price at the close of the period being reported on. Prior period earnings per share should be restated if the number of shares issued or contingently issuable subsequently changes because the market price changes.

.19 In some cases, the number of shares contingently issuable may depend on both future earnings and future prices of the shares. In that case, the number of shares which would be issuable should be based on both conditions, that is, market prices and earnings to date as they exist at the end of each period being reported on. (For example, if (a) a certain number of shares will be issued at the end of three years following an acquisition if earnings of the acquired company increase during those three years by a specified amount and (b) a stipulated number of additional shares will be issued if the value of the shares issued in the acquisition is not at least a designated amount at the end of the three-year period, the number of shares to be included in the earnings per share for each period should be determined by reference to the cumulative earnings of the acquired company and the value of the shares at the end of the latest period.) Prior-period earnings per share should be restated if the number of shares issued or contingently issuable subsequently changes from the number of shares previously included in the earnings per share computation.

.20 *Securities of subsidiaries.* At times subsidiaries issue securities which should be considered common stock equivalents from the standpoint of consolidated and parent company financial statements for the purpose of computing earnings per share. This could occur when convertible securities, options, warrants or common stock issued by the subsidiary are in the hands of the public and the subsidiary's results of operations are either consolidated or reflected on the equity method. Circumstances in which conversion or exercise of a subsidiary's securities should be assumed for the purpose of computing the consolidated

and parent company earnings per share, or which would otherwise require recognition in the computation of earnings per share data, include those where:

As to the Subsidiary

a. Certain of the subsidiary's securities are common stock equivalents in relation to its own common stock.

b. Other of the subsidiary's convertible securities, although not common stock equivalents in relation to its own common stock, would enter into the computation of its fully diluted earnings per share.

As to the Parent

a. The subsidiary's securities are convertible into the parent company's common stock.

b. The subsidiary issues options and warrants to purchase the parent company's common stock.

The treatment of these securities for the purpose of consolidated and parent company reporting of earnings per share is discussed in the following four paragraphs.

.21 If a subsidiary has dilutive warrants or options outstanding or dilutive convertible securities which are common stock equivalents from the standpoint of the subsidiary, consolidated and parent company primary earnings per share should include the portion of the subsidiary's income that would be applicable to the consolidated group based on its holdings and the subsidiary's primary earnings per share. (See section 2011.39.)

.22 If a subsidiary's convertible securities are not common stock equivalents from the standpoint of the subsidiary, only the portion of the subsidiary's income that would be applicable to the consolidated group based on its holdings and the fully diluted earnings per share of the subsidiary should be included in consolidated and parent company fully diluted earnings per share. (See section 2011.40.)

.23 If a subsidiary's securities are convertible into its parent company's stock, they should be considered among the common stock equivalents of the parent company for the purpose of computing consolidated and parent company primary and fully diluted earnings per share if

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the conditions set forth in section 2011.33 exist. If these conditions do not exist, the subsidiary's convertible securities should be included in the computation of the consolidated and parent company fully diluted earnings per share only.

.24 If a subsidiary issues options or warrants to purchase stock of the parent company, they should be considered common stock equivalents by the parent in computing consolidated and parent company primary and fully diluted earnings per share.

.25 *Dividends per share.* Dividends constitute historical facts and usually are so reported. However, in certain cases, such as those affected by stock dividends or splits or reverse splits, the presentation of dividends per share should be made in terms of the current equivalent of the number of common shares outstanding at the time of the dividend. A disclosure problem exists in presenting data as to dividends per share following a pooling of interests. In such cases, it is usually preferable to disclose the dividends declared per share by the principal constituent and to disclose, in addition, either the amount per equivalent share or the total amount for each period for the other constituent, with appropriate explanation of the circumstances. When dividends per share are presented on other than an historical basis, the basis of presentation should be disclosed.

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AC Section 2011B

Earnings per Share—Appendix B

SUMMARY OF DIFFERING VIEWPOINTS

.01 This section contains a summary of various viewpoints on a number of matters relating to the computation of earnings per share data, which viewpoints differ from the conclusions of the Board as stated in section 2011. The views in this section therefore do not represent the views of the Board as a whole.

Common Stock Equivalent or Residual Concept

.02 Section 2011.26 concludes that, for purposes of computing primary earnings per share, certain securities should be considered the equivalent of common stock. Section 2011.28 further concludes that such treatment—as to convertible securities—should be based on a determination of status made at the time of issuance of each security, based on conditions existing at that date and not subsequently changed. Viewpoints which differ from those conclusions are based on a number of positions, which are summarized below.

Concept Has No Validity

.03 Some believe there should be no such category as ''common stock equivalent'' or ''residual'' security, and hence no such classification as ''primary'' earnings per share including such securities. They contend that the common stock equivalent or residual security concept involves assumptions and arbitrary, intricate determinations which result in figures of questionable meaning which are more likely to confuse than enlighten readers. They advocate that earnings per share data be presented in a tabulation — as part of the financial statements — which first discloses the relationship of net income and the number of common shares actually outstanding and then moves through adjustments to determine adjusted net income and the number of common shares which would be outstanding if all conversions, exercises and contingent issuances took place. Under this approach, all the figures involved would be readily determinable, understandable and significant. Such information, together with the other

disclosures required in section 2011 regarding the terms of securities, would place the reader in a position to make his own judgment regarding prospects of conversion or exercise and the resulting impact on per share earnings. Accounting should not make or pre-empt that judgment.

.04 Until convertible securities, etc., are in fact converted, the actual common stockholders are in control, and the entire earnings could often be distributed as dividends. The conversions, exercises and contingent issuances may, in fact, never take place. Hence, the reporting as "primary" earnings per share of an amount which results from treating as common stock securities which are not common stock is, in the view of some, improper.

Concept Has Validity Both At Issuance and Subsequently

.05 Some who believe in the validity of the common stock equivalent or residual concept feel that the status of a security should be determined not only at the time of its issuance but from time to time thereafter. Securities having the characteristics associated with residual securities—among other things the ability to participate in the economic benefits resulting from the underlying earnings and earnings potential of the common stock through the right of their holders to become common stockholders—do change their nature with increases and decreases in the market value of the common stock after issuance. These securities are designed for this purpose, and therefore, in certain circumstances, they react to changes in the earnings or earnings potential of the issuer just as does the common stock. Furthermore, although many such securities are issued under market and yield conditions which do not place major emphasis at the time of issuance on their common stock characteristics, both the issuer and the holder recognize the possibility that these characteristics may become of increasing significance if, and when, the value of the underlying common stock increases. The limitation of the residual concept for convertible securities to "at issuance only" disregards these significant factors. (For example, a convertible security with a cash yield of 4% at time of issuance [assumed to be in excess of the yield test for common stock equivalent status in section 2011] may well appreciate in value subsequent to issuance,

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due to its common stock characteristics, to such an extent that its cash yield will drop to 2% or less. It seems unsound to consider such a security a "senior security" for earnings per share purposes at such later dates merely because its yield at date of issuance—possibly years previously—was 4%. This seems particularly unwise when the investment community evaluates such a security currently as the substantial equivalent of the common stock into which it is convertible.) Thus, the "at issuance only" application of the residual security concept is, in the opinion of some, illogical and arbitrary. In connection with the computation of earnings per share data, this approach disregards current conditions in reporting a financial statistic whose very purpose is a reflection of the *current* substantive relationship between the earnings of the issuer and its complex capital structure.

.06 Furthermore, the adoption of the treasury stock method to determine the number of shares to be considered as common stock equivalents under outstanding options and warrants (see section 2011.36-.38) is apparent recognition of the fact that market conditions subsequent to issuance should influence the determination of the status of a security. Thus, the conclusions of section 2011 in these matters are inconsistent.

.07 As for the contention that use of the residual concept subsequent to issuance has a "circular" effect—in that reported earnings per share influences the market, which, in turn, influences the classification status of a security, which, in turn, influences the computation of earnings per share, which, in turn influences the market—analysts give appropriate recognition to the increasing importance of the common stock characteristics of convertible securities as the market rises or falls. It seems only appropriate that a computation purporting to attribute the earnings of a corporation to the various components of its capital structure should also give adequate recognition to the changing substance of these securities. Thus, the movement of securities in and out of residual status subsequent to their issuance is a logical and integral part of the entire concept.

.08 As for the contention that the dual presentation of earnings per share data required by section 2011 appro-

priately reflects the dilutive effect of any convertible securities which were not residual at time of issuance but which might subsequently be considered as residual, the disclosure of "fully-diluted" earnings per share data is aimed at *potential* (i.e., possible future) dilution; for issuers with securities having extremely low yields of the levels described in the preceding paragraph, the dilution has already taken place—these common stock equivalents are being so traded in the market, and any method which does not reflect these conditions results in an amount for "primary earnings per share" which may be misleading. Furthermore, whenever an issuer has more than one convertible security outstanding, the effect of even the "potential" dilution of such "residual" securities is not appropriately reflected in any meaningful manner in the fully-diluted earnings per share amount, since its impact is combined with that of other convertible securities of the issuer which may not currently be "residual".

Criteria and Methods for Determination of Residual Status

.09 Section 2011.33 concludes that a cash yield test—based on a specified percentage of the bank prime interest rate—should be used to determine the residual status of convertible securities, and that options and warrants should be considered residual securities at all times. Viewpoints differing from those conclusions and supporting other criteria or methods are summarized below.

Convertible Securities

.10 *Investment value method.* As explained in section 2011.08-.11, a previous Opinion specified a relative value method for the determination of the residual status of a security. In practice the method has been applied by comparing the market value of a convertible security with its "investment value", and by classifying a security as residual at time of issuance if such market value were 200% or more of investment value, with certain practical modifications of this test subsequent to time of issuance to assure the substance of an apparent change in status and to prevent frequent changes of status for possible temporary fluctuations in the market.

.11 The establishment of investment values for convertible securities involves considerable estimation, and

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frequently requires the use of experts. Published financial services report estimates of investment value for many, but not all, convertible securities. Most convertible securities are issued under conditions which permit a reasonable estimate of their investment values. In addition, reference to the movements of long-term borrowing rates for groups of issuers with similar credit and risk circumstances—or even reference to general long-term borrowing rates—can furnish effective evidence for an appropriate determination of the investment value of a convertible security subsequent to its issuance. As in many determinations made for accounting purposes, estimates of this nature are often necessary. The necessity of establishing some percentage or level as the line of demarcation between residual and non-residual status is common to all methods under consideration—including the market parity test and various yield tests—and appears justifiable in the interest of reasonable consistency of treatment, both for a single issuer and among issuers.

.12 The investment value method is somewhat similar to the cash yield method specified in section 2011.33. However, the latter method has two apparent weaknesses, in the view of those who support the investment value method. In the first place, it does not differentiate between issuers—that is, it is based on the same borrowing rate for all issuers, without regard for their credit ratings or other risks inherent in their activities. Second, it is based on the current bank prime interest rate, which is essentially a short-term borrowing rate. The relationship between this rate—assuming that it is constant in all sections of the country at any given time—and the long-term corporate borrowing rate may fluctuate to such an extent that the claimed ease of determination may be offset by a lack of correlation. The investment value method, based on the terms of each issue and the status of each issuer, is thus considered by some to be a more satisfactory method.

.13 *Market parity method.* This method compares a convertible security's market value with its conversion value. In general, if the two values are substantially equivalent and in excess of redemption price, the convertible security is considered to be "residual".

.14 The market parity method has the advantage, as compared to the investment value method, of using amounts that usually are readily available or ascertainable, and of avoiding estimates of investment value. More importantly, in the view of some, the equivalence of values is clearly an indication of the equivalence of the securities, while a comparison of relative values of the characteristics of a security is an indication of its status only if arbitrary rules, such as the "major portion of value" test, are used. In similar vein, the yield test also requires the establishment of a point at which to determine residuality. On the other hand, a practical application of the market parity test would also require the establishment of a percentage relationship at which to determine residual status, due to the many variables involved and the need for consistent application. Also, the call or redemption price of a convertible security has an effect on the point at which market parity is achieved.

.15 *Yield methods.* There are various other methods of determining the residual nature of a convertible security based on yield relationships. Each of these is based on a comparison of the cash yield on the convertible security (based on its market value) and some predetermined rate of yield (based on other values, conditions or ratings). The discussion of the various methods contained in section 2011 comprehends the advantages and disadvantages of these other methods.

Options and Warrants

.16 As explained in section 2011.35-.38, options and warrants should be regarded as common stock equivalents at all times; the "treasury stock method" should be used in most cases to determine the number of common shares to be considered the equivalent of the options and warrants; and the number of common shares so computed should be included in the computation of both the "primary" and "fully-diluted" earnings per share (assuming a dilutive effect). Viewpoints which differ from those conclusions and support other treatments or other methods of measurement are summarized below.

.17 *Exclusion from computation of primary earnings per share.* In section 2011 the Board has for the first time

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considered options and warrants to be common stock equivalents at all times and, because of the treasury stock method of computation established, the primary earnings per share will in some cases be affected by the market price of the stock obtainable on exercise, rather than solely by the economics of the transaction entered into. Some believe that this produces a circular effect in that the reporting of earnings per share may then influence the market which, in turn, influences earnings per share. They believe that earnings per share should affect the market and not vice versa. They point out that the classification of convertible debentures and convertible preferred stocks is determined at time of issuance only and consequently subsequent fluctuations in the market prices of these securities do not affect primary earnings per share. Therefore, they believe that the dual, equally prominent presentation of primary and fully diluted earnings per share is most informative when the effect of options and warrants, other than those whose exercise price is substantially lower than market price at time of issuance, is included only in the fully diluted earnings per share which would be lower than primary earnings per share and thus would emphasize the potential dilution.

.18 *Determination of equivalent common shares.* Some believe that the "treasury stock method" described in section 2011.36 is unsatisfactory and that other methods are preferable. Under one such method the number of equivalent shares is computed by reference to the relationship between the market value of the option or warrant and the market value of the related common stock. In general, it reflects the impact of options and warrants on earnings per share whenever the option or warrant has a market value, and not only when the market price of the related common stock exceeds the exercise price (as does the treasury stock method).

.19 *Measurement of effect of options and warrants.* Some believe that the effect of outstanding options and warrants on earnings per share should be computed by assuming exercise as of the beginning of the period and assuming some use of the funds so attributed to the issuer. The uses which have been suggested include application of such assumed proceeds to (a) reduce outstanding short or long term borrowings, (b) invest in government obli-

gations or commercial paper, (c) invest in operations of the issuer or (d) fulfill other corporate objectives of the issuer. Each of these methods is felt by some to be the preferable approach. Many who support one of these methods feel that the "treasury stock method" is improper since (a) it fails to reflect any dilution unless the market price of the common stock exceeds the exercise price, (b) it assumes a hypothetical purchase of treasury stock which in many cases—due to the significant number of common shares involved—would either not be possible or be possible only at a considerably increased price per share, and (c) it may be considered to be the attribution of earnings assumed on the funds received—in which case the earnings rate for each issuer is a function of the price-earnings ratio of its common stock and is thus similar in result to an arbitrary assumption of a possibly inappropriate earnings rate.

.20 Some believe that no increment in earnings should be attributed to the funds assumed to be received upon the exercise of options and warrants, particularly if such instruments are to be reflected in the computation of primary earnings per share, since the funds were not available to the issuer during the period.

Computational Methods—Convertible Securities

.21 Section 2011A.06 concludes that the "if converted" method of computation should be used for primary earnings per share when convertible securities are considered the equivalent of common stock. Some believe that this method does not properly reflect the actual circumstances existing during the period, and favor, instead, the so-called "two-class" method of computation. (See section 2011A.09-.10.) Under the latter method, securities considered common stock equivalents are treated as common shares with a different dividend rate from that of the regular common shares. The residual security concept is based on common stock equivalence without the necessity of actual conversion; therefore, this method properly recognizes the fact that these securities receive a preferential distribution before the common stock—and also share in the potential benefits of the undistributed earnings through their substantial common stock characteristics in the same way as do the common shares. These securities are designed to achieve these two goals. Those who favor this

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method believe that the "if converted" method disregards the realities of what occurred during the period. Thus, in their view, the "if converted" method is a "pro-forma" method which assumes conversion and the elimination of preferential distributions to these securities; as such, it is not suitable for use in the computation of *primary earnings per share data,* since the assumed conversions did not take place and the preferential distributions did take place.

.22 Those who favor the "two-class" method point out that it is considered appropriate in the case of certain participating and two-class common situations. In their view, the circumstances existing when common stock equivalents are outstanding are similar; therefore, use of this method is appropriate.

Recognition of Common Stock Equivalents in the Financial Statements

.23 Section 2011.39 concludes that the designation of securities as common stock equivalents is solely for the purpose of determining primary earnings per share; no changes from present practice are recommended in the presentation of such securities in the financial statements. Some believe, however, that the financial statements should reflect a treatment of such securities which is consistent with the method used to determine earnings per share in the financial statements. Accordingly, convertible debt considered to be a common stock equivalent would be classified in the balance sheet in association with stockholders' equity—either under a separate caption immediately preceding stockholders' equity, or in a combined section with a caption such as "Equity of common stockholders and holders of common stock equivalents." In the statement of income and retained earnings, interest paid on convertible debt considered a common stock equivalent would be shown as a "distribution to holders of common stock equivalents," either following the caption of "net income" in the statement of income or grouped with other distributions in the statement of retained earnings.

.24 Some believe that the inconsistency of the positions taken on this matter in section 2011A.21 is clearly evident in the requirement that, when a subsidiary has convertible securities which are common stock equivalents,

the portion of the income of the subsidiary to be included in the consolidated statement of income of the parent and its subsidiaries should be computed disregarding the effect of the common stock equivalents, but that the computation of the primary earnings per share of the parent should reflect the effect of these common stock equivalents in attributing the income of the subsidiary to its various outstanding securities. This inconsistent treatment is, in the opinion of some, not only illogical but misleading.

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AC Section 2011C

Earnings per Share—Appendix C

ILLUSTRATIVE STATEMENTS

.01 The following exhibits illustrate the disclosure of earnings per share data on the assumption that section 2011 was effective for all periods covered. The format of the disclosure is illustrative only, and does not necessarily reflect a preference by the Accounting Principles Board.

.02 **Exhibit A.** This exhibit illustrates the disclosure of earnings per share data for a company with a simple capital structure (see section 2011.14). The facts assumed for Exhibit A are as follows:

	Number of Shares	
Common stock outstanding	*1968*	*1967*
Beginning of year	3,300,000	3,300,000
End of year	3,300,000	3,300,000
Issued or acquired during year	None	None
Common stock reserved under employee stock options granted	7,200	7,200
Weighted average number of shares	3,300,000	3,300,000

NOTE: Shares issuable under employee stock options are excluded from the weighted average number of shares on the assumption that their effect is not dilutive (see section 2011.14).

EXHIBIT A

EXAMPLE OF DISCLOSURE OF EARNINGS PER SHARE

Simple Capital Structure

	Thousands Excess per share data	
(Bottom of Income Statement)	*1968*	*1967*
Income before extraordinary item	$ 9,150	$7,650
Extraordinary item—gain on sale of property less applicable income taxes	900	.....
Net Income	$10,050	$7,650
Earnings per common share:		
Income before extraordinary item	$ 2.77	$ 2.32
Extraordinary item	.28	.....
Net Income	$ 3.05	$ 2.32

.03 Exhibit B. This exhibit illustrates the disclosure of earnings per share data for a company with a complex capital structure (see section 2011.15). The facts assumed for Exhibit B are as follows:

Market price of common stock. The market price of the common stock was as follows:

	1968	*1967*	*1966*
Average Price:			
First quarter	50	45	40
Second quarter	60	52	41
Third quarter	70	50	40
Fourth quarter	70	50	45
December 31 closing price	72	51	44

Cash dividends. Cash dividends of $0.125 per common share were declared and paid for each quarter of 1966 and 1967. Cash dividends of $0.25 per common share were declared and paid for each quarter of 1968.

Convertible debentures. 4% convertible debentures with a principal amount of $10,000,000 due 1986 were sold for cash at a price of 100 in the last quarter of 1966. Each $100 debenture was convertible into two shares of common stock. No debentures were converted during 1966 or 1967. The entire issue was converted at the beginning of the third quarter of 1968 because the issue was called by the company.

These convertible debentures were not common stock equivalents under the terms of section 2011. The bank prime rate at the time the debentures were sold in the last quarter of 1966 was 6%. The debentures carried a coupon interest rate of 4% and had a market value of $100 at issuance. The cash yield of 4% was not less than 66⅔% of the bank prime rate (see section 2011.33). Cash yield is the same as the coupon interest rate in this case only because the market value at issuance was $100.

Convertible preferred stock. 600,000 shares of convertible preferred stock were issued for assets in a purchase transaction at the beginning of the second quarter of 1967. The annual dividend on each share of this con-

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vertible preferred stock is $0.20. Each share is convertible into one share of common stock. This convertible stock had a market value of $53 at the time of issuance and was therefore a common stock equivalent under the terms of section 2011 at the time of its issuance because the cash yield on market value was only 0.4% and the bank prime rate was 5.5% (see section 2011.33).

Holders of 500,000 shares of this convertible preferred stock converted their preferred stock into common stock during 1968 because the cash dividend on the common stock exceeded the cash dividend on the preferred stock.

Warrants. Warrants to buy 500,000 shares of common stock at $60 per share for a period of five years were issued along with the convertible preferred stock mentioned above. No warrants have been exercised. (Note that the number of shares issuable upon exercise of the warrants is less than 20% of outstanding common shares; hence section 2011.38 is not applicable.)

The number of common shares represented by the warrants (see section 2011.36) was 71,428 for each of the third and fourth quarters of 1968 ($60 exercise price × 500,000 warrants = $30,000,000; $30,000,000 ÷ $70 share market price = 428,572 shares; 500,000 shares − 428,572 shares = 71,428 shares). No shares were deemed to be represented by the warrants for the second quarter of 1968 or for any preceding quarter (see section 2011.36) because the market price of the stock did not exceed the exercise price for substantially all of three consecutive months until the third quarter of 1968.

Common stock. The number of shares of common stock outstanding were as follows:

	1968	*1967*
Beginning of year	3,300,000	3,300,000
Conversion of preferred stock	500,000	....
Conversion of debentures	200,000	....
End of year	4,000,000	3,300,000

Weighted average number of shares. The weighted average number of shares of common stock and common stock equivalents was determined as follows:

	1968	*1967*
Common stock:		
Shares outstanding from beginning of period	3,300,000	3,300,000
500,000 shares issued on conversion of preferred stock; assume issuance evenly during year	250,000	....
200,000 shares issued on conversion of convertible debentures at beginning of third quarter of 1968	100,000	....
	3,650,000	3,300,000
Common stock equivalents:		
600,000 shares convertible preferred stock issued at the beginning of the second quarter of 1967, excluding 250,000 shares included under common stock in 1968	350,000	450,000
Warrants: 71,428 common share equivlents outstanding for third and fourth quarters of 1968, i. e., one-half year	35,714	....
	385,714	450,000
Weighted average number of shares	4,035,714	3,750,000

The weighted average number of shares would be adjusted to calculate fully diluted earnings per share as follows:

	1968	*1967*
Weighted average number of shares	4,035,714	3,750,000
Shares applicable to convertible debentures converted at the beginning of the third quarter of 1968, excluding 100,000 shares included under common stock for 1968	100,000	200,000
Shares applicable to warrants included above	(35,714)	....
Shares applicable to warrants based on year-end price of $72 (see section 2011.42)	83,333	....
	4,183,333	3,950,000

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Income before extraordinary item and net income would be adjusted for interest expense on the debentures in calculating fully diluted earnings per share as follows:

	Thousands		
	Before Adjustment	*Interest, net of tax effect*	*After Adjustment*
1967: Net income	$10,300	$208	$10,508
1968:			
Income before extraordinary item	12,900	94	12,994
Net income	13,800	94	13,894

NOTES: (a) Taxes in 1967 were 48%; in 1968 they were 52.8%.
(b) Net income is before dividends on preferred stock.

EXHIBIT B

EXAMPLE OF DISCLOSURE OF EARNINGS PER SHARE

Complex Capital Structure

(Bottom of Income Statement)	*Thousands Except per share data*	
	1968	*1967*
Income before extraordinary item	$12,900	$10,300
Extraordinary item—gain on sale of property less applicable income taxes	900	......
Net Income	$13,800	$10,300
Earnings per common share and common equivalent share (note x):		
Income before extraordinary item	$ 3.20	$ 2.75
Extraordinary item	.22	......
Net Income	$ 3.42	$ 2.75
Earnings per common share—assuming full dilution (note x):		
Income before extarordinary item	$ 3.11	$ 2.66
Extraordinary item	.21	......
Net Income	$ 3.32	$ 2.66

.04

EXHIBIT C

EXAMPLE OF NOTE X * TO EXHIBIT B

The $0.20 convertible preferred stock is callable by the company after March 31, 1972 at $53 per share. Each share is convertible into one share of common stock.

During 1968, 700,000 shares of common stock were issued on conversions: 500,000 shares on conversion of preferred stock and 200,000 on conversion of all the 4% convertible debentures.

Warrants to acquire 500,000 shares of the company's stock at $60 per share were outstanding at the end of 1968 and 1967. These warrants expire March 31, 1972.

Earnings per common share and common equivalent share were computed by dividing net income by the weighted average number of shares of common stock and common stock equivalents outstanding during the year. The convertible preferred stock has been considered to be the equivalent of common stock from the time of its issuance in 1967. The number of shares issuable on conversion of preferred stock was added to the number of common shares. The number of common shares was also increased by the number of shares issuable on the exercise of warrants when the market price of the common stock exceeds

* The following disclosure in the December 31, 1968 balance sheet is assumed for this note:

	1968	*1967*
Long-term debt:		
4% convertible debentures, due 1986..	—	$10,000,000
Stockholders' equity (note x):		
Convertible voting preferred stock of $1 par value, $0.20 cumulative dividend. Authorized 600,000 shares; issued and outstanding 100,000 shares (600,000 in 1967)	$ 100,000	$ 600,000
(Liquidation value $22 per share, aggregating $2,200,000 in 1968 and $13,200,000 in 1967)		
Common stock of $1 par value per share. Authorized 5,000,000 shares; issued and outstanding 4,000,000 shares (3,300,000 in 1967)	4,000,000	3,300,000
Additional paid-in capital	xxx	xxx
Retained earnings	xxx	xxx
	$ xxx	$ xxx

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the exercise price of the warrants. This increase in the number of common shares was reduced by the number of common shares which are assumed to have been purchased with the proceeds from the exercise of the warrants; these purchases were assumed to have been made at the average price of the common stock during that part of the year when the market price of the common stock exceeded the exercise price of the warrants.

Earnings per common share and common equivalent share for 1968 would have been $3.36 for net income and $3.14 for income before extraordinary item had the 4% convertible debentures due 1986 been converted on January 1, 1968. (These debentures were called for redemption as of July 1, 1968 and all were converted into common shares.)

Earnings per common share—assuming full dilution for 1968 were determined on the assumptions that the convertible debentures were converted and the warrants were exercised on January 1, 1968. As to the debentures, net earnings were adjusted for the interest net of its tax effect. As to the warrants, outstanding shares were increased as described above except that purchases of common stock are assumed to have been made at the year-end price of $72.

Earnings per common share—assuming full dilution for 1967 were determined on the assumption that the convertible debentures were converted on January 1, 1967. The outstanding warrants had no effect on the earnings per share data for 1967, as the exercise price was in excess of the market price of the common stock.

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AC Section 2011D

Earnings per Share—Appendix D

DEFINITIONS OF TERMS

.01 There are a number of terms used in discussion of earnings per share which have special meanings in that context. When used in section 2011 they are intended to have the meaning given in the following definitions. Some of the terms are not used in section 2011 but are provided as information pertinent to the subject of earnings per share.

.02 **Call price.** The amount at which a security may be redeemed by the issuer at the issuer's option.

.03 **Cash yield.** The cash received by the holder of a security as a distribution of accumulated or current earnings or as a contractual payment for return on the amount invested, without regard to the par or face amount of the security. As used in section 2011 the term ''cash yield'' refers to the relationship or ratio of such cash to be received annually to the market value of the related security at the specified date. For example, a security with a coupon rate of 4% (on par of $100) and a market value of $80 would have a cash yield of 5%.

.04 **Common stock.** A stock which is subordinate to all other stocks of the issuer.

.05 **Common stock equivalent.** A security which, because of its terms or the circumstances under which it was issued, is in substance equivalent to common stock.

.06 **Contingent issuance.** A possible issuance of shares of common stock that is dependent upon the exercise of conversion rights, options or warrants, the satisfaction of certain conditions, or similar arrangements.

.07 **Conversion price.** The price that determines the number of shares of common stock into which a security is convertible. For example, $100 face value of debt convertible into 5 shares of common stock would be stated to have a conversion price of $20.

.08 **Conversion rate.** The ratio of (a) the number of common shares issuable upon conversion to (b) a unit of

a convertible security. For example, a preferred stock may be convertible at the rate of 3 shares of common stock for each share of preferred stock.

.09 **Conversion value.** The current market value of the common shares obtainable upon conversion of a convertible security, after deducting any cash payment required upon conversion.

.10 **Dilution (Dilutive).** A reduction in earnings per share resulting from the assumption that convertible securities have been converted or that options and warrants have been exercised or other shares have been issued upon the fulfillment of certain conditions. (See section 2011, footnote 4.)

.11 **Dual presentation.** The presentation with equal prominence of two types of earnings per share amounts on the face of the income statement—one is primary earnings per share; the other is fully diluted earnings per share.

.12 **Earnings per share.** The amount of earnings attributable to each share of common stock. For convenience, the term is used in section 2011 to refer to either net income (earnings) per share or to net loss per share. It should be used without qualifying language only when no potentially dilutive convertible securities, options, warrants or other agreements providing for contingent issuances of common stock are outstanding.

.13 **Exercise price.** The amount that must be paid for a share of common stock upon exercise of a stock option or warrant.

.14 **Fully diluted earnings per share.** The amount of current earnings per share reflecting the maximum dilution that would have resulted from conversions, exercises and other contingent issuances that individually would have decreased earnings per share and in the aggregate would have had a dilutive effect. All such issuances are assumed to have taken place at the beginning of the period (or at the time the contingency arose, if later).

.15 **"If converted" method.** A method of computing earnings per share data that assumes conversion of convertible securities as of the beginning of the earliest period reported (or at time of issuance, if later).

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.16 **Investment value.** The price at which it is estimated a convertible security would sell if it were not convertible, based upon its stipulated preferred dividend or interest rate and its other senior security characteristics.

.17 **Market parity.** A market price relationship in which the market price of a convertible security and its conversion value are approximately equal.

.18 **Option.** The right to purchase shares of common stock in accordance with an agreement, upon payment of a specified amount. As used in section 2011, options include but are not limited to options granted to and stock purchase agreements entered into with employees. Options are considered ''securities'' in section 2011.

.19 **Primary earnings per share.** The amount of earnings attributable to each share of common stock outstanding, including common stock equivalents.

.20 **Redemption price.** The amount at which a security is required to be redeemed at maturity or under a sinking fund arrangement.

.21 **Security.** The evidence of a debt or ownership or related right. For purposes of section 2011 it includes stock options and warrants, as well as debt and stock.

.22 **Senior security.** A security having preferential rights and which is not a common stock or common stock equivalent, for example, nonconvertible preferred stock.

.23 **Supplementary earnings per share.** A computation of earnings per share, other than primary or fully diluted earnings per share, which gives effect to conversions, etc., which took place during the period or shortly thereafter as though they had occurred at the beginning of the period (or date of issuance, if later).

.24 **Time of issuance.** The time of issuance generally is the date when agreement as to terms has been reached and announced, even though such agreement is subject to certain further actions, such as directors' or stockholders' approval.

.25 **Treasury stock method.** A method of recognizing the use of proceeds that would be obtained upon exercise of options and warrants in computing earnings per share. It assumes that any proceeds would be used to purchase

common stock at current market prices. (See section 2011.36-.38.)

.26 "Two-class" method. A method of computing primary earnings per share that treats common stock equivalents as though they were common stocks with different dividend rates from that of the common stock.

.27 Warrant. A security giving the holder the right to purchase shares of common stock in accordance with the terms of the instrument, usually upon payment of a specified amount.

.28 Weighted average number of shares. The number of shares determined by relating (a) the portion of time within a reporting period that a particular number of shares of a certain security has been outstanding to (b) the total time in that period. Thus, for example, if 100 shares of a certain security were outstanding during the first quarter of a fiscal year and 300 shares were outstanding during the balance of the year, the weighted average number of outstanding shares would be 250.

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AC Section 2012

Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions

[Source: APB Opinion No. 30, as amended.]

Effective for events and transactions occurring after September 30, 1973 unless otherwise indicated

INTRODUCTION

.01 In section 2010, *Reporting the Results of Operations,* issued in 1966, the Board concluded that net income for a period should reflect all items of profit and loss recognized during the period except for certain prior period adjustments. The section further provided that *extraordinary items* should be segregated from the results of ordinary operations and shown separately in the income statement and that their nature and amounts should be disclosed.

.02 Financial reporting practices in recent years indicate that interpreting the criteria for extraordinary items in section 2010 has been difficult and significant differences of opinion exist as to certain of its provisions. The Board is also concerned with the varying accounting treatments accorded to certain transactions involving the sale, abandonment, discontinuance, condemnation, or expropriation of a segment of an entity (referred to in this section as disposals of a segment of a business).

.03 The purposes of this section are (1) to provide more definitive criteria for extraordinary items by clarifying and, to some extent, modifying the existing definition and criteria, (2) to specify disclosure requirements for ex-

traordinary items, (3) to specify the accounting and reporting for disposal of a segment of a business, (4) to specify disclosure requirements for other unusual or infrequently occurring events and transactions that are not extraordinary items.

DISCUSSION

.04 Some accountants believe that financial statements would be improved by presenting an all-inclusive income statement without separate categories for continuing operations, discontinued operations and extraordinary items. In their view, the use of arbitrary and subjectively defined categories tends to mislead investors and to invite abuse of the intended purposes of the classifications. They believe, therefore, that basically an income statement should reflect only the two broad categories, (a) revenue and gains and (b) expenses and losses. They also believe that investors would be better served by reporting separately the primary types of revenue and expense, including identification of items that are unusual or occur infrequently. Alternatively, sufficient information relating to those items should be otherwise disclosed to permit investors to evaluate their relevance. These accountants believe that such changes should be implemented at the present time.

.05 Other accountants believe that the income statement is more useful if the effects of events or transactions that occur infrequently and are of an unusual nature are segregated from the results of the continuing, ordinary, and typical operations of an entity. They also believe that the criteria for income statement classification should relate to the environment in which an entity operates. In their view the criteria in APB Opinion No. 9, paragraph 21,[1] for determining whether an event or transaction should be reported as extraordinary lack precision. Accordingly, they conclude that the criteria should be clarified and modified to provide that to be classified as an extraordinary item an event or transaction should be both unusual in nature and infrequent in occurrence when considered in relation to the environment in which the entity operates. They also believe that to enhance the usefulness of the income statement (a) the results of continuing operations of an entity should be reported sepa-

[1] Editor's Note: Footnote reference eliminated.

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rately from the operations of a segment of the business which has been or will be discontinued and (b) the gain or loss from disposal of a segment should be reported in conjunction with the operations of the segment and not as an extraordinary item. They further believe that material events and transactions that are either unusual or occur infrequently, but not both, should be adequately disclosed.

.06 Still other accountants agree in part with the views described in paragraph .05 but believe that a combination of infrequency of occurrence and abnormality of financial effect should also result in classifying an event or transaction as extraordinary.

APPLICABILITY

.07 This section supersedes section 2010.19-.21, section 2010.28, insofar as it refers to examples of financial statements, and section 2010A. It also amends section 2011.13 and section 2011.30, footnote 10, *Earnings per Share,* insofar as this section prescribes the presentation and computation of earnings per share of continuing and discontinued operations. This section does not modify or amend the conclusions of sections 4091.44 and 4091.60, *Accounting for Income Taxes,* or of section 1091.60, *Business Combinations,* with respect to the classification of the effects of certain events and transactions as extraordinary items. Prior sections that refer to the superseded paragraphs noted above are modified to insert a cross reference to this section.[2]

OPINION

Income Statement Presentation and Disclosure

.08 *Discontinued Operations of a Segment of a Business.* For purposes of this section, the term *discontinued operations* refers to the operations of a segment of a business as defined in paragraph .13 that has been sold, abandoned, spun off, or otherwise disposed of or, although still operating, is the subject of a formal plan for disposal (see paragraph .14). The Board concludes that the results of

[2] This section amends sections 1021-1029, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* to the extent that they describe an extraordinary item.

continuing operations should be reported separately from discontinued operations and that any gain or loss from disposal of a segment of a business (determined in accordance with paragraphs .15 and .16) should be reported in conjunction with the related results of discontinued operations and not as an extraordinary item. Accordingly, operations of a segment that has been or will be discontinued should be reported separately as a component of income before extraordinary items and the cumulative effect of accounting changes (if applicable) in the following manner:

Income from continuing operations before income taxes[3]	$xxxx	
Provision for income taxes	xxx	
Income from continuing operations[3]		$xxxx
Discontinued operations (Note ......):		
Income (loss) from operations of discontinued Division X (less applicable income taxes of $..........)	$xxxx	
Loss on disposal of Division X, including provision of $.......... for operating losses during phase-out period (less applicable income taxes of $..........)	xxxx	xxxx
Net Income		$xxxx

Amounts of income taxes applicable to the results of discontinued operations and the gain or loss from disposal of the segment should be disclosed on the face of the income statement or in related notes. Revenues applicable to the discontinued operations should be separately disclosed in the related notes.

.09 Earnings per share data for income from continuing operations and net income, computed in accordance with section 2011, should be presented on the face of the income

[3] These captions should be modified appropriately when an entity reports an extraordinary item and/or the cumulative effect of a change in accounting principle in accordance with section 1051, *Accounting Changes*. The presentation of per share data will need similar modification.

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statement.[4] If presented, per share data for the results of discontinued operations and gain or loss from disposal of the business segment may be included on the face of the income statement or in a related note.

.10 *Extraordinary Items.* The Board has also reconsidered the presentation of extraordinary items in an income statement as prescribed in APB Opinion No. 9, and reaffirms the need to segregate extraordinary items for the reasons given in paragraph .05 of this section and section 2010.18.

.11 In the absence of discontinued operations and changes in accounting principles, the following main captions should appear in an income statement if extraordinary items are reported (sections 2010.16-.18):

Income before extraordinary items[5]	$xxx
Extraordinary items (less applicable income taxes of $..........) (Note ....)	xxx
Net income	$xxx

The caption *extraordinary items* should be used to identify separately the effects of events and transactions, other than the disposal of a segment of a business, that meet the criteria for classification as extraordinary as discussed in paragraphs .19-.24. Descriptive captions and the amounts for *individual* extraordinary events or transactions should be presented, preferably on the face of the income statement, if practicable; otherwise disclosure in related notes is acceptable. The nature of an extraordinary event or transaction and the principal items entering into the determination of an extraordinary gain or loss should be described. The income taxes applicable to extraordinary items should be disclosed on the face of the income statement; alterna-

[4] The presence of a common stock equivalent or other dilutive securities together with income from continuing operations and extraordinary items may result in diluting one of the per share amounts which are required to be disclosed on the face of the income statement—i. e., income from continuing operations, income before extraordinary items and before the cumulative effect of accounting changes, if any, and net income—while increasing another. In such a case, the common stock equivalent or other dilutive securities should be recognized for all computations even though they have an anti-dilutive effect on one of the per share amounts.

[5] This caption should be modified appropriately when an entity reports the cumulative effect of an accounting change.

tively, disclosure in the related notes is acceptable. The caption *net income* should replace the three captions shown above if the income statement includes no extraordinary items.

.12 Earnings per share data for income before extraordinary items and net income should be presented on the face of the income statement, as prescribed by section 2011.

Accounting for the Disposal of a Segment of a Business

.13 For purposes of this section, the term *segment of a business* refers to a component of an entity whose activities represent a separate major line of business or class of customer. A segment may be in the form of a subsidiary, a division, or a department, and in some cases a joint venture or other nonsubsidiary investee, provided that its assets, results of operations, and activities can be clearly distinguished, physically and operationally and for financial reporting purposes, from the other assets, results of operations, and activities of the entity. Financial statements of *current and prior* periods that include results of operations prior to the measurement date (as defined in paragraph .14) should disclose the results of operations of the disposed segment, less applicable income taxes, as a separate component of income before extraordinary items (see paragraph .08). The fact that the results of operations of the segment being sold or abandoned cannot be separately identified strongly suggests that the transaction should not be classified as the disposal of a segment of the business. The disposal of a segment of a business should be distinguished from other disposals of assets incident to the evolution of the entity's business, such as the disposal of part of a line of business, the shifting of production or marketing activities for a particular line of business from one location to another, the phasing out of a product line or class of service, and other changes occasioned by technological improvements. The disposal of two or more unrelated assets that individually do not constitute a segment of a business should not be combined and accounted for as a disposal of a segment of business.

.14 *Definition of Measurement and Disposal Dates.* For purposes of applying the provisions of this section, the

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measurement date of a disposal is the date on which the management having authority to approve the action commits itself to a formal plan to dispose of a segment of the business, whether by sale or abandonment. The plan of disposal should include, as a minimum, identification of the major assets to be disposed of, the expected method of disposal, the period expected to be required for completion of the disposal, an active program to find a buyer if disposal is to be by sale, the estimated results of operations of the segment from the measurement date to the disposal date, and the estimated proceeds or salvage to be realized by disposal. For purposes of applying this section, the *disposal date* is the date of closing the sale if the disposal is by sale or the date that operations cease if the disposal is by abandonment.

.15 *Determination of Gain or Loss on Disposal of a Segment of a Business.* If a loss is expected from the proposed sale or abandonment of a segment, the estimated loss should be provided for at the measurement date.[6] If a gain is expected, it should be recognized when realized, which ordinarily is the disposal date. The determination of whether a gain or a loss results from the disposal of a segment of a business should be made at the measurement date based on estimates at that date of the net realizable value of the segment after giving consideration to any estimated costs and expenses directly associated with the disposal and, if a plan of disposal is to be carried out over a period of time and contemplates continuing operations during that period, to any estimated income or losses from operations. If it is expected that net losses from operations will be incurred between the measurement date and the expected disposal date, the computation of the gain or loss on disposal should also include an estimate of such amounts. If it is expected that income will be generated from operations during that period the computation of the gain or loss should include the estimated income, limited however to the amount of any loss otherwise recognizable

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[6] If financial statements for a date prior to the measurement date have not been issued, and the expected loss provides evidence of conditions that existed at the date of such statements and affects estimates inherent in the process of preparing them, the financial statements should be adjusted for any change in estimates resulting from the use of such evidence. (See AU section 560.03, volume 1, AICPA PROFESSIONAL STANDARDS.)

from the disposal; any remainder should be accounted for as income when realized. The Board believes that the estimated amounts of income or loss from operations of a segment between measurement date and disposal date included in the determination of loss on disposal should be limited to those amounts that can be projected with reasonable accuracy. In the usual circumstance, it would be expected that the plan of disposal would be carried out within a period of one year from the measurement date and that such projections of operating income or loss would not cover a period exceeding approximately one year.[7]

.16 Gain or loss from the disposal of a segment of a business should not include adjustments, costs, and expenses associated with normal business activities that should have been recognized on a going-concern basis up to the measurement date, such as adjustments of accruals on long-term contracts or write-down or write-off of receivables, inventories, property, plant, and equipment used in the business, equipment leased to others, or intangible assets. However, such adjustments, costs, and expenses which (a) are clearly a *direct* result of the decision to dispose of the segment and (b) are clearly not the adjustments of carrying amounts or costs, or expenses that should have been recognized on a going-concern basis prior to the measurement date should be included in determining the gain or loss on disposal. Results of operations before the measurement date should not be included in the gain or loss on disposal. [As modified, effective for fiscal years beginning on or after January 1, 1975, pursuant to FASB Statement No. 2.] (Section 4211.)

.17 Costs and expenses *directly* associated with the decision to dispose include items such as severance pay, additional pension costs, employee relocation expenses, and future rentals on long-term leases to the extent they are not offset by sub-lease rentals.

.18 *Disclosure.* In addition to the amounts that should be disclosed in the financial statements (paragraph .08), the notes to financial statements for the period encompassing the measurement date should disclose:

[7] When disposal is estimated to be completed within one year and subsequently is revised to a longer period of time, any revision of the net realizable value of the segment should be treated as a change in estimate (see paragraph .25).

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(a) the identity of the segment of business that has been or will be discontinued,

(b) the expected disposal date, if known (see paragraph .14),

(c) the expected manner of disposal,

(d) a description of the remaining assets and liabilities of the segment at the balance sheet date,[8] and

(e) the income or loss from operations and any proceeds from disposal of the segment during the period from the measurement date to the date of the balance sheet.

For periods subsequent to the measurement date and including the period of disposal, notes to the financial statements should disclose the information listed in (a), (b), (c), and (d) above and also the information listed in (e) above compared with the prior estimates.

Criteria for Extraordinary Items

.19 Judgment is required to segregate in the income statement the effects of events or transactions that are extraordinary items (as required by paragraph .11). The Board concludes that an event or transaction should be presumed to be an ordinary and usual activity of the reporting entity, the effects of which should be included in income from operations, unless the evidence clearly supports its classification as an extraordinary item as defined in this section.

.20 Extraordinary items are events and transactions that are distinguished by their unusual nature *and* by the infrequency of their occurrence. Thus, *both* of the following criteria should be met to classify an event or transaction as an extraordinary item:

(a) *Unusual nature*—the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activi-

[8] Consideration should be given to disclosing this information by segregation in the balance sheet of the net assets and liabilities (current and noncurrent) of the discontinued segment. Only liabilities which will be assumed by others should be designated as liabilities of the discontinued segment. If the loss on disposal cannot be estimated within reasonable limits, this fact should be disclosed.

ties of the entity, taking into account the environment in which the entity operates. (See discussion in paragraph .21.)

(b) *Infrequency of occurrence*—the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates. (See discussion in paragraph .22.)

.21 *Unusual Nature.* The specific characteristics of the entity, such as type and scope of operations, lines of business, and operating policies should be considered in determining ordinary and typical activities of an entity. The environment in which an entity operates is a primary consideration in determining whether an underlying event or transaction is abnormal and significantly different from the ordinary and typical activities of the entity. The environment of an entity includes such factors as the characteristics of the industry or industries in which it operates, the geographical location of its operations, and the nature and extent of governmental regulation. Thus, an event or transaction may be unusual in nature for one entity but not for another because of differences in their respective environments. Unusual nature is not established by the fact that an event or transaction is beyond the control of management.

.22 *Infrequency of Occurrence.* For purposes of this section, an event or transaction of a type not reasonably expected to recur in the foreseeable future is considered to occur infrequently. Determining the probability of recurrence of a particular event or transaction in the foreseeable future should take into account the environment in which an entity operates. Accordingly, a specific transaction of one entity might meet that criterion and a similar transaction of another entity might not because of different probabilities of recurrence. The past occurrence of an event or transaction for a particular entity provides evidence to assess the probability of recurrence of that type of event or transaction in the foreseeable future. By definition, extraordinary items occur infrequently. However, mere infrequency of occurrence of a particular event or transaction does not alone imply that its effects should be classified as

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extraordinary. An event or transaction of a type that occurs frequently in the environment in which the entity operates cannot, by definition, be considered as extraordinary, regardless of its financial effect.

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

(a) Write-down or write-off of receivables, inventories, equipment leased to others, or intangible assets.

(b) Gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations.

(c) Gains or losses on disposal of a segment of a business.

(d) Other gains or losses from sale or abandonment of property, plant, or equipment used in the business.

(e) Effects of a strike, including those against competitors and major suppliers.

(f) Adjustment of accruals on long-term contracts.

In rare situations, an event or transaction may occur that clearly meets both criteria specified in paragraph .20 of this section and thus gives rise to an extraordinary gain or loss that includes one or more of the gains or losses enumerated above. In these circumstances, gains or losses such as (a) and (d) above should be included in the extraordinary item if they are a direct result of a major casualty (such as an earthquake), an expropriation, or a prohibition under a newly enacted law or regulation that clearly meets both criteria specified in paragraph .20. However, any portion of such losses which would have resulted from a valuation of assets on a going concern basis should not be included in the extraordinary items. Disposals of a segment of a business should be accounted for pursuant to paragraph .13 and presented in the income statement pursuant to paragraph .08 even though the circumstances of the disposal meet the criteria specified in paragraph .20. [As modified, effective for fiscal years beginning on or after January 1, 1975, pursuant to FASB Statement No. 2.] (See section 4211.)

.24 *Materiality.* The effect of an extraordinary event or transaction should be classified separately in the income

statement in the manner described in paragraph .11 if it is material in relation to income before extraordinary items or to the trend of annual earnings before extraordinary items, or is material by other appropriate criteria. Items should be considered individually and not in the aggregate in determining whether an extraordinary event or transaction is material. However, the effects of a series of related transactions arising from a single specific and identifiable event or plan of action that otherwise meets the two criteria in paragraph .20 should be aggregated to determine materiality.

Adjustment of Amounts Reported in Prior Periods

.25 Circumstances attendant to disposals of a segment of a business and extraordinary items frequently require estimates, for example, of associated costs and occasionally of associated revenue, based on judgment and evaluation of the facts known at the time of first accounting for the event. Each adjustment in the current period of a loss on disposal of a business segment or of an element of an extraordinary item that was reported in a prior period should be separately disclosed as to year of origin, nature, and amount and classified separately in the current period in the same manner as the original item. If the adjustment is the correction of an error, the provisions of section 1051.36-.37, *Accounting Changes,* should be applied. [As amended, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.] (See section 2014.)

Disclosure of Unusual or Infrequently Occurring Items

.26 A material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both criteria for classification as an extraordinary item, should be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction should be disclosed on the face of the income statement or, alternatively, in notes to the financial statements. Gains or losses of a similar nature that are not individually material should be aggregated. Such items should not be reported on the face of the income statement net of income taxes or in any manner in-

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consistent with the provisions of paragraphs .08 and .11 of this section or in any other manner that may imply that they are extraordinary items. Similarly, the earnings per share effects of those items should not be disclosed on the face of the income statement.[9]

EFFECTIVE DATE

.27 This section shall be effective for events and transactions occurring after September 30, 1973. Events and transactions that were reported as extraordinary items in statements of income for fiscal years ending before October 1, 1973 should not be restated, except that a statement of income including operations of discontinued segments of a business may be reclassified in comparative statements to conform with the provisions of paragraphs .08 and .09 of this section and the Board encourages such reclassification. In addition, the accounting for events and transactions that have been reported previously for the fiscal year in which September 30, 1973 occurs may be restated retroactively to comply with the provisions of this section, and the Board encourages such restatement. Differences in classification of the effects of events and transactions in the financial statements of the current and any prior periods presented should be disclosed in notes to the financial statements.

The next page is 8045.

[9] Exceptions to the final two sentences of this paragraph are specified in the following AICPA industry audit guides: *Audits of Banks*, p. 36; *Audits of Fire and Casualty Insurance Companies*, p. 66; and *Audits of Stock Life Insurance Companies*, p. 89.

AC Section 2013

Reporting Gains and Losses from Extinguishment of Debt

an amendment of section 2012

[Source: FASB Statement No. 4.]

March 1975

INTRODUCTION AND BACKGROUND INFORMATION

.01 *APB Opinion No. 26* [section 5362], "Early Extinguishment of Debt," became effective for extinguishment of debt occurring on or after January 1, 1973. Paragraph 19 of that Opinion [section 5362.19] states "that all extinguishments of debt before scheduled maturities are fundamentally alike. The accounting for such transactions should be the same regardless of the means used to achieve the extinguishment." Paragraph 20 of the same Opinion [section 5362.20] states that "a difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. . . . The criteria in *APB Opinion No. 9* [section 2010] ['Reporting the Results of Operations'] should be used to determine whether the losses or gains are ordinary or extraordinary items. Gains and losses should not be amortized to future periods."

.02 *APB Opinion No. 30* [section 2012], "Reporting the Results of Operations," became effective for events and transactions occurring after September 30, 1973 and superseded *APB Opinion No. 9* [section 2010] with respect to the determination of extraordinary items. *APB Opinion No. 30* [section 2012] and the related Accounting Interpretation issued by the AICPA staff (see *The Journal of Accountancy*, November 1973, pages 82-84) [section U2012.001-.013] can be read literally to preclude classifying most if not all gains or losses from early extinguishment of debt as an extraordinary item in the income statement. The Board has observed that in those cases coming to its attention where a gain or loss from early extinguishment of debt has been reported in an income statement to which *APB Opinion No. 30* [section 2012] was applicable, the gain or loss was included in income before extraordinary items.

.03 Since the effective date of *APB Opinion No. 30* [section 2012], the Board has had inquiries regarding that Opinion be-

cause application of the criteria, especially as illustrated in the related AICPA Accounting Interpretation, appears to preclude classifying gains or losses from most transactions or events as extraordinary items in the income statement. Many respondents to the Board's July 12, 1973 request for views concerning APB Opinions and Accounting Research Bulletins suggested that the conclusions of *APB Opinion No. 26* [section 5362] relating to *early* extinguishment of debt be reconsidered. Since that time, concern also has been expressed to the Board with respect to the accounting for extinguishment of debt at its *scheduled maturity date or later* because the authoritative accounting pronouncements do not address that issue. In addition, the Securities and Exchange Commission and others have expressed concern to the Board about including gains and losses from extinguishment of debt in the determination of income before extraordinary items in the income statement.

.04 The Board considered carefully the suggestions that *APB Opinion No. 26* [section 5362] be reconsidered and concluded that the issues extend beyond *APB Opinion No. 26* [section 5362] and could involve *APB Opinion No. 14* [section 5516], "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants," and *APB Opinion No. 21* [section 4111], "Interest on Receivables and Payables," and could extend to exchanges or sales and related purchases of similar monetary assets. The Board concluded that the pervasiveness of those issues makes broad reconsideration of all these Opinions and the other related issues a more comprehensive undertaking than can be accomplished in the near future. The Board also considered carefully the questions raised with respect to *APB Opinion No. 30* [section 2012] and concluded that there is insufficient experience under that Opinion to warrant a general reconsideration of the criteria set forth therein at this time.

.05 Prior to the issuance of the Exposure Draft of this Statement, the Board had been considering an Interpretation of *APB Opinion No. 26* [section 5362] that would have specified disclosure requirements regarding gains and losses from extinguishment of debt, but that course of action was changed when it became clear to the Board that the income statement classification of gains or losses on extinguishment of debt also required attention. The Board believes that an immediate response is needed to the concern expressed regarding income statement classification of gains and losses from certain extinguishments of debt. Further, the Board continues to believe that guidelines are needed regarding disclosures related to certain debt extinguishments because a

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review of a number of financial statements by the FASB staff indicates that disclosures often have been unclear, particularly with regard to the income tax effects.

.06 The Board has concluded that on the basis of existing data it can make an informed decision on the narrow issues identified in paragraph .05 without a public hearing and that the effective date and transition requirements set forth in paragraphs .11 and .12 are advisable.

.07 This Statement applies to regulated enterprises in accordance with the provisions of the Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit.'"

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Income Statement Classification

.08 Gains and losses from extinguishment of debt that are included in the determination of net income shall be aggregated and, if material,[1] classified as an extraordinary item, net of related income tax effect. That conclusion shall apply whether an extinguishment is early or at scheduled maturity date or later. The conclusion does not apply, however, to gains or losses from cash purchases of debt made to satisfy current or future sinking-fund requirements.[2] Those gains and losses shall be aggregated and the amount shall be identified as a separate item.

Disclosure

.09 Gains or losses from extinguishment of debt that are classified as extraordinary items should be described sufficiently to enable users of financial statements to evaluate their significance. Accordingly, the following information, to the extent not shown separately on the face of the income statement, shall be disclosed in a single note to the financial statements or adequately cross-referenced if in more than one note:

(a) A description of the extinguishment transactions, including the sources of any funds used to extinguish debt if it is practicable to identify the sources.

(b) The income tax effect in the period of extinguishment.

(c) The per share amount of the aggregate gain or loss net of related income tax effect.

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[1] See the first sentence of paragraph 24 of *APB Opinion No. 30* [section 2012.24].

[2] Some obligations to acquire debt have the essential characteristics of sinking-fund requirements, and resulting gains or losses are not required to be classified as extraordinary items. For example, if an enterprise is required each year to purchase a certain percentage of its outstanding bonds before their scheduled maturity, the gain or loss from such purchase is not required to be classified as an extraordinary item. Debt maturing serially, however, does not have the characteristics of sinking-fund requirements, and gain or loss from extinguishment of serial debt shall be classified as an extraordinary item.

Amendment to Existing Pronouncement

.10 This Statement amends *APB Opinion No. 30* [section 2012] only to the extent that classification of gains or losses from extinguishment of debt as an extraordinary item pursuant to the first two sentences of paragraph .08 of this Statement shall be made without regard to the criteria in paragraph 20 of that Opinion [section 2012.20].

Effective Date and Transition

.11 This Statement shall be effective for extinguishments occurring after March 31, 1975, except that it need not be applied to extinguishments occurring on or after April 1, 1975 pursuant to the terms of an offer or other commitment made prior to that date. Application to *all* extinguishments occurring during a fiscal year in which April 1, 1975 falls is encouraged. Retroactive application to extinguishments occurring in prior fiscal years is encouraged but not required.

.12 Although the requirements of this Statement may be applied retroactively, such application is not intended to change the accounting for amounts deferred on refundings of debt that occurred prior to the effective date of *APB Opinion No. 26* [section 5362] or the income statement classification of the amortization of those amounts.

The provisions of this Statement need not be applied to immaterial items.

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APPENDIX A

SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT

.13 In response to the request for comments on the Exposure Draft issued January 31, 1975, the FASB received and considered 120 letters in its deliberations on this Statement. Certain of the comments and the FASB's consideration of them are summarized in paragraphs .14-.17.

.14 For a variety of reasons, many respondents recommended that the FASB not adopt the Exposure Draft as a final Statement. Some respondents recommended that *APB Opinion No. 26* [section 5362] and related issues be reconsidered. Others recommended that the criteria for determining extraordinary items as set forth in *APB Opinion No. 30* [section 2012] be reconsidered. The Board concluded not to address these issues for the reasons stated in paragraph .04.

.15 Some respondents suggested that the proposals in the Exposure Draft, if adopted, would result in erosion of the criteria in *APB Opinion No. 30* [section 2012] for determining extraordinary items. However, this Statement is neither an amendment nor an interpretation of the criteria for classifying and reporting an event or transaction as an extraordinary item as set forth in paragraph 20 of that Opinion [section 2012.20]. Rather, the Board is proscribing the application of those criteria to certain extinguishments of debt in the same way that the application of those criteria has been proscribed with respect to the realization of tax benefits from an operating loss carryforward and to certain profits or losses resulting from the disposal of a significant part of the assets or a separable segment acquired in a business combination accounted for as a pooling of interests.[3] The Board recognizes that the application of the criteria in *APB Opinion No. 30* [section 2012] to extinguishments of debt would seldom, if ever, require that resulting gains and losses be classified as extraordinary items. In issuing this Statement requiring that a gain or loss from certain debt extinguishments be classified as an extraordinary item in the income statement, the Board is neither modifying the criteria set forth in that Opinion nor intending to start a piecemeal revision of those criteria. Although as a result of this Statement questions may be raised regarding the application of the criteria for determining extraordinary items pursuant to *APB Opinion No. 30* [section 2012], the Board has concluded that, on balance, this Statement represents a practical and reasonable solu-

[3] See paragraph 7 of *APB Opinion No. 30* [section 2012.07].

tion to the question regarding income statement classification of gains or losses from extinguishment of debt until such time as the broader issues involved can be addressed.

.16 Many respondents argued that gains and losses from extinguishment of debt pursuant to sinking-fund requirements should not be required to be classified as extraordinary items. The Board agrees primarily because acquisitions for sinking-fund purposes are made to meet continuing contractual requirements assumed in connection with the incurrence of the debt.

.17 In addition to the fact that many respondents recommended that the Exposure Draft not be issued as a final Statement, some respondents objected to the proposal that the Statement be applied retroactively. On further consideration of all the circumstances, the Board concluded that application of the Statement should be required only on a prospective basis although retroactive application is encouraged.

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AC Section 2014

Prior Period Adjustments

[Source: FASB Statement No. 16.]

June 1977

INTRODUCTION AND BACKGROUND INFORMATION

.01 The AICPA Committee on SEC Regulations and others have requested that the FASB consider the criteria for prior period adjustments stated in paragraph 23 of *APB Opinion No. 9*, "Reporting the Results of Operations," and provide further guidelines for the application of those criteria. Paragraph 23 of *APB Opinion No. 9* states:

> Adjustments related to prior periods — and thus excluded in the determination of net income for the current period — are limited to those material adjustments which (a) can be specifically identified with and directly related to the business activities of particular prior periods, and (b) are not attributable to economic events occurring subsequent to the date of the financial statements for the prior period, and (c) depend primarily on determinations by persons other than management and (d) were not susceptible of reasonable estimation prior to such determination. Such adjustments are rare in modern financial accounting. They relate to events or transactions which occurred in a prior period, the accounting effects of which could not be determined with reasonable assurance at that time, usually because of some major uncertainty then existing. Evidence of such an uncertainty would be disclosure thereof in the financial statements of the applicable period, or of an intervening period in those cases in which the uncertainty became apparent during a subsequent period. Further, it would be expected that, in most cases, the opinion of the reporting independent auditor on such prior period would have contained a qualification because of the uncertainty. Examples are material, nonrecurring adjustments or settlements of income taxes, of renegotiation proceedings or of utility revenue under rate processes. Settlements of significant amounts resulting from litigation or similar claims may also constitute prior period adjustments.

.02 The requests referred to in paragraph .01 were prompted by Securities and Exchange Commission staff administrative interpretations of *APB Opinion No. 9* [section 2010] during 1975 limiting prior period adjustments for out-of-court settlements of litigation. The view of the SEC staff was later explained in *Staff Accounting Bulletin No. 8* (see Appendix C). In addition, differing interpretations of the criteria of paragraph 23 and of the provisions of paragraph 24 of *APB Opinion No. 9* have been cited as a basis for requesting a reconsideration of the concept of prior period adjustments.

.03 Paragraph 24 of *APB Opinion No. 9* elaborates on paragraph 23 by giving examples of items that do not qualify as prior period adjustments. Paragraph 24 states:

> Treatment as prior period adjustments should not be applied to the normal, recurring corrections and adjustments which are the natural result of the use of estimates inherent in the accounting process. For example, changes in the estimated remaining lives of fixed assets affect the computed amounts of depreciation, but these changes should be considered prospective in nature and not prior period adjustments. Similarly, relatively immaterial adjustments of provisions for liabilities (including income taxes) made in prior periods should be considered recurring items to be reflected in operations of the current period. Some uncertainties, for example those relating to the realization of assets (collectibility of accounts receivable, ultimate recovery of deferred costs or realizability of inventories or other assets), would not qualify for prior period adjustment treatment, since economic events subsequent to the date of the financial statements must of necessity enter into the elimination of any previously-existing uncertainty. Therefore, the effects of such matters are considered to be elements in the determination of net income for the period in which the uncertainty is eliminated. Thus, the Board [APB] believes that prior period adjustments will be rare.

.04 *APB Opinion No. 20* [section 1051], "Accounting Changes," affirmed the conclusions of paragraph 24 of *APB Opinion No. 9* by requiring that "a change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods . . . unless the change meets all the conditions for a prior period adjustment (paragraph 23 of *APB Opinion No. 9*)."

.05 *FASB Statement No. 5* [section 4311], "Accounting for Contingencies," (effective for fiscal years beginning on or after July 1, 1975) establishes the conditions for accrual of an estimated loss

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from a loss contingency and prohibits accrual before those conditions are met. The two conditions for accrual of an estimated loss from a loss contingency set forth in paragraph 8 of Statement No. 5 [section 4311.08] are that "(a) information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements . . ." and "(b) the amount of loss can be reasonably estimated." Paragraph 8 of the Statement [section 4311.08] requires that "an estimated loss from a loss contingency . . . shall be accrued by a charge to income . . . ." A footnote to that paragraph states that "paragraphs 23 - 24 of *APB Opinion No. 9* . . . describe the 'rare' circumstances in which a prior period adjustment is appropriate" and indicates that "those paragraphs are not amended" by Statement No. 5 [section 4311].

.06 The Board has, among other things, (a) reviewed an FASB staff survey of prior period adjustments made in recent years pursuant to the criteria of *APB Opinion No. 9* [section 2010], (b) considered the relationship of the criteria of *APB Opinion No. 9* [section 2010], for prior period adjustments to the rationale of subsequent APB Opinions (see paragraphs .29-.36), and (c) examined the relationship of the criteria of *APB Opinion No. 9* [section 2010] for prior period adjustments to the conditions of *FASB Statement No. 5* [section 4311] for accrual of estimated losses from loss contingencies (see paragraph .37).

.07 An Exposure Draft of a proposed Statement on "Prior Period Adjustments" was issued July 29, 1976, and a public hearing based on the Exposure Draft was held on October 15, 1976. The Board received 162 position papers and letters of comment in response to the Exposure Draft. Ten presentations were made at the public hearing. On April 12, 1977 the FASB announced that it was unable to attain the necessary five assenting votes for issuance of a final Statement on prior period adjustments. That announcement stated that four FASB members agreed to support the position in the Exposure Draft, modified in certain respects for interim reporting, and that the other three Board members dissented for varied reasons. On June 21, 1977 the Trustees of the Financial Accounting Foundation announced that they had approved the implementation of a number of the recommendations made by the Trustees' Structure Committee in its April 1977 report, "the Structure of Establishing Financial Accounting Standards." The recommendations approved included amending the Foundation's by-laws to change the voting requirement for adoption of pronouncements by the

FASB from five affirmative votes among the seven members to a simple majority. Subsequent to the action by the Trustees, the Board reconsidered the subject and voted to issue this Statement.

.08 The Board concluded that, with limited exceptions, items of profit and loss recognized during a period shall be included in the determination of net income of that period. Paragraphs .11 and .13-.15 describe the exceptions that shall be accounted for and reported as prior period adjustments. The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in Appendix A to this Statement. The results of the FASB staff survey of prior period adjustments made pursuant to the criteria of *APB Opinion No. 9* [section 2010] in annual financial statements for fiscal years ending from July 1973 through June 1975 are summarized in Appendix B to this Statement.

.09 The Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit'," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process," and discusses the application of generally accepted accounting principles to regulated industries. FASB Statements and Interpretations should therefore be applied to regulated companies that are subject to the rate-making process in accordance with the provisions of the Addendum.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

.10 Except as specified in paragraph .11 and in paragraphs .13 and .14 with respect to prior interim periods of the current year, all items of profit and loss recognized during a period,[1] including accruals of estimated losses from loss contingencies, shall be included in the determination of net income for that period.[2]

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[1] As used in this Statement, the term "period" refers to both annual and interim reporting periods.

[2] Many items that would previously have been reported as prior period adjustments will be subject to existing disclosure requirements when that type of item is included in the determination of current net income. For example, *APB Opinion No. 28* [section 2071], "Interim Financial Reporting," specifies certain disclosures for interim reporting periods and *APB Opinion No. 30* [section 2012], "Reporting the Results of Operations," specifies disclosures for certain types of items discussed by that Opinion.

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.11 Items of profit and loss related to the following shall be accounted for and reported as prior period adjustments[3] and excluded from the determination of net income for the current period:

a) Correction of an error in the financial statements of a prior period[4] and

b) Adjustments that result from realization of income tax benefits of pre-acquisition operating loss carryforwards of purchased subsidiaries.[5]

.12 This Statement does not affect the manner of reporting accounting changes required or permitted by an FASB Statement, an FASB Interpretation, or an APB Opinion.[6]

Adjustments Related to Prior Interim Periods of the Current Fiscal Year

.13 For purposes of this Statement, an "adjustment related to prior *interim* periods of the current fiscal year" is an adjustment or settlement of litigation or similar claims, of income taxes, of renegotiation proceedings, or of utility revenue under rate-making processes provided that the adjustment or settlement meets each of the following criteria:

a) The effect of the adjustment or settlement is material in relation to income from continuing operations of the current fiscal year or in relation to the trend of income from continuing operations or is material by other appropriate criteria, and

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[3] The reporting of prior period adjustments is described in paragraph 18 of *APB Opinion No. 9* [section 2010.17], as modified by paragraph .16 of this Statement, and in paragraph 26 of *APB Opinion No. 9* [section 2010.25].

[4] As defined in paragraph 13 of *APB Opinion No. 20* [Section 1051.13]. That paragraph also describes the distinction between a correction of an error and a change in accounting estimate.

[5] See paragraph 49 of *APB Opinion No. 11* [section 4091.48], "Accounting for Income Taxes," and paragraph 88 of *APB Opinion No. 16* [section 1091.88], "Business Combinations."

[6] In addition to transition requirements of these pronouncements, accounting changes resulting in restatement of previously issued financial statements of prior periods include a change in accounting method permitted by paragraph 52 of *APB Opinion No. 16* [section 1091.52], a change in the reporting entity described in paragraph 34 of *APB Opinion No. 20* [section 1051.34], and special changes in accounting principle described in paragraphs 27 and 29 of *APB Opinion No. 20* [sections 1051.27 and 1051.29]. See also footnote 5 to *APB Opinion No. 20* [section 1051, footnote 6].

b) All or part of the adjustment or settlement can be specifically identified with and is directly related to business activities of specific prior interim periods of the current fiscal year, and

c) The amount of the adjustment or settlement could not be reasonably estimated prior to the current interim period but becomes reasonably estimable in the current interim period.

Criterion (b) above is not met solely because of incidental effects such as interest on a settlement. Criterion (c) would be met by the occurrence of an event with currently measurable effects such as new retroactive tax legislation or a final decision on a rate order. Treatment as adjustments related to prior interim periods of the current fiscal year shall not be applied to the normal recurring corrections and adjustments that are the result of the use of estimates inherent in the accounting process. Changes in provisions for doubtful accounts shall not be considered to be adjustments related to prior interim periods of the current fiscal year even though the changes result from litigation or similar claims.

.14 If an item of profit or loss occurs in *other than the first* interim period of the enterprise's fiscal year and all or a part of the item of profit or loss is an adjustment related to prior interim periods of the current fiscal year, as defined in paragraph .13 above, the item shall be reported as follows:

a) The portion of the item that is directly related to business activities of the enterprise during the current interim period, if any, shall be included in the determination of net income for that period.

b) Prior interim periods of the current fiscal year shall be restated to include the portion of the item that is directly related to business activities of the enterprise during each prior interim period in the determination of net income for that period.

c) The portion of the item that is directly related to business activities of the enterprise during prior fiscal years, if any, shall be included in the determination of net income of the first interim period of the current fiscal year.

.15 The following disclosures shall be made in interim financial reports about an adjustment related to prior interim

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periods of the current fiscal year. In financial reports for the interim period in which the adjustment occurs, disclosure shall be made of (a) the effect on income from continuing operations, net income, and related per share amounts for each prior interim period of the current fiscal year, and (b) income from continuing operations, net income, and related per share amounts for each prior interim period restated in accordance with paragraph .14 of this Statement.

Amendments to Existing Pronouncements

.16 The conclusions of this Statement require the following amendments to existing pronouncements:

a) *APB Opinion No. 9* [section 2010]. Delete paragraphs 23 and 24. The first sentence of paragraph 18 [section 2010.17] is modified to read as follows:

> Those items that are reported as prior period adjustments shall, in single period statements, be reflected as adjustments of the opening balance of retained earnings.

b) *APB Opinion No. 20* [section 1051]. Delete footnote 9 to paragraph 31 [section 1051.31, footnote 10].

c) *APB Opinion No. 30* [section 2012]. Delete the following words from the second and third sentences of paragraph 25 [section 2012.25]: "should not be reported as a prior period adjustment unless it meets the criteria for a prior period adjustment as defined in paragraph 23 of *APB Opinion No. 9*. An adjustment that does not meet such criteria," and combine the remainder of the two sentences into one sentence as follows:

> Each adjustment in the current period of a loss on disposal of a business segment or of an element of an extraordinary item that was reported in a prior period should be separately disclosed as to year of origin, nature, and amount and classified separately in the current period in the same manner as the original item.

d) *FASB Statement No. 5* [section 4311]. Delete footnote 3 to paragraph 8 [section 4311.08, footnote 3].

Effective Date and Transition

.17 This Statement shall be effective for financial statements for fiscal years beginning after October 15, 1977. Application

in financial statements for fiscal years beginning before October 16, 1977 that have not been previously issued, and in interim periods within those fiscal years, is encouraged but not required. This Statement shall not be applied retroactively to previously issued annual financial statements.

The provisions of this Statement need not be applied to immaterial items.

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Appendix A

BASIS FOR CONCLUSIONS

.18 This Appendix contains a discussion of the factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

Scope

.19 The initial request referred to in paragraph .01 was for clarification of the application of criterion (b)[7] and criterion (c)[8] of paragraph 23 of *APB Opinion No. 9* to negotiated settlements of litigation. Paragraph 23 of *APB Opinion No. 9* included "settlements of significant amounts resulting from litigation or similar claims" as an example of items that may qualify as prior period adjustments. SEC *Staff Accounting Bulletin No. 8* states the SEC staff's conclusion that "litigation is inevitably an 'economic event' and that settlements would constitute 'economic events' of the period in which they occur. Accordingly, it would seem that charges or credits relating to settlements would also not meet" criterion (b).[9] *Staff Accounting Bulletin No. 8* also states the view that when litigation is settled, management must make a number of significant judgments, and, hence, criterion (c) [10] has not been met.

.20 As described in Appendix B, the FASB staff searched approximately 6,000 annual reports for fiscal years ended from July 1973 through June 1975 and identified 191 annual reports that showed prior period adjustments that appeared to have been made pursuant to the criteria of paragraph 23 of *APB Opinion No. 9*. The purpose of the research was to determine the extent and nature of those prior period adjustments and the possible interpretative problems the

[7] Criterion (b) of paragraph 23 of *APB Opinion No. 9* requires that the adjustments "are not attributable to economic events occurring subsequent to the date of the financial statements for the prior period."

[8] Criterion (c) of paragraph 23 of *APB Opinion No. 9* requires that the adjustment "depend primarily on determinations by persons other than management."

[9] See footnote 7.

[10] See footnote 8.

Board would face if it decided to clarify the criteria in paragraph 23 of *APB Opinion No. 9*. Over one-third of the identified adjustments resulted from litigation and similar claims, and most of these were negotiated. Income tax settlements also represented over one-third of the identified adjustments. Because of the similarity of the process involved in settling litigation and income taxes, and because they constitute most of the identified prior period adjustments made pursuant to the criteria of paragraph 23 of *APB Opinion No. 9*, the Board concluded that this Statement should not be limited to the area of negotiated settlements of litigation, but rather, should address all items reported as prior period adjustments pursuant to the criteria of paragraph 23 of *APB Opinion No. 9*.

.21 Some respondents to the Exposure Draft questioned whether this Statement was intended to change the reporting of adjustments that are required by *APB Opinion No. 9* [section 2010], *11* [section 4091], and *16* [section 1091] to be reported as adjustments to paid-in capital, goodwill, or other assets. This Statement is not intended to require those adjustments to be included in the determination of net income of the current period. This Statement is also not intended to proscribe restatements of earnings per share that are required by *APB Opinions No. 15* [section 2011], "Earnings Per Share," and *16* [section 1091] or by other APB Opinions and FASB Statements.

Summary

.22 In considering possible clarification of the criteria in paragraph 23 of *APB Opinion No. 9* (see paragraph .24), the purpose of the criteria (see paragraph .25), and the effect on prior period adjustments of subsequent pronouncements (see paragraphs .29-.37), the Board determined that an amendment of *APB Opinion No. 9* [section 2010] was needed. The Board concluded for the reasons indicated in paragraphs .24-.39 that all items of profit and loss recognized during a period, with the limited exceptions indicated in paragraphs .11 and .13-.15 and explained in paragraphs .41-.46, shall be included in the determination of net income for that reporting period. The Board also concluded, for the reasons indicated in paragraphs .47-.51, that the manner of reporting accounting changes should not be modified at this time (see paragraph .12).

.23 Some respondents recommended that this project be included in or deferred pending completion of the Board's agenda project entitled "Conceptual Framework for Financial Ac-

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counting and Reporting." The Board determined that this problem required resolution at this time and could be resolved in the existing accounting framework. As outlined in paragraphs .29-.37, the all-inclusive income statement is predominant in the existing accounting framework.

Possible Clarification of Criteria

.24 Relating the criteria of paragraph 23 of *APB Opinion No. 9* and the examples given in that paragraph to prior period adjustments identified in the FASB staff survey (see Appendix B) led to the conclusion that any attempted clarification could result in an amendment of *APB Opinion No. 9* [section 2010] and that the problem could not be satisfactorily resolved by an Interpretation as indicated by the following examples:

a) Settlements of income taxes and litigation constitute the majority of identified prior period adjustments. The former is included in paragraph 23 as an example of a prior period adjustment when material and nonrecurring and the latter is included as an example of an item that *may* qualify as a prior period adjustment. Such settlements are usually negotiated and often do not depend *primarily* on determinations by *any* single party. Accordingly, for out-of-court settlements of both income taxes and litigation to qualify as prior period adjustments, the phrase "depend primarily on determinations by persons other than management" (criterion(c)) would have to be amended to read "*not* depending primarily on management."

b) The term "economic events" in criterion (b)[11] has been interpreted in significantly different ways (see paragraph .19 and Appendix C). Refining the definition of this term could result in an effective amendment.

c) Refining the requirement that prior period adjustments be "material" or of the word "nonrecurring" in the examples in paragraph 23 would likely be an effective amendment.

Purpose of the Criteria of Paragraph 23 of APB Opinion No. 9

.25 Paragraph 17 of *APB Opinion No. 9* [section 2010.16] states that "net income should reflect all items of profit and loss recog-

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[11] See footnote 7.

nized during the period with the sole exception of . . . prior period adjustments. . . ." *APB Opinion No. 9* [section 2010.16] requires restatement of affected prior periods only if the statements of the affected prior periods are presented; otherwise, only the effect on beginning retained earnings of the earliest period presented is required. The Board believes that a decision to exclude certain items of profit and loss recognized during a period from the determination of net income for that period should be based on a determination that some expected user or class of users would be benefited. Items of profit and loss clearly related to prior period operations and unrelated to the current period operations, for example, might be excluded from the determination of net income for the current period because existing and potential investors might be misled by their inclusion. The criteria of paragraph 23 of *APB Opinion No. 9* do not serve this purpose because they do not comprehend many other items of profit and loss related to prior periods and unrelated to the current period operations. The Board concluded that users will not be benefited by special treatment for some items of profit and loss recognized during a period but not for other similar items. The reasons for the limited exceptions indicated in paragraphs .11 and .13-.15 are explained in paragraphs .41-.46.

The Matching Concept

.26 A number of respondents to the Exposure Draft noted that adjustments that are reported as prior period adjustments are unrelated to operations of the current period. In their view, inclusion in net income of the current period of costs or revenues that are directly related to business activities of prior periods distorts net income in the current period by matching revenue of one period with costs of another period.

.27 *APB Statement No. 4* [sections 1021-1029], "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," explicitly avoids using the term "matching" because it has a variety of meanings in the accounting literature. In its broadest sense, matching refers to the entire process of income determination — described in paragraph 147 of *APB Statement No. 4* [section 1026.11] as "identifying, measuring, and relating revenue and expenses of an enterprise for an accounting period." Matching may also be used in a more limited sense to refer only to the process of expense recognition or in an even more limited sense to refer to the

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recognition of expenses by associating costs with revenue on a cause and effect basis.

.28 The Board reviewed items that were reported as prior period adjustments in recent years. The results of that review are summarized in Appendix B. Based on that review, the Board concluded that the items that were reported as prior period adjustments were not sufficiently different from other items that were included in the determination of net income in the current period to justify their exclusion.

Relationship to Subsequent Pronouncements

.29 *APB Opinion No. 9* [section 2010] was issued in December 1966. Since then, other APB Opinions and FASB Statements have changed the standards of accounting for some items related to prior periods. The following paragraphs refer to certain of those changes and their relationship to prior period adjustments.

.30 Paragraph 23 of *APB Opinion No. 9* includes "material, nonrecurring adjustments or settlements of income taxes" as an example of items that would meet the criteria for prior period adjustments. Paragraph 24 of Opinion No. 9 states that "relatively immaterial adjustments of provisions for liabilities (including income taxes) made in prior periods should be considered recurring items to be reflected in operations of the current period." *APB Opinion No. 11* [section 4091], issued in December 1967, requires the use of comprehensive allocation in accounting for income taxes. Prior to the issuance of that Opinion, some enterprises applied partial allocation, a method that did not require taxes to be allocated for certain timing differences. Many settlements of income taxes involve timing differences. With the use of comprehensive allocation, tax settlements relating to timing differences normally do not affect income; thus, *APB Opinion No. 11* [section 4091] probably has reduced the income effect of some settlements of income tax and accordingly the number of settlements that would be accounted for as prior period adjustments.

.31 Paragraph 45 of *APB Opinion No. 11* [section 4091.44] requires that the benefits of prior year tax loss carryforwards not recognized in the year of the loss be recognized as an extraordinary item in the year in which the benefits are realized. Previously, Chapter 10B, "Income Taxes," of *ARB No. 43* provided that ". . . where it is believed that misleading inferences would be

drawn from such inclusion, the tax reduction should be credited to surplus." Thus, *APB Opinion No. 11* [section 4091] requires that an item that is related to specific prior periods be included in the determination of current income.

.32 Paragraph 50 of *APB Opinion No. 11* [section 4091.49] requires that realized tax benefits of loss carryforwards arising prior to a "quasi-reorganization" be added to contributed capital if not recognized prior to the "quasi-reorganization." Thus, *APB Opinion No. 11* [section 4091] requires inclusion of an item that relates to specific prior periods as an addition to contributed capital in the current period. (See paragraph .34.)

.33 Paragraphs 79-83 of *APB Opinion No. 16* [section 1091.79-.83] require that adjustments resulting from resolution of certain contingencies be accounted for as adjustments of the cost of the acquired enterprise. The required accounting is prospective rather than retroactive. Thus, *APB Opinion No. 16* [section 1091] requires that resolution of certain contingencies relating to specific prior periods be reported as an adjustment of the purchase price of assets in the current period. (See paragraph .34.)

.34 *APB Opinion No. 19* [section 2021], "Reporting Changes in Financial Position," established the statement of changes in financial position as a new basic financial statement. This statement purports to present all changes in financial position that occur during the period. The interaction of Opinion No. 19 [section 2021], *APB Opinion No. 9* [section 2010], and other APB Opinions results in the following anomalies:

a) Realized tax benefits of loss carryforwards arising prior to a "quasi-reorganization" are considered related to prior operations and are added to contributed capital, but are reported as changes in financial position in the current period (see paragraph .32); whereas settlements of income taxes, when they meet the criteria of paragraph 23 of *APB Opinion No. 9*, are reported as changes in financial position in the prior period.

b) Adjustments arising from resolution of certain pre-acquisition contingencies of acquired subsidiaries, considered unrelated to current operations and thus reported as adjustments to the cost of the acquired enterprise, are reported as changes in financial position in the current period (see paragraph .33); whereas

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> adjustments of contingencies that meet the criteria of paragraph 23 of *APB Opinion No. 9* are reported as changes in financial position in the prior period.

The Board concluded that all items of profit and loss recognized in a period, with the limited exceptions indicated in paragraphs .11 and .13-.15 and explained in paragraphs .41-.46, shall be included in the determination of net income and accordingly shall be reported as changes in financial position in that reporting period.

.35 Paragraph 31 of *APB Opinion No. 20* [section 1051.31] requires that the effect of changes in accounting estimates be accounted for in the current period, or the current and future periods if the change affects both. Restatement of amounts reported in prior periods and reporting of pro forma amounts for prior periods are prohibited. However, the Opinion includes a footnote that states:

> 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*).

Thus, Opinion No. 20 [section 1051] requires that most items related to prior periods be included in the determination of current net income without disclosure of the pro forma effect of those items on prior periods but continues the requirements of paragraph 23 of *APB Opinion No. 9* that a few similar items be reported as prior period adjustments.

.36 In addition to establishing criteria for prior period adjustments, which were expected to be rare, *APB Opinion No. 9* [section 2010] also established criteria for "extraordinary items," which were to be reported separately in net income of the current period. *APB Opinion No. 30* [section 2012], "Reporting the Results of Operations," issued in June 1973, established new criteria for extraordinary items, including a change of "would not be expected to recur frequently" in *APB Opinion No. 9* [section 2010] to "not reasonably expected to recur in the foreseeable future" in *APB Opinion No. 30* [section 2012]. Although *APB Opinion No. 30* [section 2012] did not address prior period adjustments, it significantly restricted the eligibility for classification as an extraordinary item. Under Opinion No. 9 [section 2010] the statement that

prior period adjustments would be *nonrecurring* adjustments was often interpreted in practice to mean adjustments that would not be expected to recur frequently, but in the current accounting environment, including *APB Opinion No. 30* [section 2012], *nonrecurring* would be defined as "not reasonably expected to recur in the foreseeable future."

.37 Paragraph 8 of *FASB Statement No. 5* [section 4311.08], issued in March 1975, establishes two conditions for accrual of an estimated loss from a loss contingency and prohibits accrual before those conditions are met. The Board did not reexamine the concept of prior period adjustments at that time. Consideration in this Statement of the kinds of items, if any, to be accounted for as prior period adjustments led to the following questions: If pursuant to *FASB Statement No. 5* [section 4311] a loss cannot be accrued in the period when it is probable that an asset had been impaired or a liability had been incurred because the amount of loss cannot be reasonably estimated, should the loss be charged retroactively to that period when it can be reasonably estimated in a subsequent period? Does the loss accrue to the earlier period, when it was probable that an asset had been impaired or a liability had been incurred, or to the later period, when the amount of loss can be reasonably estimated? The Board believes that the requirement under *APB Opinion No. 9* [section 2010] that certain losses, when they can be reasonably estimated in a later period, be charged retroactively to an earlier period is inconsistent with the intent of *FASB Statement No. 5* [section 4311] in prohibiting accrual of an estimated loss when the amount of loss cannot be reasonably estimated, even though it is probable that an asset has been impaired or a liability has been incurred. The Board concluded that all estimated losses for loss contingencies should be charged to income rather than charging some to income and others to retained earnings as prior period adjustments.

Consideration of Specific Types of Adjustments

.38 A number of respondents questioned the appropriateness of a rate-regulated utility's reporting refunds in the period in which the refunds are ordered if the refunded amounts were originally collected subject to refund. Upon request, several of those respondents furnished additional data that further explained the effect of those refunds. The Board is aware that there are differing views about the reporting of both the contingently refundable revenue when it is billed and the

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subsequent refunds. Determining the reporting that would be appropriate for the contingently refundable revenue when it is billed is outside the scope of this Statement. Except for the possible effect of the rate-making process, the Board does not believe that the reporting of any adjustment at the time that a subsequent refund is determined is sufficiently different from the reporting of other adjustments that result from previous uncertainties to justify special treatment in this Statement. However, the Board did not consider whether the effect of the rate-making process might permit or require special treatment for those refunds. (See also paragraphs .46, concerning adjustments related to prior interim periods of the current fiscal year, and .55, concerning the Addendum to *APB Opinion No. 2* [section 6011].)

.39 A number of respondents recommended that this Statement be modified to provide that specific types of adjustments, such as renegotiation, continue to be reported as prior period adjustments. The Board rejected this recommendation because none of the items cited is sufficiently different from other adjustments that are included in the determination of net income of the current period to justify special treatment. (However, see paragraph .46 concerning adjustments related to prior interim periods of the current fiscal year.)

Prior Period Adjustments That Are Not Affected by This Statement

.40 The Board reviewed other kinds of items reported as prior period adjustments, described in paragraphs .41-.45. In each case, the Board concluded that the accounting for these items should not be modified at this time.

Correction of an error

.41 Paragraph 13 of *APB Opinion No. 20* [section 1051.13] states:

> 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.

A major distinguishing feature of a correction of an error is that the financial statements of the affected prior period, when originally issued, should have reflected the adjustment. In contrast, a prior period adjustment that meets the criteria of paragraph 23 of *APB Opinion No. 9* could not have been determined when the financial statements were originally issued. The Board concluded that a correction of an error, as defined above, should continue to be reflected by restating the financial statements of the affected prior period.

.42 Some respondents contended that the distinction between a correction of an error and a change in estimate is too vague to be a basis for different accounting. The Board noted that *APB Opinion No. 20* [section 1051] used that same distinction as the basis for different accounting for corrections of errors and changes in estimates that did not meet the criteria of Opinion No. 9 [section 2010] for prior period adjustments. No problems of application resulting from that requirement of Opinion No. 20 [section 1051] have been brought to the Board's attention.

.43 Several respondents stated that an exception to permit the reporting of corrections of errors as prior period adjustments is not justified. The Board concluded that the normal procedures of revising and reissuing financial statements promptly when an error is discovered or otherwise advising users that the financial statements contain erroneous data appear to satisfy the interests of financial statement users. Those procedures also permit enterprises to disclose the inaccuracies on as timely a basis as is practicable in the circumstances.

Income tax benefits of pre-acquisition operating loss carryforwards of purchased subsidiaries

.44 Paragraph 88 of *APB Opinion No. 16* [section 1091.88] states that "an acquiring corporation should reduce the acquired goodwill retroactively for the realized tax benefits of loss carry-forwards of an acquired company not previously recorded by the acquiring corporation." The corresponding reduction in the amount of goodwill amortization in prior years is reported as a prior period adjustment as described in paragraph 49 of *APB Opinion No. 11* [section 4091.48]. The FASB presently has on its technical agenda a project entitled "Accounting for Business Combinations and Purchased Intangibles" that includes a reconsideration of *APB Opinion No. 16* [section 1091]. The Board believes that because it is reconsidering *APB*

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Opinion No. 16 [section 1091] the requirements of that Opinion should continue in effect so as to maintain the status quo during the Board's reconsideration.

.45 Some respondents recommended that the acquired goodwill be reduced *in the current year* for the realized tax benefits of loss carryforwards of an acquired company not previously recorded by the acquiring corporation. The adjustment would thus in effect be amortized only prospectively rather than both retroactively, as a prior period adjustment, and prospectively. Accounting for realized tax benefits of loss carryforwards of an acquired company is addressed as Problem 2 of Technical Issue Two at paragraphs 512 - 520 of the August 19, 1976 FASB Discussion Memorandum, "Accounting for Business Combinations and Purchased Intangibles." As indicated in paragraph .44 above, the Board believes that the status quo should be maintained on that project during the Board's deliberations.

Adjustments Related to Prior Interim Periods of the Current Fiscal Year

.46 A number of respondents to the Exposure Draft and to the October 7, 1976 Exposure Draft on "Accounting for Income Taxes in Interim Periods" recommended that this Statement be applied to annual financial statements only, rather than to annual and interim financial statements. Several of those respondents noted that the APB concluded in paragraph 9 of *APB Opinion No. 28* [section 2071.09] that "the usefulness of such [interim financial] information rests on the relationship that it has to the annual results of operations." In those respondents' view, restatement of interim periods is necessary to make interim data relate in a meaningful way to anticipated annual results. Several other of those respondents observed that the Board has on its technical agenda a project entitled "Interim Financial Reporting" that includes a reconsideration of *APB Opinion No. 28* [section 2071] and contended that, because Opinion No. 28 [section 2071] was issued when the criteria of Opinion No. 9 [section 2010] for prior period adjustments were in effect, the Board should not change interim reporting during its reconsideration of Opinion No. 28 [section 2071] by proscribing adjustments to prior interim periods. While not necessarily agreeing with these arguments, the Board decided to continue the practice of interim period restatements in the current fiscal year on a limited basis for the present. To avoid the interpretation problems that have resulted from the criteria of paragraph 23 of Opinion No. 9, the Board (a) limited such restatements to the specific examples cited in

paragraph 23 of Opinion No. 9, (b) required that the adjustments meet the definition of materiality for extraordinary items (paragraph 24 of *APB Opinion No. 30* [section 2012.24]), and (c) required that the adjustments meet the two criteria of paragraph 23 of Opinion No. 9 that have not created interpretation problems in the past. The Board believes that application of the criteria in paragraph .13 will substantially continue existing practice for interim periods of the current fiscal year. Some Board members believe that this exception is inconsistent with some of the other conclusions of this Statement; however, they are willing to accept the provisions of paragraphs .13-.15 during the Board's consideration of its project on interim financial reporting.

Accounting changes

.47 Paragraph 25 of *APB Opinion No. 9* addressed the subject of accounting changes as follows:

> A change in the application of accounting principles may create a situation in which retroactive application is appropriate. In such situations *these changes should receive the same treatment as that for prior period adjustments.* [Emphasis added]

While distinguishing a retroactive accounting change from the prior period adjustments covered by paragraph 23 of that Opinion, the APB did prescribe the same accounting treatment for both.

.48 Accounting changes (but not prior period adjustments covered by paragraph 23 of *APB Opinion No. 9*) were subsequently dealt with in *APB Opinion No. 20* [section 1051]. Paragraph 5 of Opinion No. 20 [section 1051.05] states:

> 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.

.49 The Board believes that retroactive accounting changes, whether specified in transition requirements of FASB Statements and Interpretations and APB Opinions or in the requirements of APB Opinion No. 20 [section 1051], differ significantly in nature from the prior period adjustments covered by paragraph 23 of *APB Opinion No. 9*, as described in the following paragraph. For that reason, the Board concluded that it should not, in this standard, reexamine existing

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requirements for retroactive accounting changes or proscribe the use of retroactive accounting changes in future Statements or Interpretations.

.50 Requirements for restatements of prior periods to reflect changes in accounting principles address categories of transactions that are usually recurring and pervasive. Those restatements provide useful information for purposes of comparing financial data for periods after initial application of the accounting principles with data presented for earlier periods. In contrast, the criteria of paragraph 23 of *APB Opinion No. 9* address isolated adjustments that are stated to be "rare in modern financial accounting." The purpose of restatement of prior periods for nonrecurring items cannot be to make the affected prior period comparable to subsequent periods because comparability cannot be accomplished by shifting nonrecurring items among periods. Instead, the purpose is to exclude material items directly related to prior periods from the determination of net income in the current period to avoid impairing the significance of net income of the current period (see paragraphs 10 - 12 of *APB Opinion No. 9* [section 2010.09-.11]). As previously stated, the Board concluded that purpose is not accomplished by paragraph 23 of *APB Opinion No. 9* (see paragraph .25 above).

.51 Paragraph 52 of *APB Opinion No. 16* [section 1091.52] states that a change in accounting method of one of the combining enterprises in a pooling of interests that is made to conform the accounting methods of the combining enterprises shall be applied retroactively. Like the item discussed in paragraph .44, this provision will be reconsidered as a part of the current FASB technical agenda project entitled "Accounting for Business Combinations and Purchased Intangibles," and the Board believes the status quo should be maintained in the meantime.

Income Statement Classification

.52 Some respondents noted that most adjustments that would have been reported as prior period adjustments prior to the issuance of this Statement will not meet the criteria of *APB Opinion No. 30* [section 2012] for classification as extraordinary items. Some of those respondents recommended that this Statement require adjustments to be classified in the future as extraordinary items if they meet the present criteria of paragraph 23 of *APB Opinion No. 9*. Others contended that

inclusion of such adjustments in income from continuing operations would obscure current income from ongoing operations. Considerations of income statement classification under Opinion No. 30 [section 2012] are not different for items previously classified as prior period adjustments and for other changes in estimates. The Board concluded that income statement classification is too pervasive to be dealt with in this project and that it probably should be considered in some phase of the FASB agenda project entitled "Conceptual Framework for Financial Accounting and Reporting."

.53 A number of respondents observed that the "average" investor relies primarily on earnings per share data or earnings summaries in the financial press and thus might be misled by the inclusion of adjustments that are related to prior periods in income from continuing operations in the current period. The effect of random, irregular, or unpredictable events may make periodic earnings per share data unrepresentative of an enterprise's earning activities during that period. For example, completed contract accounting for long-term contracts may result in an enterprises's reporting activities of one period in a subsequent period. However, the Board does not believe that investors are served by excluding the effects of such events from reported earnings. Disclosure of the effects of such events is required by certain APB Opinions and FASB Statements. Thus, reliance on a single earnings per share amount or a summary in the financial press may not be a sound basis for investment decisions.

.54 Some respondents to the Exposure Draft contended that this Statement substitutes a narrow rule for managements' and auditors' judgments. The Board agrees that judgment is necessary in financial reporting but does not believe that judgment should result in special treatment for some items of profit and loss recognized during a period but not for other similar items unless special treatment is justified by different circumstances. On the other hand, management's judgment may indicate that disclosure should be furnished to allow a user to properly evaluate the enterprise's earnings. For example, *APB Opinion No. 30* [section 2012] requires disclosure of the effect of "unusual" or "infrequently occurring" items. Similar disclosure for items that are not "unusual" or "infrequently occurring," as defined in that Opinion, may also be appropriate if management feels that such disclosure is needed.

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Addendum to APB Opinion No. 2 [section 6011]

.55 A number of respondents requested that the FASB clarify how the Addendum to *APB Opinion No. 2* [section 6011] applies to prior period adjustments. The Board is aware that differing applications of the Addendum exist in practice and has not addressed that issue.

Effective Date and Transition

.56 Some respondents recommended that the Statement not apply to certain categories of preexisting contingencies. Those respondents suggested a variety of criteria for determining the preexisting contingencies to be exempted, including prior disclosure of the contingency, prior partial settlements of the same or of a related matter that were reported as prior period adjustments, and qualifications of auditors' earlier reports with respect to the contingency. The Board concluded that there was no equitable basis for exempting certain preexisting contingencies and not others.

.57 The Exposure Draft proposed that the Statement be applied to fiscal years beginning on or after December 15, 1976. Several respondents recommended earlier application to avoid an interim period of confusion. Several others recommended a delay in the effective date because management may have disclosed in good faith that an anticipated adjustment would be reported as a prior period adjustment and might as a result be charged with having misled investors if the adjustment is reported in income of the current period. Following further consideration the Board concluded that it was appropriate to modify the effective date of this Statement to fiscal years beginning after October 15, 1977.

Applicability to Interim Periods

.58 Some respondents questioned whether this Statement was intended to apply to interim as well as annual financial statements. As a result the Board added footnote 1 to paragraph .10. In addition, as explained in paragraph .46, paragraphs .13-.15 were added.

Disclosure

.59 Some respondents recommended that this Statement specify the disclosures that should be made for an adjustment that would

previously have been reported as a prior period adjustment under the criteria of *APB Opinion No. 9* [section 2010]. The Board concluded that existing disclosure requirements that have been applied to other similar items included in the determination of current net income also apply to items that would previously have been reported as prior period adjustments. For example, *APB Opinion No. 30* [section 2012] specifies the disclosure requirements for "unusual items," "infrequently occurring items," and "extraordinary items"; *APB Opinion No. 28* [section 2071] specifies the disclosure requirements for various categories of adjustments in interim financial reports; and other pronouncements specify disclosures that apply to certain types of items.

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Appendix B

SUMMARY OF FASB STAFF RESEARCH

Other Studies Available

.60 A recent survey of the annual reports of 600 industrial and commercial corporations contained the following summary of adjustments to the opening balances of retained earnings during the four fiscal years of those enterprises ended not later than February 2, 1975:[12]

Reasons for adjustment	1974	1973	1972	1971
Poolings of interests	30	56	67	69
Research and development expenditures charged to operations	23	—	—	—
Litigation or income tax settlements	12	29	26	15
Other	18	36	89	87
Total adjustments	83	121	182	171

Investigation revealed that the "other" category consisted principally of accounting changes (adopting tax allocation, adopting recommendations of AICPA Industry Audit Guides that required retroactive application, etc.) and changes in the reporting entity. The items categorized as "litigation or income tax settlements" were prior period adjustments made pursuant to the criteria of paragraph 23 of *APB Opinion No. 9*. Since the adjustments represented by this caption were few in number, the broader study described in the following paragraphs was undertaken. The adjustments in the above table that were determined to have been made pursuant to paragraph 23 of *APB Opinion No. 9* were used as a control to ensure that the selection procedures were adequate to locate substantially all of such adjustments made by enterprises included in the study.

[12] American Institute of Certified Public Accountants, *Accounting Trends & Techniques — 1975*, 29th ed. (New York: AICPA, 1975), p. 363.

Methodology

.61 The research by the FASB staff utilized the National Automated Accounting Research System (NAARS).[13] NAARS includes a file of annual reports of publicly held enterprises. Enterprises reporting or referring to prior period adjustments in either the footnotes or the retained earnings statement were identified. The control group referred to in paragraph .60 was used to provide assurance that no substantial number of items was omitted. Complete reliability of the results of such a search could not be assured because of the variety of ways that enterprises disclose such adjustments. Adjustments were located in approximately 1,200 reports and those adjustments were reviewed in detail, and the adjustments made pursuant to paragraph 23 of *APB Opinion No. 9* were identified. If it was unclear whether the adjustment belonged in this category, it was included, except that in a few instances where there was virtually no disclosure of the nature or circumstances of the adjustment, the adjustment was excluded from the study because no meaningful conclusions could be derived. Subsidiary companies that reported the same prior period adjustment reported in consolidated statements were excluded to avoid duplication. At the time the research was conducted, the NAARS system included:

Year*	Total reports including subsidiaries	Approximate total enterprises
1973	3,617	3,350
1974	3,150	2,800
1975	650	600
Total	7,417	6,750

*The NAARS system classifies fiscal year-ends from July through June as a "year" (e.g., 1974 includes fiscal years ended July 1974 through June 1975).

The detail summaries following are limited to 1974 and 1973; 1975 was reviewed to determine whether significant trends were apparent (none were noted) but the file was considered not sufficiently complete to justify any further conclusions. In addition, later 1975 results, if available, would probably have reflected the effect of the recent SEC staff interpretations.

Overall Results

.62 The following table compares 1974 and 1973 identified prior period adjustments:

[13] NAARS is a computer-assisted accounting retrieval system developed by the American Institute of Certified Public Accountants in conjunction with Mead Data Central, Inc.

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Category	1974 Number of enterprises reporting adjustments	1974 Percentage of enterprises	1973 Number of enterprises reporting adjustments	1973 Percentage of enterprises
Income taxes	30	1.1%	53	1.6%
Litigation and similar claims	37	1.3%	37	1.1%
Utility rate and similar matters	13	0.5%	13	0.4%
Renegotiation	—	0.0%	6	0.2%
Economic Stabilization	1	0.0%	2	0.1%
Other	—	0.0%	5	0.1%
Total*	81		116	
Total enterprises*	79	2.8%	112	3.3%

*Individual categories add to more than the total enterprises shown because some enterprises reported prior period adjustments in more than one category.

.63 The following table compares the relative size of the identified adjustments reported for 1974 and 1973:

Range of prior period adjustment as a percentage of net income or loss in the year reported		Number of enterprises reporting adjustments in the range			
Over	But not over	Income taxes	Litigation and similar claims	Utility rate and similar matters	All other
0%	5%	13	18	7	4
5%	10%	29	7	6	3
10%	20%	17	17	6	3
20%	50%	16	19	4	1
50%	100%	5	8	—	—
100%		2	5	2	3
Not determinable		1	—	1	—
Total		83	74	26	14

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.64 Investigation of the adjustments relating to income taxes and litigation disclosed the following circumstances:

Apparent circumstances of the adjustment, based on financial statement disclosures	Adjustments relating to	
	Income taxes	Litigation and similar claims
Negotiated settlements	56	45*
Adjudicated settlements	5	14
Combination of negotiated and adjudicated settlements	—	5
Not settled at the date the financial statements were issued	8	7
Negotiated by outside parties without participation by the enterprise	—	1
Change in estimate, with no other party involved	5	—
Not determinable	9	2
Total	83	74

*17 required court approval.

Other Findings

.65 Paragraphs .66-.70 describe other findings of the survey.

Changes in accounting estimates

.66 *APB Opinion No. 20* [section 1051] prohibits restatement of amounts reported in prior periods as a result of changes in accounting estimates except for adjustments that meet all of the criteria of paragraph 23 of *APB Opinion No. 9* (see paragraph .35). Twenty of the 197 identified 1974 and 1973 prior period adjustments were changes in previously recorded accounting estimates. These consisted of seven reversals of income tax accruals, six adjustments of prior year provisions for loss on disposal of discontinued operations, and seven adjustments of prior year provisions for other litigation and similar claims.

Frequency of occurrence

.67 Paragraph 23 of *APB Opinion No. 9* stated that prior period adjustments would be "nonrecurring." Paragraph 24 of Opinion No. 9 stated that "treatment as prior period adjustments should not be applied to the normal, recurring corrections. . . ." The term "nonrecurring" is discussed in paragraph .36 above. Many of the identified prior period adjustments appeared to be of a nature that would be reasonably expected to recur in the foreseeable future in the enterprise's operating environment. Nine enterprises reported similar or related prior period adjustments in both 1974 and 1973.

Application of criterion (a)

.68 Criterion (a) of paragraph 23 of *APB Opinion No. 9* requires that an item "can be specifically identified with and directly related to the business activities of particular prior periods." Most of the identified prior period adjustments for settlements of litigation were charged to the period in which the underlying event that gave rise to the litigation occurred. Some, however, were charged or credited to a prior period subsequent to the underlying event, including (a) the period the litigation was initiated, (b) the period of a prior criminal conviction for the alleged acts, or (c) the period that an amount was accrued in excess of the eventual cost of the settlement.

Utility rate and similar matters

.69 Utility rate making processes sometimes allow rates to customers to be increased on a provisional basis prior to the regulatory commission's final action on a requested rate increase. If a portion of the requested increase is subsequently disallowed, the utility is required to refund the disallowed portion. Of the 26 identified adjustments relating to utility rate and similar matters, 14 relate to this process.

Income taxes

.70 Identified adjustments for income tax matters included 12 settlements for which the underlying basis of the settlement was recorded (e.g., retroactive adjustment of depreciation to reflect longer useful lives). These may have been corrections of errors. As explained in paragraph .61, these adjustments were included because it was unclear whether the adjustments were made pursuant to paragraph 23 of *APB Opinion No. 9*.

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Appendix C

EXCERPTS FROM SEC STAFF ACCOUNTING BULLETIN NO. 8

.71 On June 4, 1976 the SEC published *Staff Accounting Bulletin No. 8*. This Bulletin included a statement of the SEC staff's interpretation and application of the criteria of *APB Opinion No. 9* [section 2010] for prior period adjustments.

.72 Staff Accounting Bulletins contain the following statement concerning their authoritative status:

> The statements in the Bulletin are not rules or interpretations of the Commission nor are they published as bearing the Commission's official approval; they represent interpretations and practices followed by the Division [of Corporation Finance] and the Chief Accountant in administering the disclosure requirements of the federal securities laws.

.73 *Staff Accounting Bulletin No. 8* included the following:

> H. Prior Period Adjustments
>
> Facts:
>
> Accounting Principles Board Opinion No. 9, paragraph 23, limits treatment as a prior period adjustment "to those material adjustments which (a) can be specifically identified with and directly related to the business activities of particular prior periods, and (b) are not attributable to economic events occurring subsequent to the date of the financial statements for the prior period, and (c) depend primarily on determinations by persons other than management and (d) were not susceptible of reasonable estimation prior to such determination."
>
> It is not uncommon for parties to litigation to reach settlement of the matter at issue in an out-of-court settlement.
>
> Question:
>
> Do out-of-court settlements meet the criteria for prior period adjustments?
>
> Interpretive Response:
>
> The staff has been extremely reluctant to permit registrants to charge items to retained earnings as prior period adjustments in the light of the clear intent expressed in APB 9 to limit such charges severely. That opinion effectively adopted an all-inclusive approach to the measurement of periodic

income. While such an approach may not result in the best matching of costs and revenues, it does provide assurance that all items will at some time be accounted for as elements of income and it prevents the abuses which were noted prior to the adoption of APB 9 whereby adverse circumstances could be at least partially obscured through the vehicle of a direct charge to retained earnings. If unusual items and items related to matters arising in prior years are properly isolated and described in the income statement, we believe that investors will be able to interpret results in an intelligent fashion. Were the Financial Accounting Standards Board to revise the basic accounting philosophy of the all-inclusive income statement, the staff would, of course, review its position in the light of that revision.

In the meantime, however, the staff intends to continue to apply the four restrictive tests set forth in paragraph 23 of Accounting Principles Board Opinion No. 9 strictly. In this connection, the issue which has arisen most frequently is the treatment of litigation settlements. It is the staff's view that when litigation is settled, the management must make a number of significant judgments and, hence, the test that the amounts must "depend primarily on determinations by persons other than management" (criterion (c) above) has not been met. In addition, in a business world increasingly characterized by litigation to an extent far in excess of that when Accounting Principles Board Opinion No. 9 was adopted (1966), it seems that litigation is inevitably an "economic event" and that settlements would constitute "economic events" of the period in which they occur. Accordingly, it would seem that charges or credits relating to settlements would also not meet the second test (criterion (b) above) set forth in paragraph 23 of Opinion 9 that they not be "attributable to economic events occurring subsequent to the date of the financial statements for the prior period."

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AC Section 2021

Reporting Changes in Financial Position

[Source: APB Opinion No. 19, as amended.]

Effective for fiscal periods ending after September 30, 1971 unless otherwise indicated

In view of the broadened concept of the Funds Statement adopted in this section, the Board has recommended that the title of the statement be changed to "Statement of Changes in Financial Position."

INTRODUCTION

.01 In 1963 the Accounting Principles Board issued Opinion No. 3, *The Statement of Source and Application of Funds.* Support of that Opinion by the principal stock exchanges and its acceptance by the business community have resulted in a significant increase in the number of companies that present a statement of sources and uses of funds (funds statement) in annual financial reports to shareholders. Several regulatory agencies have acted recently to require funds statements in certain reports filed with them.

.02 APB Opinion No. 3 encouraged but did not require presentation of a funds statement. In view of the present widespread recognition of the usefulness of information on sources and uses of funds, the Board has considered whether presentation of such a statement should be required to complement the income statement and the balance sheet. APB Opinion No. 3 also offered considerable latitude as to form and content of funds statements, and practice has varied widely. The Board has therefore also considered establishing guides for presenting such statements.

.03 This section sets forth the Board's conclusions.

DISCUSSION

.04 The objectives of a funds statement are (1) to summarize the financing and investing activities of the entity, including the extent to which the enterprise has generated funds from operations during the period, and (2)

to complete the disclosure of changes in financial position during the period. The information shown in a funds statement is useful to a variety of users of financial statements in making economic decisions regarding the enterprise.

.05 The funds statement is related to both the income statement and the balance sheet and provides information that can be obtained only partially, or at most in piecemeal form, by interpreting them. An income statement together with a statement of retained earnings reports results of operations but does not show other changes in financial position. Comparative balance sheets can significantly augment that information, but the objectives of the funds statement require that all such information be selected, classified, and summarized in meaningful form. The funds statement cannot supplant either the income statement or the balance sheet but is intended to provide information that the other statements either do not provide or provide only indirectly about the flow of funds and changes in financial position during the period.

.06 The concept of *funds* in funds statements has varied somewhat in practice, with resulting variations in the nature of the statements. For example, *funds* is sometimes interpreted to mean *cash* or its equivalent, and the resulting funds statement is a summary of cash provided and used. Another interpretation of *funds* is that of *working capital,* i. e., current assets less current liabilities, and the resulting funds statement is a summary of working capital provided and used.[1] However, a funds statement based on either the cash or the working capital concept of funds sometimes excludes certain financing and investing activities because they do not directly affect cash or working capital during the period. For example, issuing equity securities to acquire a building is both a financing and investing transaction but does not affect either cash or working capital. To meet all of its objectives, a funds statement should disclose separately the financing and investing aspects of all significant transactions that affect financial

[1] Examples of different uses of the term *funds* are found in *"Cash Flow" Analysis and the Funds Statement,* by Perry Mason, Accounting Research Study No. 2, published by the American Institute of Certified Public Accountants in November 1961, pp. 51-56. This study contains numerous examples of other aspects of these statements. (Accounting research studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting issues.)

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position during a period. These transactions include acquisition or disposal of property in exchange for debt or equity securities and conversion of long-term debt or preferred stock to common stock.

OPINION

Applicability

.07 The Board concludes that information concerning the financing and investing activities of a business enterprise and the changes in its financial position for a period is essential for financial statement users, particularly owners and creditors, in making economic decisions. When financial statements purporting to present both financial position (balance sheet) and results of operations (statement of income and retained earnings) are issued, a statement summarizing changes in financial position should also be presented as a basic financial statement for each period for which an income statement is presented.[2] These conclusions apply to all profit-oriented business entities, whether or not the reporting entity normally classifies its assets and liabilities as current and noncurrent.

Concept

.08 The Board also concludes that the statement summarizing changes in financial position should be based on a broad concept embracing all changes in financial position and that the title of the statement should reflect this broad concept. The Board therefore recommends that the title be Statement of Changes in Financial Position (referred to below as "the Statement"). The Statement of each reporting entity should disclose all important aspects of its financing and investing activities regardless of whether cash or other elements of working capital are directly affected. For example, acquisitions of property by issuance of securities or in exchange for other property, and conversions of long-term debt or preferred stock to common stock, should be appropriately reflected in the Statement.

Format

.09 The Board recognizes the need for flexibility in form, content, and terminology of the Statement to meet

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[2] The Board recognizes that a statement of changes in financial position will be omitted in some circumstances; for example, from financial statements restricted for internal use only (see AU section 516.05-.06) and financial statements prepared for special purposes (see AU section 621, volume 1, AICPA PROFESSIONAL STANDARDS).

its objectives in differing circumstances. For example, a working capital format is not relevant to an entity that does not distinguish between current and noncurrent assets and liabilities. Each entity should adopt the presentation that is most informative in its circumstances. The Board believes, however, that the guides set forth in the paragraphs that follow should be applied in preparing and presenting the Statement.

.10 The ability of an enterprise to provide working capital or cash from operations is an important factor in considering its financing and investing activities. Accordingly, the Statement should prominently disclose working capital or cash provided from or used in operations for the period, and the Board believes that the disclosure is most informative if the effects of extraordinary items (see section 2012, *Reporting the Results of Operations*) are reported separately from the effects of normal items. The Statement for the period should begin with income or loss before extraordinary items, if any, and add back (or deduct) items recognized in determining that income or loss which did not use (or provide) working capital or cash during the period. Items added and deducted in accordance with this procedure are not sources or uses of working capital or cash, and the related captions should make this clear, e. g., "Add —Expenses not requiring outlay of working capital in the current period." An acceptable alternative procedure, which gives the same result, is to begin with total revenue that provided working capital or cash during the period and deduct operating costs and expenses that required the outlay of working capital or cash during the period. In either case the resulting amount of working capital or cash should be appropriately described, e. g., "Working capital provided from [used in] operations for the period, exclusive of extraordinary items." This total should be immediately followed by working capital or cash provided or used by income or loss from extraordinary items, if any; extraordinary income or loss should be similarly adjusted for items recognized that did not provide or use working capital or cash during the period. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

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.11 Provided that these guides are met, the Statement may take whatever form gives the most useful portrayal of the financing and investing activities and the changes in financial position of the reporting entity. The Statement may be in balanced form or in a form expressing the changes in financial position in terms of cash, of cash and temporary investments combined, of all quick assets, or of working capital. The Statement should disclose all important changes in financial position for the period covered; accordingly, types of transactions reported may vary substantially in relative importance from one period to another.[3]

Content

.12 Whether or not working capital flow is presented in the Statement, net changes in each element of working capital (as customarily defined) should be appropriately disclosed for at least the current period, either in the Statement or in a related tabulation.

a. If the format shows the flow of cash, changes in other elements of working capital (e. g., in receivables, inventories, and payables) constitute sources and uses of cash and should accordingly be disclosed in appropriate detail in the body of the Statement.

b. If the format shows the flow of working capital and two-year comparative balance sheets are presented, the changes in each element of working capital for the current period (but not for earlier periods) can be computed by the user of the statements. Nevertheless, the Board believes that the objectives of the Statement usually require that the net change in working capital be analyzed in appropriate detail in a tabulation accompanying the Statement, and accordingly this detail should be furnished.

.13 The effects of other financing and investing activities should be individually disclosed. For example, both outlays for acquisitions and proceeds from retirements of property should be reported;[4] both long-term borrowings

[3] As stated in section 2051.23, *Consolidated Financial Statements,* in some cases parent-company financial statements (including, in conformity with this section, a statement of changes in financial position) may be needed in addition to consolidated financial statements for adequate disclosure.

[4] However, normal trade-ins to replace equipment should ordinarily be reported on a net basis.

and repayments of long-term debt should be reported; and outlays for purchases[5] of consolidated subsidiaries should be summarized in the consolidated Statement by major categories of assets obtained and obligations assumed. Related items should be shown in proximity when the result contributes to the clarity of the Statement. Individual immaterial items may be combined.

.14 In addition to working capital or cash provided from operations (see paragraph .10) and changes in elements of working capital (see paragraph .12), the Statement should clearly disclose:

a. Outlays for purchase of long-term assets (identifying separately such items as investments, property, and intangibles).

b. Proceeds from sale (or working capital or cash provided by sale) of long-term assets (identifying separately such items as investments, property, and intangibles) not in the normal course of business, less related expenses involving the current use of working capital or cash.

c. Conversion of long-term debt or preferred stock to common stock.

d. Issuance, assumption, redemption, and repayment of long-term debt.

e. Issuance, redemption, or purchase of capital stock for cash or for assets other than cash.

f. Dividends in cash or in kind or other distributions to shareholders (except stock dividends and stock split-ups as defined in section 5561—*Stock Dividends and Stock Split-Ups*).

Terminology

.15 The amount of working capital or cash provided from operations is not a substitute for or an improvement upon properly determined net income as a measure of results of operations and the consequent effect on financial position. Terms referring to "cash" should not be used

[5] When a business combination is accounted for as a pooling of interests, financial statements (including, in conformity with this section, statements of changes in financial position) of the separate companies should be restated on a combined basis for all periods presented. See section 1091.57, *Business Combinations*.

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to describe amounts provided from operations unless all non-cash items have been appropriately adjusted. The adjusted amount should be described accurately, in conformity with the nature of the adjustments, e. g., "Cash provided from operations for the period" or "Working capital provided from operations for the period" as appropriate. The Board strongly recommends that isolated statistics of working capital or cash provided from operations, especially per-share amounts, not be presented in annual reports to shareholders. If any per-share data relating to flow of working capital or cash are presented, they should as a minimum include amounts for inflow from operations, inflow from other sources, and total outflow, and each per-share amount should be clearly identified with the corresponding total amount shown in the Statement.

EFFECTIVE DATE

.16 This section shall be effective for fiscal periods ending after September 30, 1971. However, the Board encourages earlier application of the provisions of this section.

The next page is 8071.

AC Section 2031

Current Assets and Current Liabilities

[Source: ARB 43, Chap. 3A, as amended.]

Issue date, unless otherwise indicated: June, 1953

.01 The working capital of a borrower has always been of prime interest to grantors of credit; and bond indentures, credit agreements, and preferred stock agreements commonly contain provisions restricting corporate actions which would effect a reduction or impairment of working capital. Many such contracts forego precise or uniform definitions and merely provide that current assets and current liabilities shall be determined in accordance with generally accepted accounting principles. Considerable variation and inconsistency exist, however, with respect to their classification and display in financial statements. In this section the committee discusses the nature of current assets and current liabilities with a view toward a more useful presentation thereof in financial statements.

.02 The committee believes that, in the past, definitions of current assets have tended to be overly concerned with whether the assets may be immediately realizable. The discussion which follows takes cognizance of the tendency for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations and less upon the debtor's ability to pay in case of liquidation. It should be emphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business. Accordingly, the views expressed in this section represent a departure from any narrow definition or strict *one year* interpretation of either current assets or current liabilities; the objective is to relate the criteria developed to the operating cycle of a business.

.03 Financial position, as it is reflected by the records and accounts from which the statement is prepared is revealed in a presentation of the assets and liabilities of the enterprise. In the statements of manufacturing, trading, and service enterprises these assets and liabilities are generally classified and segregated; if they are classified logically, summations or totals of the *current* or *circulating* or *working* assets, hereinafter referred to as *current assets,* and of obligations currently payable, designated as *current liabilities,* will permit the ready determination of working capital. *Working capital,* sometimes called *net working capital,* is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business. If the conventions of accounting relative to the identification and presentation of current assets and current liabilities are made logical and consistent, the amounts, bases of valuations, and composition of such assets and liabilities and their relation to the total assets or capital employed will provide valuable data for credit and management purposes and afford a sound basis for comparisons from year to year. It is recognized that there may be exceptions, in special cases, to certain of the inclusions and exclusions as set forth in this section. When such exceptions occur they should be accorded the treatment merited in the particular circumstances under the general principles outlined herein.

.04 For accounting purposes, the term *current assets* is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as (a) cash available for current operations and items which are the equivalent of cash; (b) inventories of merchandise, raw materials, goods in process, finished goods, operating supplies, and ordinary maintenance material and parts; (c) trade accounts, notes, and acceptances receivable; (d) receivables from officers, employees, affiliates, and others, if collectible in the ordinary course of business within a year; (e) instalment or deferred accounts and notes receivable if they conform gen-

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erally to normal trade practices and terms within the business; (f) marketable securities representing the investment of cash available for current operations; and (g) prepaid expenses such as insurance, interest, rents, taxes, unused royalties, current paid advertising service not yet received, and operating supplies. Prepaid expenses are not current assets in the sense that they will be converted into cash but in the sense that, if not paid in advance, they would require the use of current assets during the operating cycle.

.05 The ordinary operations of a business involve a circulation of capital within the current asset group. Cash is expended for materials, finished parts, operating supplies, labor, and other factory services, and such expenditures are accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an *operating cycle.*

The next page is 8073-3.

A one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within a year. However, where the period of the operating cycle is more than twelve months, as in, for instance, the tobacco, distillery, and lumber businesses, the longer period should be used. Where a particular business has no clearly defined operating cycle, the one-year rule should govern.

.06 This concept of the nature of current assets contemplates the exclusion from that classification of such resources as: (a) cash and claims to cash which are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated[1] for the liquidation of long-term debts; (b) investments in securities (whether marketable or not) or advances which have been made for the purposes of control, affiliation, or other continuing business advantage; (c) receivables arising from unusual transactions (such as the sale of capital assets, or loans or advances to affiliates, officers, or employees) which are not expected to be collected within twelve months; (d) cash surrender value of life insurance policies; (e) land and other natural resources; (f) depreciable assets; and (g) long-term prepayments which are fairly chargeable to the operations of several years, or deferred charges such as unamortized debt issue costs, bonus payments under a long-term lease, and costs of rearrangement of factory layout or removal to a new location. [As amended, effective October 1, 1971, by APB Opinion No. 21 (See section 4111.); as modified, effective for fiscal years beginning on or after January 1, 1975, pursuant to FASB Statement No. 2. (See section 4211.)]

.07 The term *current liabilities* is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. As a balance-sheet category, the classification is intended to include obligations for items which

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

have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services;[2] and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually twelve months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, amounts required to be expended within one year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons.[3]

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[2] Examples of such current liabilities are obligations resulting from advance collections on ticket sales, which will normally be liquidated in the ordinary course of business by the delivery of services. On the contrary, obligations representing long-term deferments of the delivery of goods or services would not be shown as current liabilities. Examples of the latter are the issuance of a long-term warranty or the advance receipt by a lessor of rental for the final period of a ten-year lease as a condition to execution of the lease agreement.

[3] Loans accompanied by pledge of life insurance policies would be classified as current liabilities when, by their terms or by intent, they are to be repaid within twelve months. The pledging of life insurance policies does not affect the classification of the asset any more than does the pledging of receivables, inventories, real estate, or other assets as collateral for a short-term loan. However, when a loan on a life insurance policy is

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.08 This concept of current liabilities would include estimated or accrued amounts which are expected to be required to cover expenditures within the year for known obligations (a) the amount of which can be determined only approximately (as in the case of provisions for accruing bonus payments) or (b) where the specific person or persons to whom payment will be made cannot as yet be designated (as in the case of estimated costs to be incurred in connection with guaranteed servicing or repair of products already sold). The current liability classification, however, is not intended to include debts to be liquidated by funds which have been accumulated in accounts of a type not properly classified as current assets, or long-term obligations incurred to provide increased amounts of working capital for long periods. When the amounts of the periodic payments of an obligation are, by contract, measured by current transactions, as for example by rents or revenues received in the case of equipment trust certificates or by the depletion of natural resources in the case of property obligations, the portion of the total obligation to be included as a current liability should be that representing the amount accrued at the balance-sheet date. [As amended, effective December 31, 1975, by FASB Statement No. 6.] (See section 2033.)

.09 The amounts at which various current assets are carried do not always represent their present realizable cash values. Accounts receivable net of allowances for uncollectible accounts, and for unearned discounts where unearned discounts are considered, are effectively stated at the amount of cash estimated as realizable. However, practice varies with respect to the carrying basis for current assets such as marketable securities and inventories. In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value.* The basis for carrying inventories is stated in section 5121.15. It is important that the amounts at which current assets are stated be supplemented by information which reveals, for

obtained from the insurance company with the intent that it will not be paid but will be liquidated by deduction from the proceeds of the policy upon maturity or cancellation, the obligation should be excluded from current liabilities.

* Modified by section 5132, *Accounting for Certain Marketable Securities.*

temporary investments, their market value at the balance-sheet date, and for the various classifications of inventory items, the basis upon which their amounts are stated and, where practicable, indication of the method of determining the cost—e.g., *average cost, first-in first-out, last-in first-out,* etc.

.10 Unearned discounts (other than cash or quantity discounts and the like), finance charges and interest included in the face amount of receivables should be shown as a deduction from the related receivables. [As amended, effective for fiscal periods beginning after December 31, 1965, by APB Opinion No. 6.]

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AC Section 2032

Offsetting Securities Against Taxes Payable

[Source: APB Opinion No. 10, Par. 7.]

Effective for fiscal periods beginning after December 31, 1966

.01 It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists. Accordingly, the offset of cash or other assets against the tax liability or other amounts owing to governmental bodies is not acceptable except in the circumstances described in paragraph .03 below.

.02 Most securities now issued by governments are not by their terms designed specifically for the payment of taxes and, accordingly, should not be deducted from taxes payable on the balance sheet.

.03 The only exception to this general principle occurs when it is clear that a purchase of securities (acceptable for the payment of taxes) is in substance an advance payment of taxes that will be payable in the relatively near future, so that in the special circumstances the purchase is tantamount to the prepayment of taxes. This occurs at times, for example, as an accommodation to a local government and in some instances when governments issue securities that are specifically designated as being acceptable for the payment of taxes of those governments.

The next page is 8081.

AC Section 2033

Classification of Short-Term Obligations Expected to Be Refinanced

an amendment of Section 2031
[Source: FASB Statement No. 6.]

May 1975

INTRODUCTION AND BACKGROUND INFORMATION

.01 Some short-term obligations are expected to be refinanced on a long-term basis and, therefore, are not expected to require the use of enterprise working capital during the ensuing fiscal year. Examples include commercial paper, construction loans, and the currently maturing portion of long-term debt. Those obligations have been presented in balance sheets in a number of ways, including the following: (a) classification as current liabilities, (b) classification as long-term liabilities, and (c) presentation as a class of liabilities distinct from both current liabilities and long-term liabilities.

.02 For purposes of this Statement, *short-term obligations* are those that are scheduled to mature within one year after the date of an enterprise's balance sheet or, for those enterprises that use the operating cycle concept of working capital described in paragraphs 5 and 7 of Chapter 3A, "Current Assets and Current Liabilities," of *Accounting Research Bulletin (ARB) No. 43* [sections 2031.05 and 2031.07], within an enterprise's operating cycle that is longer than one year. *Long-term obligations* are those scheduled to mature beyond one year (or the operating cycle, if applicable) from the date of an enterprise's balance sheet. *Refinancing a short-term obligation on a long-term basis* means either replacing it with a long-term obligation or with equity securities or renewing, extending, or replacing it with short-term obligations for an uninterrupted period extending beyond one year (or the operating cycle, if applicable) from the date of an enterprise's balance sheet. Accordingly, despite the fact that the short-term obligation is scheduled to mature during the ensuing fiscal year (or the operating cycle, if applicable), it will not require the use of working capital during that period.

.03 Exclusion of some short-term obligations from the current liability classification has been supported by paragraph 8 of Chapter 3A of *ARB No. 43* [section 2031.08], which states that the current liability classification "is not intended to include a contractual obligation falling due at an early date which is expected to be refunded." In assessing whether a short-term obligation is "expected to be refunded," enterprise *intent* to refinance on a long-term basis and its *prior ability* to refinance its short-term obligations have sometimes been considered sufficient for exclusion of the short-term obligation from current liabilities. In other cases, *future ability* to refinance as demonstrated by the existence of an agreement for long-term financing has been viewed as necessary.

.04 SEC *Accounting Series Release (ASR) No. 148*, issued November 13, 1973, requires that commercial paper and other short-term debt be classified as a current liability unless (a) the borrower has a noncancelable binding agreement from a creditor to refinance the paper or other short-term debt and (b) the refinancing would extend the maturity date beyond one year (or operating cycle, if longer) and (c) the borrower's intention is to exercise this right.

.05 Because of the diverse practices referred to in paragraphs .01 and .03 of this Statement and questions brought to the Board's attention concerning the differences between the criteria in paragraph 8 of Chapter 3A of *ARB No. 43* [section 2031.08] and those in *ASR No. 148,* the Board concluded that it should examine the criteria for classification of short-term obligations that are expected to be refinanced on a long-term basis.

.06 The Board concluded that on the basis of existing data it could make an informed decision on the classification of short-term obligations expected to be refinanced without a public hearing. An Exposure Draft of a proposed Statement on "Classification of Short-Term Obligations Expected to Be Refinanced" was issued on November 11, 1974. Ninety-two letters were received in response to the request for comments. On January 9, 1975, the Board announced that it would not issue a final statement effective for fiscal periods ending December 31, 1974, as had been proposed in the Exposure Draft, to allow additional time for consideration of points raised in the comment letters. Appendix A describes the principal changes from the Exposure Draft and also sets

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forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others. Examples of application of this Statement are presented in Appendix B.

APPLICABILITY

.07 The balance sheets of most enterprises show separate classifications of current assets and current liabilities (commonly referred to as classified balance sheets) permitting ready determination of working capital. Enterprises in several specialized industries (including broker-dealers and finance, real estate, and stock life insurance companies) for which the current/noncurrent distinction is deemed in practice to have little or no relevance prepare unclassified balance sheets. The standards established by this Statement apply only when an enterprise is preparing a classified balance sheet for financial accounting and reporting purposes.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Classification

.08 Short-term obligations arising from transactions in the normal course of business that are due in customary terms shall be classified as current liabilities. Those obligations (as described in the second sentence of paragraph 7 of Chapter 3A of *ARB No. 43* [section 2031.07]) are "obligations for items which have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services; . . . and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes."

.09 A short-term obligation other than one classified as a current liability in accordance with paragraph .08 shall be

excluded from current liabilities only if the conditions in paragraphs .10 and .11 are met.[1]

Intent to Refinance

.10 The enterprise intends to *refinance the obligation on a long-term basis* (see paragraph .02).

Ability to Consummate the Refinancing

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

a) *Post-balance-sheet-date issuance of a long-term obligation or equity securities.* After the date of an enterprise's balance sheet but before that balance sheet is issued, a long-term obligation or equity securities[2] have been issued for the purpose of refinancing the short-term obligation on a long-term basis; or

b) *Financing agreement.* Before the balance sheet is issued, the enterprise has entered into a financing agreement that clearly permits the enterprise to refinance the short-term obligation on a long-term basis on terms that are readily determinable, and all of the following conditions are met:

 (i) The agreement does not expire within one year (or operating cycle—see paragraph .02) from the date of the enterprise's balance sheet and during that period the agreement is not cancelable by the lender or the prospective lender or investor (and

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[1] Paragraph 8 of Chapter 3A, *ARB No. 43* [section 2031.08], describes a circumstance, unaffected by this Statement, in which obligations maturing within one year would be excluded from current liabilities as follows: "The current liability classification, however, is not intended to include . . . debts to be liquidated by funds which have been accumulated in accounts of a type not properly classified as current assets. . . ." Footnote 1 to paragraph 6(a) of Chapter 3A, *ARB No. 43* [section 2031.06 (a)], describes another circumstance, also unaffected by this Statement. Under that paragraph, "funds that are clearly to be used in the near future for liquidation of long-term debts, payments to sinking funds, or for similar purposes should . . . be excluded from current assets. However, where such funds are considered to offset maturing debt which has properly been set up as a current liability, they may be included within the current asset classification." Accordingly, funds obtained on a long-term basis prior to the balance sheet date would be excluded from current assets if the obligation to be liquidated is excluded from current liabilities.

[2] If equity securities have been issued, the short-term obligation, although excluded from current liabilities, shall not be included in owners' equity.

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obligations incurred under the agreement are not callable during that period) except for violation of a provision[3] with which compliance is objectively determinable or measurable.[4]

(ii) No violation of any provision in the financing agreement exists at the balance-sheet date and no available information indicates that a violation has occurred thereafter but prior to the issuance of the balance sheet, or, if one exists at the balance-sheet date or has occurred thereafter, a waiver has been obtained.

(iii) The lender or the prospective lender or investor with which the enterprise has entered into the financing agreement is expected to be financially capable of honoring the agreement.

.12 If an enterprise's ability to consummate an intended refinancing of a short-term obligation on a long-term basis is demonstrated by post-balance-sheet-date issuance of a long-term obligation or equity securities (paragraph .11(a)), the amount of the short-term obligation to be excluded from current liabilities shall not exceed the proceeds of the new long-term obligation or the equity securities issued. If ability to refinance is demonstrated by the existence of a financing agreement (paragraph .11(b)), the amount of the short-term obligation to be excluded from current liabilities shall be reduced to the amount available for refinancing under the agreement when the amount available is less than the amount of the short-term obligation. The amount to be excluded shall be reduced further if information (such as restrictions in other agreements or restrictions as to transferability of funds) indicates that funds obtainable under the agreement will not be available to liquidate the short-term obligation. Further, if amounts that could be obtained under the financing agreement fluctuate (for example, in relation to the enterprise's needs, in proportion to the value of collateral, or in accordance with other terms of the agreement), the amount to be excluded from current liabilities shall be

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[3] For purposes of this Statement, *violation of a provision* means failure to meet a condition set forth in the agreement or breach or violation of a provision such as a restrictive covenant, representation, or warranty, whether or not a grace period is allowed or the lender is required to give notice.

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

limited to a reasonable estimate of the minimum amount expected to be available at any date from the scheduled maturity of the short-term obligation to the end of the fiscal year (or operating cycle—see paragraph .02). If no reasonable estimate can be made, the entire outstanding short-term obligation shall be included in current liabilities.

.13 The enterprise may intend to seek an alternative source of financing rather than to exercise its rights under the existing agreement when the short-term obligation becomes due. The enterprise must intend to exercise its rights under the existing agreement, however, if that other source does not become available.[5]

.14 Replacement of a short-term obligation with another short-term obligation after the date of the balance sheet but before the balance sheet is issued is not, by itself, sufficient to demonstrate an enterprise's ability to refinance the short-term obligation on a long-term basis. If, for example, the replacement is made under the terms of a revolving credit agreement that provides for renewal or extension of the short-term obligation for an uninterrupted period extending beyond one year (or operating cycle—see paragraph .02) from the date of the balance sheet, the revolving credit agreement must meet the conditions in paragraph .11(b) to justify excluding the short-term obligation from current liabilities. Similarly, if the replacement is a roll-over of commercial paper accompanied by a "stand-by" credit agreement, the stand-by agreement must meet the conditions in paragraph .11(b) to justify excluding the short-term obligation from current liabilities.

Disclosure

.15 A total of current liabilities shall be presented in classified balance sheets. If a short-term obligation is excluded from current liabilities pursuant to the provisions of this Statement, the notes to the financial statements shall include a general description of the financing agreement and the terms of any new obligation incurred or expected to be incurred or equity securities issued or expected to be issued as a result of a refinancing.

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

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Amendments to Existing Pronouncement

.16 The Board's conclusions require deletion of the following words from the second sentence of paragraph 8 of Chapter 3A, *ARB No. 43* [section 2031.08] : *a contractual obligation falling due at an early date which is expected to be refunded, or.* Footnote 4 and the reference to it in paragraph 8 of Chapter 3A [section 2031.08] are also deleted.

Effective Date and Transition

.17 The provisions of this Statement shall be effective December 31, 1975 and shall apply to balance sheets dated on or after that date and to related statements of changes in financial position. Reclassification in financial statements for periods ending prior to December 31, 1975 is permitted but not required.

The provisions of this Statement need not be applied to immaterial items.

Appendix A

BASIS FOR CONCLUSIONS

.18 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement. Individual Board members gave greater weight to some factors than to others. The Appendix also sets forth suggestions made by those responding to the Exposure Draft and reasons for accepting some and rejecting others.

SCOPE OF THIS STATEMENT

.19 Some respondents indicated that the Exposure Draft appeared to require all enterprises to prepare a classified balance sheet regardless of normal industry practice or other justification for adopting a balance sheet format that does not identify current assets and current liabilities. The question of whether it is appropriate for an enterprise to present an unclassified balance sheet is beyond the scope of this Statement. Accordingly, paragraph .07 indicates that the standards established by this Statement apply only if an enterprise is preparing a classified balance sheet.

.20 The Board also concluded that it should not, as part of this project, re-examine the accounting concept of working capital described in detail in Chapter 3A of *ARB No. 43* [section 2031]. Paragraph 7 of Chapter 3A [section 2031.07] defines current liabilities as those whose liquidation "is reasonably expected to require the use of existing resources properly classified as current assets, or the creation of other current liabilities." That paragraph goes on to say that the current liabilities classification "is intended to include obligations for items which have entered into the operating cycle . . . and debts which arise from operations directly related to the operating cycle. . . ." Accordingly, paragraph .08 of this Statement requires that short-term obligations arising from transactions in the normal course of business that are to be paid in customary terms shall be included in current liabilities. On the other hand, short-term obligations arising from the acquisition or construction of noncurrent assets would be excluded from current liabilities if the conditions in paragraphs .10 and .11 are met. Similarly, short-term obligations not directly related to the operating cycle — for example, a note given to a supplier to replace an account payable that originally arose in the normal course of

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business and had been due in customary terms — would be excluded if the conditions in paragraphs .10 and .11 are met. This Statement does not specify disclosures relating to short-term obligations that are *included* in current liabilities, although the Statement does make explicit that a total of current liabilities shall be presented in classified balance sheets (see paragraph .15).

BALANCE SHEET CLASSIFICATION

.21 The alternative solutions considered by the Board with regard to the question of how to classify a short-term obligation that is expected to be refinanced on a long-term basis (see paragraph .02) ranged between:

a) A *strict maturity-date* approach under which all obligations scheduled to mature within one year (or, in certain cases, within an enterprise's operating cycle) would be classified as current liabilities regardless of any intention to refinance on a long-term basis.

b) An approach based *solely* on management's intention to seek refinancing on a long-term basis without requiring evidence of the enterprise's ability to do so.

.22 The Board also considered alternatives within that range. Those alternatives all require that the *intent* of the enterprise to refinance a short-term obligation on a long-term basis be demonstrated by an *ability* to consummate the refinancing, but they differ in terms of the conditions required to demonstrate that ability.

.23 The Board rejected a strict maturity-date approach because the scheduled maturity date of an obligation is not necessarily indicative of the point in time at which that obligation will require the use of the enterprise's funds. Inclusion of all short-term obligations within the current liability classification ignores the fact that enterprises, for sound economic reasons, often use commercial paper and other short-term debt instruments as means of long-term financing or that they often replace the currently maturing portion of long-term debt with other long-term debt. Borrowings under long-term revolving credit agreements and borrowings backed by long-term stand-by credit agreements are commonplace. A strict maturity-date approach would

deny that these borrowings are sometimes, in substance, long-term financing. That approach would also result in a major change in the concept of current liabilities described in paragraph 7 of Chapter 3A of *ARB No. 43* [section 2031.07] as "obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities."

.24 The Board also rejected classification based solely on an enterprise's intention to seek refinancing on a long-term basis. The Board concluded that intent, while essential, is insufficient to justify excluding a short-term obligation from current liabilities. The intent of an enterprise is an essential condition because without intent to refinance there is a presumption that liquidation of the short-term obligation would require the use of current assets or the creation of other current liabilities. The existence of a financing agreement, even one that requires that funds obtained thereunder be used to liquidate the short-term obligation, is irrelevant if the enterprise does not intend to refinance on a long-term basis. In the Board's judgment, however, intent alone does not provide sufficiently objective evidence to overcome the presumption that a short-term obligation will require the use of funds at its scheduled maturity date. The intent must be supported by a demonstrated ability to carry out that intent.

.25 The two conditions set forth in this Statement for exclusion of a short-term obligation from current liabilities — intent and ability — are essentially the same as the requirements proposed in the Exposure Draft. That draft had proposed that a short-term obligation be classified as a current liability unless all of the following conditions were met:

a) The borrower has a noncancelable binding agreement to refinance the obligation from a source reasonably expected to be financially capable of honoring the agreement.

b) The maturity date of the new obligation expected to be incurred by the borrower as a result of the refinancing under the agreement will be more than one year from the date of the financial statements.

c) The borrower intends to exercise its rights under the agreement.

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.26 Many respondents to the Exposure Draft indicated that the requirement of a "noncancelable binding agreement" was unrealistic because lenders generally do not make unqualified commitments. Financing agreements often include provisions that could restrict borrowing under the agreement. As indicated by the conditions in paragraphs .11(b)(i) and .11(b)(ii) of this Statement, the inclusion of a restrictive covenant, representation, warranty, or other provision in a financing agreement does not prevent a short-term obligation from being excluded from current liabilities provided that compliance with the provision can be objectively determined or measured and provided that there is no evidence of a violation for which a waiver has not been obtained. In the Board's view, inability to objectively determine or measure compliance, or the existence of a violation of a provision for which a waiver has not been obtained, raises a serious doubt about the enterprise's ability to consummate an intended refinancing to avoid the use of working capital and, consequently, requires classification of the short-term obligation as a current liability. The existence of a situation that permits the lender to cancel the agreement or otherwise to prevent the enterprise from exercising its rights thereunder after expiration of a grace period or after notice to the enterprise or both is also considered a violation of a provision that will, in the absence of a waiver, require classification of the short-term obligation as a current liability.

.27 The Board has concluded that exclusion of a short-term obligation from current liabilities should not be precluded as long as the financing agreement *clearly permits* the enterprise to replace the short-term obligation with a long-term obligation or with equity securities or to renew, extend, or replace the short-term obligation with another short-term obligation for an uninterrupted period extending beyond one year (or operating cycle). The Board considered and rejected the proposal that a short-term obligation should be excluded from current liabilities only if a financing agreement is *specifically linked* to the short-term obligation, either by specifically permitting or requiring that funds obtained thereunder be used to liquidate the short-term obligation. In the Board's judgment, that proposal places undue emphasis on the form of an agreement rather than on its substance. It is neither practicable nor realistic to trace specific funds to their ultimate use. The financial position of an enterprise that has refinanced under a linked agreement will be indistinguishable from the financial position of an enterprise that has entered into the same transactions under an

agreement that is not linked but clearly permits refinancing the short-term obligation. Moreover, whether or not a financing agreement is specifically linked to a particular short-term obligation, the enterprise is not precluded from issuing another short-term obligation at approximately the same time as the old obligation is refinanced under the agreement. The potential effect of such a transaction can be avoided only if a strict maturity-date approach is adopted, but the Board rejected that alternative for the reasons stated in paragraph .23. The Board believes that the requirement in paragraph .10 that the enterprise intend to refinance on a long-term basis and thus not to use working capital to repay the maturing short-term obligation more closely comports with the spirit of this Statement and Chapter 3A of *ARB No. 43* [section 2031] than would a requirement for specific linkage.

.28 Respondents to the Exposure Draft indicated that many enterprises enter into agreements that assure their ability to refinance short-term obligations although they might not intend to exercise their rights under the agreement if an alternative source of financing becomes available. One of the conditions in the Exposure Draft was that the enterprise intend to exercise its rights under the agreement (see paragraph .25(c)). A footnote in the Exposure Draft indicated that this condition would be met if the enterprise intended to exercise its rights under the agreement when the short-term obligations could not continue to be refinanced on a short-term basis. Respondents asked the Board to clarify the intent of the condition in the Exposure Draft and the related footnote. The Board believes that the justification for excluding a short-term obligation from current liabilities is not negated simply because an enterprise may intend to seek a more advantageous source of financing (including, perhaps, short-term financing) than that provided under the financing agreement in existence when the balance sheet is issued. However, the condition in paragraph .11(b)(i) requires that the agreement extend beyond one year (or operating cycle) from the date of the enterprise's balance sheet to demonstrate clearly the enterprise's ability to avoid using working capital to repay the short-term obligation. Moreover, paragraph .13 requires that the enterprise intend to exercise its rights under the agreement if another source of financing does not become available.

.29 A number of respondents to the Exposure Draft asked whether events occurring after the date of the balance sheet but before the balance sheet is issued should be considered in

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assessing an enterprise's ability to consummate the refinancing of a short-term obligation on a long-term basis. In particular, the two types of post-balance-sheet-date events cited were (a) actual issuance of a long-term obligation or equity securities for the purpose of refinancing the short-term obligation on a long-term basis and (b) entering into a financing agreement after the balance-sheet date but before the balance sheet is issued. In the Board's judgment, both of those types of post-balance-sheet-date events should be considered in determining liability classification and in assessing an enterprise's ability to consummate an intended refinancing, and they are explicitly provided for in paragraphs .11(a) and .11(b).

.30 Several respondents to the Exposure Draft asked whether a short-term obligation could be excluded from current liabilities if it is intended to be replaced (or, in fact, has been replaced after the balance sheet date) by issuing equity securities. A short-term obligation will not require the use of working capital regardless of whether refinancing on a long-term basis is accomplished by issuing debt securities or equity securities. Accordingly, *refinancing on a long-term basis* is defined in paragraph .02 to include issuance of equity securities, and a short-term obligation intended to be refinanced in that manner would be excluded from current liabilities if the conditions in paragraphs .10 and .11 are met. Although it is appropriate to exclude the short-term obligation from current liabilities when those conditions are met, the Board concluded that it is not appropriate to include the short-term obligation in owners' equity (see footnote 2 to paragraph .11(a)). The intent of an enterprise to refinance a short-term obligation on a long-term basis and its ability to do so relate to the question of whether the obligation is expected to require the use of working capital, not whether it is a liability. The obligation is a liability and not owners' equity at the date of the balance sheet.

EFFECTIVE DATE AND TRANSITION

.31 Many respondents opposed the proposal in the Exposure Draft that balance sheets for dates prior to the effective date of the Statement be restated to conform to the provisions of the Statement. They indicated that restatement would not achieve comparability of balance sheets for dates prior to the effective date of the Statement with balance sheets for subsequent dates because of the new conditions established

by paragraph .11. After considering all of the circumstances, the Board concluded that prospective application of this Statement is appropriate, with restatement permitted but not required, and that the effective date in paragraph .17 is advisable.

Appendix B

EXAMPLES OF APPLICATION OF THIS STATEMENT

.32 The following examples provide guidance for applying this Statement. It should be recognized that these examples do not comprehend all possible circumstances and do not include all the disclosures that would typically be made regarding long-term debt or current liabilities.

GENERAL ASSUMPTIONS

.33 The assumptions on which the examples are based are:

a) ABC Company's fiscal year end is December 31, 19x5.

b) The date of issuance of the December 31, 19x5 financial statements is March 31, 19x6; the Company's practice is to issue a classified balance sheet.

c) At December 31, 19x5, short-term obligations include $5,000,000 representing the portion of 6% long-term debt maturing in February 19x6 and $3,000,000 of 9% notes payable issued in November 19x5 and maturing in July 19x6.

d) The Company intends to refinance on a long-term basis both the current maturity of long-term debt and the 9% notes payable.

e) Accounts other than the long-term debt maturing in February 19x6 and the notes payable maturing in July 19x6 are:

Current assets	$30,000,000
Other assets	$50,000,000
Accounts payable and accruals	$10,000,000
Other long-term debt	$25,000,000
Shareholders' equity	$37,000,000

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f) Unless otherwise indicated, the examples also assume that the lender or prospective lender is expected to be capable of honoring the agreement, that there is no evidence of a violation of any provision, and that the terms of borrowings available under the agreement are readily determinable.

EXAMPLE 1

.34 The Company negotiates a financing agreement with a commercial bank in December 19x5 for a maximum borrowing of $8,000,000 at any time through 19x7 with the following terms:

a) Borrowings are available at ABC Company's request for such purposes as it deems appropriate and will mature three years from the date of borrowing.

b) Amounts borrowed will bear interest at the bank's prime rate.

c) An annual commitment fee of ½ of 1% is payable on the difference between the amount borrowed and $8,000,000.

d) The agreement is cancelable by the lender only if:

(i) The Company's working capital, excluding borrowings under the agreement, falls below $10,000,000.

(ii) The Company becomes obligated under lease agreements to pay an annual rental in excess of $1,000,000.

(iii) Treasury stock is acquired without the prior approval of the prospective lender.

(iv) The Company guarantees indebtedness of unaffiliated persons in excess of $500,000.

.35 The enterprise's intention to refinance meets the condition specified by paragraph .10. Compliance with the provisions listed in paragraph .34(d) is objectively determinable or measurable; therefore, the condition specified by paragraph .11(b)(i) is met. The proceeds of borrowings under the agreement are clearly available for the liquidation of the 9% notes payable and the long-term debt maturing

in February 19x6. Both obligations, therefore, would be classified as other than current liabilities.

.36 Following are the liability section of ABC Company's balance sheet at December 31, 19x5 and the related footnote disclosures required by this Statement, based on the information in paragraphs .33 and .34. Because the balance sheet is issued subsequent to the February 19x6 maturity of the long-term debt, the footnote describes the refinancing of that obligation.

	December 31, 19x5
Current Liabilities:	
Accounts payable and accruals	$10,000,000
Total Current Liabilities	10,000,000
Long-Term Debt:	
9% notes payable (Note A)	3,000,000*
6% debt due February 19x6 (Note A)	5,000,000*
Other long-term debt	25,000,000
Total Long-Term Debt	33,000,000
Total Liabilities	$43,000,000

*These obligations may also be shown in captions distinct from both current liabilities and long-term debt, such as "Interim Debt," "Short-Term Debt Expected to Be Refinanced," and "Intermediate Debt."

Note A

The Company has entered into a financing agreement with a commercial bank that permits the Company to borrow at any time through 19x7 up to $8,000,000 at the bank's prime rate of interest. The Company must pay an annual commitment fee of ½ of 1% of the unused portion of the commitment. Borrowings under the financing agreement mature three years after the date of the loan. Among other things, the agreement prohibits the acquisition of treasury stock without prior approval by the bank, requires maintenance of working capital of $10,000,000 exclusive of borrowings under the agreement, and limits the annual rental under lease agreements to $1,000,000. In February 19x6, the Company borrowed $5,000,000 at 8% and liquidated the 6% long-term debt, and it intends to borrow additional funds available under the agreement to refinance the 9% notes payable maturing in July 19x6.

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EXAMPLE 2

.37 A foreign subsidiary of the enterprise negotiates a financing agreement with its local bank in December 19x5. Funds are available to the subsidiary for its unrestricted use, including loans to affiliated companies; other terms are identical to those cited in paragraph .34. Local laws prohibit the transfer of funds outside the country.

.38 The requirement of paragraph .11(b)(i) is met because compliance with the provisions of the agreement is objectively determinable or measurable. Because of the laws prohibiting the transfer of funds, however, the proceeds from borrowings under the agreement are not available for liquidation of the debt maturing in February and July 19x6. Accordingly, both the 6% debt maturing in February 19x6 and the 9% notes payable maturing in July 19x6 would be classified as current liabilities.

EXAMPLE 3

.39 Assume that instead of utilizing the agreement cited in paragraph .34, the Company issues $8,000,000 of ten-year debentures to the public in January 19x6. The Company intends to use the proceeds to liquidate the $5,000,000 debt maturing February 19x6 and the $3,000,000 of 9% notes payable maturing July 19x6. In addition, assume the debt maturing February 19x6 is paid prior to the issuance of the balance sheet, and the remaining proceeds from the sale of debentures are invested in a U.S. Treasury note maturing the same day as the 9% notes payable.

.40 Since the Company refinanced the long-term debt maturing in February 19x6 in a manner that meets the conditions set forth in paragraph .11 of this Statement, that obligation would be excluded from current liabilities. In addition, the 9% notes payable maturing in July 19x6 would also be excluded because the Company has obtained funds expressly intended to be used to liquidate those notes and not intended to be used in current operations. In balance sheets after the date of sale of the debentures and before the maturity date of the notes payable, the Company would exclude the notes payable from current liabilities if the U.S. Treasury note is excluded from current assets (see paragraph 6 of Chapter 3A of *ARB No. 43* [section 2031.06], which is not altered by this Statement)

.41 If the debentures had been sold prior to January 1, 19x6, the $8,000,000 of obligations to be paid would be excluded from current liabilities in the balance sheet at that date if the $8,000,000 in funds were excluded from current assets.

.42 If, instead of issuing the ten-year debentures, the Company had issued $8,000,000 of equity securities and all other facts in this example remained unchanged, both the 6% debt due February 19x6 and the 9% notes payable due July 19x6 would be classified as liabilities other than current liabilities, such as "Indebtedness Due in 19x6 Refinanced in January 19x6."

EXAMPLE 4

.43 In December 19x5 the Company negotiates a revolving credit agreement providing for unrestricted borrowings up to $10,000,000. Borrowings will bear interest at 1% over the prevailing prime rate of the bank with which the agreement is arranged but in any event not less than 8%, will have stated maturities of ninety days, and will be continuously renewable for ninety-day periods at the Company's option for three years provided there is compliance with the terms of the agreement. Provisions of the agreement are similar to those cited in paragraph .34(d). Further, the enterprise intends to renew obligations incurred under the agreement for a period extending beyond one year from the balance-sheet date. There are no outstanding borrowings under the agreement at December 31, 19x5.

.44 In this instance, the long-term debt maturing in February 19x6 and the 9% notes payable maturing in July 19x6 would be excluded from current liabilities because the Company consummated a financing agreement meeting the conditions set forth in paragraph .11(b) prior to the issuance of the balance sheet.

EXAMPLE 5

.45 Assume that the agreement cited in Example 4 included an additional provision limiting the amount to be borrowed by the Company to the amount of its inventory, which is pledged as collateral and is expected to range between a high

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of $8,000,000 during the second quarter of 19x6 and a low of $4,000,000 during the fourth quarter of 19x6.

.46 The terms of the agreement comply with the conditions required by this Statement; however, because the minimum amount expected to be available from February to December 19x6 is $4,000,000, only that amount of short-term obligations can be excluded from current liabilities (see paragraph .12). Whether the obligation to be excluded is a portion of the currently maturing long-term debt or some portions of both it and the 9% notes payable depends on the intended timing of the borrowing.

.47 If the Company intended to refinance only the 9% notes payable due July 19x6 and the amount of its inventory is expected to reach a low of approximately $2,000,000 during the second quarter of 19x6 but be at least $3,000,000 in July 19x6 and thereafter during 19x6, the $3,000,000 9% notes payable would be excluded from current liabilities at December 31, 19x5 (see paragraph .12).

EXAMPLE 6

.48 In lieu of the facts given in paragraphs .33(c) and .33(d), assume that during 19x5 the Company entered into a contract to have a warehouse built. The warehouse is expected to be financed by issuance of the Company's commercial paper. In addition, the Company negotiated a stand-by agreement with a commercial bank that provides for maximum borrowings equal to the expected cost of the warehouse, which will be pledged as collateral. The agreement also requires that the proceeds from the sale of commercial paper be used to pay construction costs. Borrowings may be made under the agreement only if the Company is unable to issue new commercial paper. The proceeds of borrowings must be used to retire outstanding commercial paper and to liquidate additional liabilities incurred in the construction of the warehouse. At December 31, 19x5 the Company has $7,000,000 of commercial paper outstanding and $1,000,000 of unpaid construction costs resulting from a progress billing through December 31.

.49 Because the commercial paper will be refinanced on a long-term basis, either by uninterrupted renewal or, failing that, by a borrowing under the agreement, the commercial paper would be excluded from current liabilities. The $1,000,000 liability for the unpaid progress billing results

from the construction of a noncurrent asset and will be refinanced on the same basis as the commercial paper and, therefore, it would also be excluded from current liabilities (see paragraphs .08 and .20).

EXAMPLE 7

.50 Following are two methods of presenting liabilities in ABC Company's balance sheet at December 31, 19x5 assuming the Company intends to refinance the 6% debt maturing in February 19x6 and the 9% notes payable maturing in July 19x6 but has not met the conditions required by this Statement to exclude those obligations from current liabilities.

Alternative 1

	December 31, 19x5
Current Liabilities:	
Accounts payable and accruals	$10,000,000
Notes payable, due July 19x6	3,000,000
6% debt due February 19x6	5,000,000
Total Current Liabilities	18,000,000
Long-Term Debt	25,000,000
Total Liabilities	$43,000,000

Alternative 2

		December 31, 19x5
Current Liabilities:		
Accounts payable and accruals		$10,000,000
Short-term debt expected to be refinanced:		
Notes payable, due July 19x6	$3,000,000	
6% debt due February 19x6	5,000,000	8,000,000
Total Current Liabilities		18,000,000
Long-Term Debt		25,000,000
Total Liabilities		$43,000,000

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AC Section 2033-1

Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security: An Interpretation of Section 2033

[Source: FASB Interpretation No. 8.]

January 1976

INTRODUCTION

.01 *FASB Statement No. 6* [section 2033], "Classification of Short-Term Obligations Expected to Be Refinanced," specifies that a short-term obligation shall be excluded from current liabilities only if the enterprise intends to refinance the obligation on a long-term basis and before the balance sheet is issued has either (a) completed the refinancing by issuing a long-term obligation or by issuing equity securities or (b) has entered into a financing agreement that permits refinancing on a long-term basis. (See paragraphs 9—11 of the Statement [section 2033.09—.11].)

.02 The FASB has been asked to clarify whether a short-term obligation should be included in or excluded from current liabilities if it is repaid after the balance sheet date and subsequently replaced by long-term debt before the balance sheet is issued. For example, assume that an enterprise has issued $3,000,000 of short-term commercial paper during the year to finance construction of a plant. At June 30, 1976, the enterprise's fiscal year end, the enterprise intends to refinance the commercial paper by issuing long-term debt. However, because the enterprise temporarily has excess cash, in July 1976 it liquidates $1,000,000 of the commercial paper as the paper matures. In August 1976, the enterprise completes a $6,000,000 long-term debt offering. Later during the month of August, it issues its June 30, 1976 financial statements. The proceeds of the long-term debt offering are to be used to replenish $1,000,000 in working capital, to pay $2,000,000 of commercial paper as it matures in September 1976, and to pay $3,000,000 of construction costs expected to be incurred later that year to complete the plant.

INTERPRETATION

.03 The concept that a short-term obligation will not require the use of current assets during the ensuing fiscal year if it is to be excluded from current liabilities underlies *FASB Statement*

No. 6 [section 2033] (see paragraphs 1, 2, and 20 of the Statement [sections 2033.01, 2033.02, and 2033.20]). That concept is also fundamental to Chapter 3A, "Current Assets and Current Liabilities," of *ARB No. 43* [section 2031], which was not changed by *FASB Statement No. 6* [section 2033] (except as specified in paragraph 16 of the Statement [section 2033.16]). Repayment of a short-term obligation *before* funds are obtained through a long-term refinancing requires the use of current assets. Therefore, if a short-term obligation is repaid after the balance sheet date and subsequently a long-term obligation or equity securities are issued whose proceeds are used to replenish current assets before the balance sheet is issued, the short-term obligation shall not be excluded from current liabilities at the balance sheet date.

.04 In the example described in paragraph .02 above, the $1,000,000 of commercial paper liquidated in July would be classified as a current liability in the enterprise's balance sheet at June 30, 1976. The $2,000,000 of commercial paper liquidated in September 1976 but refinanced by the long-term debt offering in August 1976 would be excluded from current liabilities in balance sheets at the end of June 1976, July 1976, and August 1976.[1] It should be noted that the existence of a financing agreement at the date of issuance of the financial statements rather than a completed financing at that date would not change these classifications.

EFFECTIVE DATE

.05 This Interpretation shall be effective February 29, 1976 and shall apply to balance sheets dated on or after that date and to related statements of changes in financial position. Reclassification in financial statements for periods ending prior to February 29, 1976 is permitted but not required.

→ *The next page is 8111.* ←

[1] At the end of August 1976, $2,000,000 of cash would be excluded from current assets or if included in current assets, a like amount of debt would be classified as a current liability. (See footnote 1 and paragraph 40 of *FASB Statement No. 6* [section 2033.40].)

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AC Section 2041

Comparative Financial Statements

[Source: ARB 43, Chap. 2A, as amended.]

Issue date, unless otherwise indicated: June, 1953

.01 The presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise. Such presentation emphasizes the fact that statements for a series of periods are far more significant than those for a single period and that the accounts for one period are but an instalment of what is essentially a continuous history.

.02 In any one year it is ordinarily desirable that the balance sheet, the income statement, and the surplus statement be given for one or more preceding years as well as for the current year. Footnotes, explanations, and accountants' qualifications which appeared on the statements for the preceding years should be repeated, or at least referred to, in the comparative statements to the extent that they continue to be of significance. If, because of reclassifications or for other reasons, changes have occurred in the manner of or basis for presenting corresponding items for two or more periods, information should be furnished which will explain the change. This procedure is in conformity with the well recognized principle that any change in practice which affects comparability should be disclosed.

.03 It is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out. When accounting changes and corrections of errors in previously issued financial statements occur, refer to section 1051, *Accounting Changes*. [As amended, effective for fiscal periods beginning after July 31, 1971 by APB Opinion No. 20.]

.04 Circumstances vary so greatly that it is not practicable to deal here specifically with all situations. The independent accountant should, however, make very clear what statements are included within the scope of his report.

The next page is 8121.

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AC Section 2042

Capital Changes

[Source: APB Opinion No. 12, Pars. 9, 10.]

Effective for fiscal periods beginning after December 31, 1967, unless otherwise indicated

.01 Section 2010.06 states that "The statement of income and the statement of retained earnings (separately or combined) are designed to reflect, in a broad sense, the 'results of operations'." Section 2010.27 states that certain capital transactions ". . . should be excluded from the determination of net income or the results of operations under all circumstances." Companies generally have reported the current year's changes in stockholders' equity accounts other than retained earnings in separate statements or notes to the financial statements when presenting both financial position and results of operations for one or more years. A question has arisen as to whether, because of the language of section 2010, changes in stockholders' equity accounts other than retained earnings are required to be reported.

.02 When both financial position and results of operations are presented, disclosure of changes in the separate accounts comprising stockholders' equity (in addition to retained earnings) and of the changes in the number of shares of equity securities during at least the most recent annual fiscal period and any subsequent interim period presented is required to make the financial statements sufficiently informative. Disclosure of such changes may take the form of separate statements or may be made in the basic financial statements or notes thereto.

The next page is 8131.

AC Section 2043

Disclosure of Depreciable Assets and Depreciation

[Source: APB Opinion No. 12, Pars. 4, 5.]

Effective for fiscal periods beginning after December 31, 1967, unless otherwise indicated

.01 Disclosure of the total amount of depreciation expense entering into the determination of results of operations has become a general practice. The balances of major classes of depreciable assets are also generally disclosed. Practice varies, however, with respect to disclosure of the depreciation method or methods used.

.02 Because of the significant effects on financial position and results of operations of the depreciation method or methods used, the following disclosures should be made in the financial statements or in notes thereto:

a. Depreciation expense for the period,

b. Balances of major classes of depreciable assets, by nature or function, at the balance-sheet date,

c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance-sheet date, and

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

The next page is 8141.

AC Section 2044

Classification and Disclosure of Allowances

[Source: APB Opinion No. 12, Pars. 2, 3.]

Effective for fiscal periods beginning after December 31, 1967, unless otherwise indicated

.01 Although it is generally accepted that accumulated allowances for depreciation and depletion and asset valuation allowances for losses such as those on receivables and investments should be deducted from the assets to which they relate, there are instances in which these allowances are shown among liabilities or elsewhere on the credit side of the balance sheet.

.02 It is the Board's opinion that such allowances should be deducted from the assets or groups of assets to which the allowances relate, with appropriate disclosure.

The next page is 8151.

AC Section 2045

Disclosure of Accounting Policies

[Source: APB Opinion No. 22, as amended.]

Effective for fiscal years beginning after December 31, 1971, unless otherwise indicated

INTRODUCTION

.01 In recent years, a number of business enterprises have adopted the practice of including in their annual reports to shareholders a separate summary of the significant accounting policies followed in preparing the financial statements. This disclosure has been favorably received by users of financial statements and endorsed by organizations representing corporate business.

.02 Practice by those entities that present summaries of accounting policies has varied considerably. Some present the summary of accounting policies as an integral part of the financial statements; others present it as supplementary information. In addition, both the nature and the degree of disclosure vary, and related guidelines are lacking.

.03 Disclosure of accounting policies by those entities that do not present separate summaries has varied also. Some have included, in footnotes relating to particular items in the financial statements, descriptions of all significant accounting policies. Most entities, however, have disclosed no information as to certain significant accounting policies.

.04 In view of the increasing recognition of the usefulness of disclosure of accounting policies, the Accounting Principles Board has considered whether this disclosure should be required in financial statements and whether guides should be established for the form and scope of disclosure. This section sets forth the Board's conclusions.

DISCUSSION

.05 Financial statements are the end product of the financial accounting process, which is governed by generally accepted accounting principles on three levels: pervasive principles, broad operating principles, and detailed princi-

ples.[1] Applying generally accepted accounting principles requires that judgment be exercised as to the relative appropriateness of acceptable alternative principles and methods of application in specific circumstances of diverse and complex economic activities. Although the combined efforts of professional accounting bodies, of business, and of the regulatory agencies have significantly reduced the number of acceptable alternatives and are expected to reduce the number further, judgment must nevertheless be exercised in applying principles at all three levels.

.06 The *accounting policies* of a reporting entity are the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, changes in financial position, and results of operations in accordance with generally accepted accounting principles and that, accordingly, have been adopted for preparing the financial statements.

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

OPINION

Applicability

.08 The Board concludes that information about the accounting policies adopted by a reporting entity is essential for financial statement users. When financial statements are issued purporting to present fairly financial position, changes in financial position, and results of operations in accordance with generally accepted accounting principles, a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements. In circumstances where it may be appropriate to issue one or more of the basic financial statements without the others, purporting to present fairly the information given in accordance with generally accepted

[1] See *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* sections 1026, 1027, and 1028.

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accounting principles, statements so presented should also include disclosure of the pertinent accounting policies.

.09 The Board also concludes that information about the accounting policies adopted and followed by not-for-profit entities should be presented as an integral part of their financial statements.

.10 The provisions of paragraphs .08 and .09 above are not intended to apply to unaudited financial statements issued as of a date between annual reporting dates (e. g., each quarter) if the reporting entity has not changed its accounting policies since the end of its preceding fiscal year.[2]

.11 This section does not supersede any prior pronouncement of the American Institute of Certified Public Accountants relating to disclosure requirements.

Content

.12 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, changes in financial position, or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives;

b. Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry;

c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

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[2] The Board recognizes also that it may be appropriate to omit disclosure of accounting policies in some other circumstances; for example, from financial statements restricted to internal use only (see AU section 516.05-.06) and from certain special reports in which incomplete or no financial presentations are made (AU section 621).

.13 Examples of disclosures by a business entity commonly required with respect to accounting policies would include, among others, those relating to basis of consolidation, depreciation methods, amortization of intangibles, inventory pricing, recognition of profit on long-term construction-type contracts, and recognition of revenue from franchising and leasing operations. This list of examples is not all-inclusive. [As amended, effective for fiscal years beginning on or after January 1, 1975, by FASB Statement No. 2.] (See section 4211.) [As amended, effective for fiscal years beginning on or after January 1, 1976, by FASB Statement No. 8.] (See section 1083.)

.14 Financial statement disclosure of accounting policies should not duplicate details (e. g., composition of inventories or of plant assets) presented elsewhere as part of the financial statements. In some cases, the disclosure of accounting policies should refer to related details presented elsewhere as part of the financial statements; for example, changes in accounting policies during the period should be described with cross-reference to the disclosure required by section 1051, *Accounting Changes,* of the current effect of the change and of the pro forma effect of retroactive application.

Format

.15 The Board recognizes the need for flexibility in matters of format (including the location) of disclosure of accounting policies provided that the reporting entity identifies and describes its significant accounting policies as an integral part of its financial statements in accordance with the foregoing guides in this section. The Board believes that the disclosure is particularly useful if given in a separate *Summary of Significant Accounting Policies* preceding the notes to financial statements or as the initial note. Accordingly, it expresses its preference for that format under the same or a similar title.

EFFECTIVE DATE

.16 This section shall be effective for fiscal years beginning after December 31, 1971. The Board, however, encourages earlier application of the provisions of this section.

The next page is 8181.

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AC Section 2051

Consolidated Financial Statements

[Source: ARB 43, Chap. 1A, Par. 3; ARB 51, as amended.]

Issue date, unless otherwise indicated: August, 1959

.01 Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.[1]

PURPOSE OF CONSOLIDATED STATEMENTS

.02 The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

CONSOLIDATION POLICY

.03 The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal

[1] The above rule was adopted by the membership of the Institute in 1934. It had been recommended in 1932 to the New York Stock Exchange by the Institute's committee on cooperation with stock exchanges.

reorganization or in bankruptcy). There may also be situations where the minority interest in the subsidiary is so large, in relation to the equity of the shareholders of the parent in the consolidated net assets, that the presentation of separate financial statements for the two companies would be more meaningful and useful. However, the fact that the subsidiary has a relatively large indebtedness to bondholders or others is not in itself a valid argument for exclusion of the subsidiary from consolidation. (Also, see section 1081 for the treatment of foreign subsidiaries.)

.04 In deciding upon consolidation policy, the aim should be to make the financial presentation which is most meaningful in the circumstances. The reader should be given information which is suitable to his needs, but he should not be burdened with unnecessary detail. Thus, even though a group of companies is heterogeneous in character, it may be better to make a full consolidation than to present a large number of separate statements. On the other hand, separate statements or combined statements would be preferable for a subsidiary or group of subsidiaries if the presentation of financial information concerning the particular activities of such subsidiaries would be more informative to shareholders and creditors of the parent company than would the inclusion of such subsidiaries in the consolidation. For example, separate statements may be required for a subsidiary which is a bank or an insurance company and may be preferable for a finance company where the parent and the other subsidiaries are engaged in manufacturing operations.

.05 A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations.

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.06 Consolidated statements should disclose the consolidation policy which is being followed. In most cases this can be made apparent by the headings or other information in the statements, but in other cases a footnote is required.

CONSOLIDATION PROCEDURE GENERALLY

.07 In the preparation of consolidated statements, intercompany balances and transactions should be eliminated. This includes intercompany open account balances, security holdings, sales and purchases, interest, dividends, etc. As consolidated statements are based on the assumption that they represent the financial position and operating results of a single business enterprise, such statements should not include gain or loss on transactions among the companies in the group. Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated; the concept usually applied for this purpose is gross profit or loss. (See also paragraph .16.) However, in a regulated industry where a parent or subsidiary manufactures or constructs facilities for other companies in the consolidated group, the foregoing is not intended to require the elimination of intercompany profit to the extent that such profit is substantially equivalent to a reasonable return on investment ordinarily capitalized in accordance with the established practice of the industry.

ELIMINATION OF INTERCOMPANY INVESTMENTS [2]

.08 The earned surplus or deficit of a purchased [3] subsidiary at the date of acquisition by the parent should not be included in consolidated earned surplus.

.09 When one company purchases two or more blocks of stock of another company at various dates and eventually obtains control of the other company, the date of acquisition (for the purpose of preparing consolidated statements) depends on the circumstances. If two or more purchases are made over a period of time, the earned surplus of the subsidiary at acquisition should generally be determined on a step-by-step basis; however, if small purchases are made

[2] As amended, effective for fiscal periods beginning after October 31, 1970, by APB Opinion No. 16.

[3] See section 1091 for the difference in treatment between a purchase and a pooling of interests.

over a period of time and then a purchase is made which results in control, the date of the latest purchase, as a matter of convenience, may be considered as the date of acquisition. Thus there would generally be included in consolidated income for the year in which control is obtained the postacquisition income for that year, and in consolidated earned surplus the postacquisition income of prior years, attributable to each block previously acquired. For example, if a 45% interest was acquired on October 1, 1957 and a further 30% interest was acquired on April 1, 1958, it would be appropriate to include in consolidated income for the year ended December 31, 1958, 45% of the earnings of the subsidiary for the three months ended March 31, and 75% of the earnings for the nine months ended December 31, and to credit consolidated earned surplus in 1958 with 45% of the undistributed earnings of the subsidiary for the three months ended December 31, 1957.

.10 When a subsidiary is purchased during the year, there are alternative ways of dealing with the results of its operations in the consolidated income statement. One method, which usually is preferable, especially where there are several dates of acquisition of blocks of shares, is to include the subsidiary in the consolidation as though it had been acquired at the beginning of the year, and to deduct at the bottom of the consolidated income statement the preacquisition earnings applicable to each block of stock. This method presents results which are more indicative of the current status of the group, and facilitates future comparison with subsequent years. Another method of prorating income is to include in the consolidated statement only the subsidiary's revenue and expenses subsequent to the date of acquisition.

.11 Where the investment in a subsidiary is disposed of during the year, it may be preferable to omit the details of operations of the subsidiary from the consolidated income statement, and to show the equity of the parent in the earnings of the subsidiary prior to disposal as a separate item in the statement.

.12 Shares of the parent held by a subsidiary should not be treated as outstanding stock in the consolidated balance sheet.

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MINORITY INTERESTS

.13 The amount of intercompany profit or loss to be eliminated in accordance with paragraph .07 is not affected by the existence of a minority interest. The complete elimination of the intercompany profit or loss is consistent with the underlying assumption that consolidated statements represent the financial position and operating results of a single business enterprise. The elimination of the intercompany profit or loss may be allocated proportionately between the majority and minority interests.

.14 In the unusual case in which losses applicable to the minority interest in a subsidiary exceed the minority interest in the equity capital of the subsidiary, such excess and any further losses applicable to the minority interest should be charged against the majority interest, as there is no obligation of the minority interest to make good such losses. However, if future earnings do materialize, the majority interest should be credited to the extent of such losses previously absorbed.

INCOME TAXES

[.15] [Superseded, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 23.] (See section 4095.)

.16 If income taxes have been paid on intercompany profits on assets remaining within the group, such taxes should be deferred. [As amended, effective for fiscal periods beginning after December 31, 1967, by APB Opinion No. 11.]

STOCK DIVIDENDS OF SUBSIDIARIES

.17 Occasionally, subsidiary companies capitalize earned surplus arising since acquisition, by means of a stock dividend or otherwise. This does not require a transfer to capital surplus on consolidation, inasmuch as the retained earnings in the consolidated financial statements should reflect the accumulated earnings of the consolidated group not distributed to the shareholders of, or capitalized by, the parent company.

UNCONSOLIDATED SUBSIDIARIES IN CONSOLIDATED STATEMENTS

.18 The equity method described in section 5131 should be used for all subsidiaries which are not consolidated unless the limitations described at 2051.03 and at 1081.08 apply. When these limitations apply, the investment in a subsidiary should be carried at cost. Under the cost method, dividends received from a subsidiary out of its net earnings accumulated subsequent to the date of investment are recognized as income and dividends in excess of earnings subsequent to the date of investment are reductions of cost of the investment. Provision should be made for any material impairment of the investment, such as through losses sustained by the subsidiaries, unless it is deemed to be temporary.* When the cost method is followed, the consolidated statements should disclose, by footnote or otherwise, the cost of the investment in the unconsolidated subsidiaries, the equity of the consolidated group of companies in their net assets, the dividends received from them in the current period, and the equity of the consolidated group in their earnings for the period; this information may be given in total or by individual subsidiaries or groups of subsidiaries. [As amended, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 18.]

.19 When the cost method of dealing with unconsolidated subsidiaries is followed, if there is a difference between the cost of the investment and the equity in net assets at the date of acquisition, appropriate recognition should be given to the possibility that, had the subsidiaries been consolidated, part of such difference would have been reflected in adjusted depreciation or amortization. Also, appropriate recognition should be given to the necessity for an adjust-

* Modified by section 5132, *Accounting for Certain Marketable Securities.*

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ment for intercompany gains or losses on transactions with unconsolidated subsidiaries. It is not necessary to eliminate the intercompany gain on sales to such subsidiaries, if the gain on the sales does not exceed the unrecorded equity in undistributed earnings of the unconsolidated subsidiaries. If such gain is material, it should be appropriately disclosed. Where the sales are made by the unconsolidated subsidiaries to companies included in the consolidated group, the intercompany gains or losses should be eliminated in arriving at the amount of the equity in the undistributed earnings of the unconsolidated subsidiaries which will be disclosed in a footnote or otherwise. (See paragraph .18.) [As amended, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 18.]

.20 Where the unconsolidated subsidiaries carried at cost are, in the aggregate, material in relation to the consolidated financial position or operating results, summarized information as to their assets, liabilities and operating results should be given in the footnotes or separate statements should be presented for such subsidiaries, either individually or in groups, as appropriate. [As amended, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 18.]

COMBINED STATEMENTS

.21 To justify the preparation of consolidated statements, the controlling financial interest should rest directly or indirectly in one of the companies included in the consolidation. There are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations. Combined statements would also be used to present the financial position and the results of operations of a group of unconsolidated subsidiaries. They might also be used to combine the financial statements of companies under common management.

.22 Where combined statements are prepared for a group of related companies, such as a group of unconsolidated subsidiaries or a group of commonly controlled companies, intercompany transactions and profits or losses should be eliminated, and if there are problems in connection with such matters as minority interests, foreign operations, different fiscal periods, or income taxes, they should be treated in the same manner as in consolidated statements.

PARENT-COMPANY STATEMENTS

.23 In some cases parent-company statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent. Consolidating statements, in which one column is used for the parent company and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information.

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AC Section 2062

Accounting and Reporting by Development Stage Enterprises

[Source: FASB Statement No. 7.]

June 1975

INTRODUCTION

.01 This Statement specifies the guidelines for identifying an enterprise in the development stage and the standards of financial accounting and reporting applicable to such an enterprise. The transition requirements of this Statement are also applicable to certain established operating enterprises.[1]

.02 Some development stage enterprises have adopted special financial accounting and reporting practices, including special forms of financial statement presentation or types of disclosure, that are different from those used by established operating enterprises. Some of the special practices have resulted from applying regulations of the Securities and Exchange Commission; other practices appear simply to have evolved. Special accounting practices have included (a) deferral of all types of costs without regard to their recoverability, (b) nonassignment of dollar amounts to shares of stock issued for consideration other than cash, and (c) offset of revenue against deferred costs. Special reporting formats have included statements of (a) assets and unrecovered preoperating costs, (b) liabilities, (c) capital shares, and (d) cash receipts and disbursements. Sometimes, a balance sheet or a statement of operations is presented in conjunction with one or more special formats. Other development stage enterprises issue financial statements like those of established operating enterprises that present financial position, changes in financial position, and results of operations in conformity with generally accepted accounting principles.

.03 No special standards of financial accounting and reporting were established for development stage enterprises by the

[1] See paragraphs .14—.16.

AICPA Accounting Principles Board or its predecessor, the Committee on Accounting Procedure. In 1973, the AICPA Committee on Companies in the Development Stage issued an exposure draft of a proposed Audit Guide recommending special financial statements and accounting methods, but no action was taken on the exposure draft and the matter was referred to the FASB. *FASB Statement No. 2* [section 4211], "Accounting for Research and Development Costs," issued in October 1974, has been interpreted by the FASB to apply to "the accounting for research and development costs of development stage enterprises whose financial statements present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles."[2] However, pending the issuance of a Statement on the subject of accounting and reporting by development stage enterprises, the FASB Interpretation stated that "a development stage enterprise that issues financial statements that do not purport to present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles need not apply *Statement No. 2* in accounting for its research and development costs."[3]

.04 The standards of financial accounting and reporting set forth in this Statement apply to any separate financial statements of a development stage subsidiary or other investee[4] of an established operating enterprise, as well as to the financial statements of a separate development stage enterprise (or of a group of companies that, as a whole, is considered to be in the development stage). Hereinafter, the term "development stage enterprise" is used to include a development stage subsidiary or other investee that is issuing separate financial statements.

.05 This Statement applies to development stage enterprises in all industries. This Statement applies to development stage enterprises in regulated industries in accordance with the provisions of the Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit.'" However, paragraphs .11—.12 of this Statement, which require disclosure

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[2] *FASB Interpretation No. 5,* "Applicability of FASB Statement No. 2 to Development Stage Enterprises," par. 6 [section 4211-2.06].

[3] *Ibid.,* par. 7 [section 4211-2.07].

[4] The terms *subsidiary* and *investee* are defined in paragraph 3 of *APB Opinion No. 18* [section 5131.03], "The Equity Method of Accounting for Investments in Common Stock."

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of additional information, apply to development stage enterprises in regulated industries in all cases.

.06 This Statement supersedes *FASB Interpretation No. 5* [section 4211-2], "Applicability of FASB Statement No. 2 to Development Stage Enterprises." It does not supersede, alter, or amend any other present requirement in an Accounting Research Bulletin (ARB), Accounting Principles Board (APB) Opinion, or FASB Statement or Interpretation. Neither does this Statement change generally accepted accounting principles that are currently applicable to established operating enterprises but that are not explicitly stated in an ARB, APB Opinion, or FASB Statement or Interpretation. For example, this Statement does not change generally accepted accounting principles applicable to (a) established operating enterprises generally in expanding their existing businesses, (b) established operating enterprises in the extractive industries in their exploration and development activities, and (c) established operating enterprises in the real estate industry in developing their properties.

.07 Standards of financial accounting and reporting for development stage enterprises are set forth in paragraphs .08—.16. Appendix B sets forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others. Appendix A provides background information.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Guidelines for Identifying a Development Stage Enterprise

.08 For purposes of this Statement, an enterprise shall be considered to be in the development stage if it is devoting substantially all of its efforts to establishing a new business and either of the following conditions exists:

a) Planned principal operations have not commenced.

b) Planned principal operations have commenced, but there has been no significant revenue therefrom.

.09 A development stage enterprise will typically be devoting most of its efforts to activities such as financial planning; raising capital; exploring for natural resources; developing

natural resources; research and development;[5] establishing sources of supply; acquiring property, plant, equipment, or other operating assets, such as mineral rights; recruiting and training personnel; developing markets; and starting up production.

Financial Accounting and Reporting

.10 Financial statements issued by a development stage enterprise shall present financial position, changes in financial position, and results of operations in conformity with the generally accepted accounting principles that apply to established operating enterprises and shall include the additional information required by paragraphs .11—.12. Special accounting practices and reporting formats, such as those described in paragraph .02 of this Statement, that are based on a distinctive accounting for development stage enterprises are no longer acceptable. Generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred. Accordingly, capitalization or deferral of costs shall be subject to the same assessment of recoverability that would be applicable in an established operating enterprise. For a development stage subsidiary or other investee, the recoverability of costs shall be assessed within the entity for which separate financial statements are being presented.

.11 In issuing the same basic financial statements as an established operating enterprise, a development stage enterprise shall disclose therein certain additional information. The basic financial statements to be presented[6] and the additional information shall include the following:

a) A balance sheet, including any cumulative net losses reported with a descriptive caption such as "deficit

[5] *Research and development* is defined in paragraph 8 of *FASB Statement No. 2* [section 4211.08], "Accounting for Research and Development Costs."

[6] Under some circumstances, an established operating enterprise may issue less than a full set of financial statements, for example, only a balance sheet. This Statement does not preclude that possibility for development stage enterprises. Also, different titles or formats used by some established operating enterprises may be used provided that the prescribed information is included.

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accumulated during the development stage" in the stockholders' equity section.

b) An income statement, showing amounts of revenue and expenses for each period covered by the income statement and, in addition, cumulative amounts from the enterprise's inception.[7]

c) A statement of changes in financial position, showing the sources and uses of financial resources for each period for which an income statement is presented[8] and, in addition, cumulative amounts from the enterprise's inception.

d) A statement of stockholders' equity, showing from the enterprise's inception:[9]

   1) For each issuance, the date and number of shares of stock, warrants, rights, or other equity securities issued for cash and for other consideration.

   2) For each issuance, the dollar amounts (per share or other equity unit and in total) assigned to the consideration received for shares of stock, warrants, rights, or other equity securities. Dollar amounts shall be assigned to any noncash consideration received.

   3) For each issuance involving noncash consideration, the nature of the noncash consideration and the basis for assigning amounts.

.12 The financial statements shall be identified as those of a development stage enterprise and shall include a description of the nature of the development stage activities in which the enterprise is engaged.

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[7] For a dormant enterprise that is reactivated to undertake development stage activities, the disclosure of cumulative amounts required by this paragraph shall be from inception of the development stage.

[8] Subject to the exceptions described in paragraphs 7 and 16 of *APB Opinion No. 19* [sections 2021.07 and 2021.16], "Reporting Changes in Financial Position."

[9] Separate issuances of equity securities within the same fiscal year for the same type of consideration and for the same amount per equity unit may be combined in the statement of stockholders' equity. Appropriate modification of the statement of stockholders' equity may be required for (a) a combined group of companies that, as a whole, is considered to be in the development stage and (b) an unincorporated development stage enterprise.

.13 The financial statements for the first fiscal year in which an enterprise is no longer considered to be in the development stage shall disclose that in prior years it had been in the development stage. If financial statements for prior years are presented for comparative purposes, the cumulative amounts and other additional disclosures required by paragraphs .11—.12 need not be shown.

Effective Date and Transition

.14 This Statement shall be effective for fiscal periods beginning on or after January 1, 1976, although earlier application is encouraged. Thereafter, when financial statements, or financial summaries or other data derived therefrom, are presented for periods prior to the effective date of this Statement, they shall be restated, where necessary, to conform to the provisions of this Statement. Accordingly, any items that would have been accounted for differently by a development stage enterprise if the provisions of paragraph .10 had then been applicable shall be accounted for by prior period adjustment (described in paragraphs 18 and 26 of *APB Opinion No. 9* [sections 2010.17 and 2010.25], "Reporting the Results of Operations").

.15 An established operating enterprise that during its development stage would have accounted for any items differently if the provisions of paragraph .10 had then been applicable shall account for those items by prior period adjustment. In some cases, those items will have been amortized or otherwise included in an income statement in periods prior to the effective date of this Statement. Financial statements, or financial summaries or other data derived therefrom, for those periods shall be restated when they are included for comparative purposes with financial data for periods after the effective date of this Statement.

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.16 The nature of any adjustment or restatement resulting from application of paragraphs .14—.15 and, where appropriate, its effect on income before extraordinary items, net income, and related per share amounts shall be disclosed in the period of change for all periods presented. Any related income tax effects shall be recognized and disclosed.

The provisions of this Statement need not be applied to immaterial items.

Appendix A

BACKGROUND INFORMATION

.17 In April 1973, the FASB placed on its technical agenda a project on "Accounting for Research and Development and Similar Costs." The scope of the project also encompassed accounting and reporting by development stage enterprises, the subject of this Statement.

.18 A task force of sixteen persons from industry, government, public accounting, the financial community, and academe was appointed in July 1973 to provide counsel to the Board in preparing a Discussion Memorandum analyzing issues related to the project.

.19 The FASB did not undertake a major research effort in connection with the project but rather relied primarily on published research studies and articles that are cited in the Discussion Memorandum. Especially important in this regard was *Accounting for Companies in the Development Stage*, an exposure draft of an Audit Guide originally issued for comment in 1973 by the Committee on Companies in the Development Stage of the American Institute of Certified Public Accountants.

.20 The Discussion Memorandum was issued by the Board on December 28, 1973, and a public hearing on the subject was held on March 15, 1974. Seventy-four position papers, letters of comment, and outlines of oral presentations were received by the Board in response to the Discussion Memorandum. Thirty-nine of those responses included recommendations about development stage enterprises. Fourteen oral presentations were made at the public hearing.

.21 In the course of its deliberations following the hearing, the Board concluded that accounting and reporting by development stage enterprises should be addressed in a separate Statement of Financial Accounting Standards. An Exposure Draft of a proposed Statement on "Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components" was issued on July 19, 1974. The Board received 138 letters of comment on the Exposure Draft. In November 1974, the Board announced that "because of questions raised in many of the comment

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letters received during exposure of the proposed Statement on development stage companies, the Standards Board is continuing its consideration of that subject and a final Statement is not expected to be issued before April or May of 1975."[10]

Appendix B

BASIS FOR CONCLUSIONS

.22 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others.

SCOPE OF THIS STATEMENT

.23 As indicated by the title, the Exposure Draft, "Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components," explicitly encompassed a development stage subsidiary, division, or other component of an established operating enterprise as well as a separate development stage enterprise. A number of respondents to the Exposure Draft interpreted the inclusion of subsidiaries, divisions, or other components of an established operating enterprise to mean that new financial accounting standards were being proposed for the costs incurred by established operating enterprises in expanding their existing businesses. Those respondents suggested that any changes called for by the proposed new standards in that regard were unclear. They further suggested that the proposed new standards for financial statement presentation and disclosure were inapplicable to components of established operating enterprises except as they might apply to separate financial statements occasionally issued by subsidiaries in the development stage.

.24 In addition to accounting for research and development costs and accounting for development stage enterprises, the Discussion Memorandum comprehended accounting for start-up costs and other costs that are similar to research and

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[10] *FASB Status Report,* No. 19, November 16, 1974.

development costs in the sense that they share certain distinguishing characteristics.[11] In issuing the Exposure Draft, however, the Board did not intend to propose new financial accounting standards for start-up costs and those other "similar costs" incurred by established operating enterprises. To eliminate that possible source of confusion and to deal more directly with the financial accounting and reporting matters affecting development stage enterprises, the scope of this Statement is restricted to the financial statements of a development stage enterprise (or of a group of companies that, as a whole, is considered to be in the development stage) and to any separate financial statements of a development stage subsidiary or other investee of an established operating enterprise (see paragraph .04).

Development Stage Enterprises in the Extractive Industries

.25 A number of respondents to the Exposure Draft questioned the application of this Statement to development stage enterprises in certain industries (see paragraph .05 of this Statement), especially to development stage enterprises in the extractive industries. The Discussion Memorandum made a distinction for the extractive industries between (1) costs that are indistinguishable in nature from those costs incurred in other industries and (2) costs that are incurred uniquely in the extractive industries. It stated that "research and development and similar costs that are indistinguishable in nature from the research and development and similar costs incurred in other industries are embraced by this project." The Discussion Memorandum also stated that costs that are incurred uniquely in the extractive industries are generally believed to warrant separate consideration and "are specifically outside the scope of this project."[12] *FASB Statement No. 2* [section 4211], "Accounting for Research and Development Costs," in paragraph .03, recognized that distinction by indicating that it "does not apply to activities that are unique to enterprises in the extractive industries."

.26 Chapter four, "Companies in the Development Stage," of the Discussion Memorandum states that "this Discussion Memorandum excludes from this project only those 'costs that are incurred uniquely in the extractive industries.' Therefore, whether extractive industry companies in the

[11] *FASB Discussion Memorandum*, "Accounting for Research and Development and Similar Costs," pp. 2-5.

[12] *Ibid.*, pp. 8-9.

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development stage have sufficiently different characteristics to warrant exclusion from or special handling in a definition of a company in the development stage requires consideration."[13]

.27 The AICPA Committee on Companies in the Development Stage indicated in its 1973 exposure draft that the proposed provisions should be applicable to any development stage enterprise in any industry. Similarly, the APB Committee on Extractive Industries states, "new companies still in the exploratory and development stage in the oil and gas industry are no different than companies in a similar stage in other industries and probably should not be afforded any special treatment."[14]

.28 The Board has concluded that consideration of the accounting for costs incurred in activities that are unique to enterprises in the extractive industries is outside the scope of this Statement. Paragraph .06 explains that this Statement does not change generally accepted accounting principles that are applicable to established operating enterprises but that are not explicitly stated in an ARB, APB Opinion, or FASB Statement or Interpretation, and cites as an example generally accepted accounting principles that are applicable to established operating enterprises in the extractive industries in their exploration and development activities. The effect of this Statement being applicable to development stage enterprises in all industries, therefore, is not to change the generally accepted accounting principles applicable to costs incurred in activities that are unique to enterprises in the extractive industries, but to require those generally accepted accounting principles applicable to established operating enterprises in the extractive industries to be applied to development stage enterprises in the extractive industries as well. This includes presentation of the same basic financial statements.

GUIDELINES FOR IDENTIFYING A DEVELOPMENT STAGE ENTERPRISE

.29 The broad guidelines set forth in paragraphs .08—.09 for identifying a development stage enterprise are designed to

[13] *Ibid.*, p. 55.

[14] American Institute of Certified Public Accountants, Accounting Principles Board Committee on Extractive Industries, *Accounting and Reporting Practices in the Oil and Gas Industry* (New York: AICPA, May 31, 1973), p. 24.

include enterprises engaged in diverse areas of economic activity. The point at which an enterprise ceases to be in the development stage, and, therefore, need not present the cumulative amounts since its inception and other additional disclosures required by paragraphs .11—.12, must be evaluated in each case.

ACCOUNTING

.30 The Board has concluded that the generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred. The primary reasons for this conclusion are:

a) The kinds of transactions engaged in by development stage enterprises are also common to established operating enterprises in expanding their existing businesses. Accounting treatment should be governed by the nature of the transaction rather than by the degree of maturity of the enterprise. Thus, the determination of whether a particular cost should be charged to expense when incurred or should be capitalized or deferred should be based on the same accounting standards regardless of whether the enterprise incurring the cost is already operating or is in the development stage.

b) Any different standards for a development stage enterprise that would result in deferral of costs that would not be deferred if the generally accepted accounting principles applicable to established operating enterprises had been applied may cause financial statement users to reach unjustified conclusions about the nature of the costs incurred by a development stage enterprise. The Board believes that adequate financial statement disclosures concerning the costs incurred by a development stage enterprise, both for the current period and cumulatively since its inception, will mitigate that possibility and provide useful financial information for decisions about that kind of enterprise.

.31 Established operating enterprises incur costs under various circumstances and with varying degrees of

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uncertainty about future benefits, especially in expanding their existing businesses. Authoritative accounting literature does not contain general criteria or guidelines for determining when costs should be charged to expense as incurred and when costs should be capitalized or deferred,[15] and this Statement does not attempt to specify such criteria or guidelines.

.32 The absence of explicit criteria or guidelines, however, does not provide a free choice to defer costs or to charge them to expense when incurred. The scope of generally accepted accounting principles is broader than the authoritative literature and encompasses practices that have evolved and gained acceptance with time and experience. Many of those practices are described in *APB Statement No. 4* [sections 1021—1029], "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises." For example, paragraph 160 of *APB Statement No. 4* [section 1026.24] describes generally accepted accounting principles as calling for immediate recognition as expense when "(1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose."[16]

.33 In concluding that the generally accepted accounting principles applicable to established operating enterprises shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred, the Board is relying primarily on the assessment of recoverability of incurred costs that those principles require. Heretofore, some have felt that generally

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[15] Guidance is provided for some specific situations. For example, *FASB Statement No. 2* [section 4211] prescribes that the research and development costs encompassed by that Statement shall be charged to expense when incurred and describes the considerations that led to that conclusion. Also, AICPA Industry Audit Guides provide guidance about accounting for costs incurred by enterprises in particular industries. Although Audit Guides do not constitute authoritative accounting literature, those issued in recent years state that members of the AICPA may be called upon to justify departures from the recommendations contained therein.

[16] *APB Statement No. 4*, in paragraph 4 [section 1021.04], describes its status as follows: "The accounting principles described are those that the [Accounting Principles] Board believes are generally accepted today. The Board has not evaluated or approved present generally accepted accounting principles except to the extent that principles have been adopted in Board Opinions. Publication of this Statement does not constitute approval by the Board of accounting principles that are not covered in its Opinions."

accepted accounting principles did not apply to the special accounting practices and special financial reporting formats that have been used by some development stage enterprises. The Board's conclusion that the generally accepted accounting principles applicable to established operating enterprises also apply to development stage enterprises, including presentation of the same basic financial statements, eliminates the special practices and formats and the question about the applicability of generally accepted accounting principles to them.

SEC Regulations and AICPA Committee Proposal

.34 Both the regulations of the Securities and Exchange Commission (SEC) and the proposed Audit Guide issued by the AICPA Committee on Companies in the Development Stage provide for the use by development stage enterprises of certain accounting practices that differ from those appropriate for established operating enterprises.

.35 Article 5A of SEC *Regulation S-X* prescribes the form and content of financial statements filed with the SEC by development stage enterprises. It provides for separate statements of (a) assets and unrecovered promotional, exploratory, and development costs; (b) liabilities; (c) capital shares; (d) other securities; and (e) cash receipts and disbursements. Among the types of costs indicated as includible in *unrecovered promotional, exploratory, and development costs* are:

> (a) development expenses, (b) plant and equipment maintenance expenses, (c) rehabilitation expenses, (d) general administrative expenses incurred in a period when there was little or no actual mining and (e) other expenses. . . . General administrative expenses incurred in connection with subcaptions (a), (b) and (c) should be included therein. Any other general administrative expenses not chargeable to those subcaptions nor written off as costs or other operating charges (including taxes, protection and conservation of property when inactive) shall be included under subcaption (d).[17]

Rule 12-06a of *Regulation S-X* allows for the offset of certain proceeds and other income against promotional, exploratory, and development costs.

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[17] U. S., Securities and Exchange Commission, *Regulation S-X,* Rule 5a-02, "Statement of Assets and Unrecovered Promotional, Exploratory, and Development Costs," item 14.

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.36 The AICPA Committee proposed the presentation of cumulative cost outlays, together with assets, liabilities, and investment by stockholders, in a special statement referred to as a "preoperating accountability statement." Cumulative cost outlays would have been deferred and amortized by charges against income when operations commenced. Incidental revenue received during the development stage would have been deducted from the cumulative cost outlays.

.37 The AICPA Committee stated the basis for its conclusion as follows:

> A company in the development stage is engaged in building an enterprise, and the expenditures it makes are in the nature of investments for the future. Costs incurred during the development stage are accumulated because they have been incurred in the expectation that they will generate future revenues or otherwise benefit periods after the company reaches the operating stage. Accumulating costs is consistent with the business fact that for many companies a development stage must precede the attainment of ordinary business operations. . . . The only outlays that should not be carried as accumulated costs during the preoperating period are those relating to known losses. . . .
>
> For a company in the development stage there is from inception a presumption that uncertainty as to cost recovery will both exist and persist. (By contrast, the presumption for an operating company is that cost recoverability can be reasonably evaluated.) It would be unrealistic and arbitrary to write off immediately the costs incurred during the development stage simply because of this predictable uncertainty.[18]

.38 Both the SEC and AICPA Committee approaches draw attention to the uncertainty about cost recovery surrounding most development stage costs by segregating them in a special category in a special financial statement (or group of statements) similar to the conventional balance sheet. Those costs are not reported as "assets," and they need not be subjected to the assessment of recoverability that is applied to costs incurred by established operating enterprises. The Board believes, however, that the distinction between costs that would be reported as "assets" and costs that would be reported as "unrecovered costs" or "cumulative cost outlays"

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[18] American Institute of Certified Public Accountants, Committee on Companies in the Development Stage, *Accounting for Companies in the Development Stage,* an exposure draft of an Audit Guide (New York: AICPA, March 1973), pp. 25-26, 28.

under the SEC and AICPA Committee approaches is one that is likely to be overlooked by many financial statement users. In addition, as indicated in paragraphs .30—.33, the Board believes that all costs of a development stage enterprise should be subjected to the same assessment of recoverability applicable to costs incurred by established operating enterprises. In the Board's view, the nature of development stage activities and their related costs can best be indicated by the additional financial statement disclosures required by paragraphs .11—.12, rather than by accumulation or deferral of costs that would be charged to expense when incurred if generally accepted accounting principles applicable to established operating enterprises were applied.

.39 Accumulation or deferral of development stage costs requires amortization after operations commence. Article 5A does not address the question of amortization, and the AICPA Committee noted that "while the current practices are anything but uniform, the most prevalent policy noted is to amortize such costs over a short period of time, usually not more than five years."[19] The Board believes that the difficulty in reasonably relating subsequent revenue to accumulated or deferred costs that would not be deferred under generally accepted accounting principles applicable to established operating enterprises limits the usefulness of the data that would result from such accumulation or deferral by a development stage enterprise. Moreover, the initial operating periods of such an enterprise would include both the amortization of those costs incurred during the development stage and the charging to expense of certain costs incurred currently.

.40 Some respondents to the Discussion Memorandum and to the Exposure Draft supported the SEC approach, the proposed approach of the AICPA Committee, or similar approaches. The reasons offered were generally similar to those stated by the AICPA Committee (see paragraph .37). A number of respondents to the Discussion Memorandum and to the Exposure Draft recommended that development stage enterprises follow the same accounting standards as established operating enterprises. The reasons given by the respondents were generally similar to those specified in paragraph .30.

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[19] *Ibid.*, p. 11.

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Relationship to "Similar Costs"

.41 The Exposure Draft stated that the Board was considering an additional pronouncement on the "similar costs" identified in the Discussion Memorandum. A number of respondents to the Exposure Draft indicated that because, in their view, many costs incurred by development stage enterprises are within a broader category of costs that include start-up costs generally, the Board should address accounting for those "similar costs" before issuing a final Statement on development stage enterprises. The Board considered those suggestions, but concluded that it could reach an informed decision on the issues covered in this Statement without first addressing the more pervasive issues associated with accounting for "similar costs." In the Board's view, this Statement will significantly improve financial accounting and reporting for development stage enterprises.

FINANCIAL STATEMENT PRESENTATION AND ADDITIONAL DISCLOSURES

.42 The Board believes that a development stage enterprise should present the same basic financial statements as any other enterprise. The conventional balance sheet, income statement, statement of changes in financial position, and statement of stockholders' equity are sufficiently adaptable to provide the distinctive information that might be considered useful for development stage enterprises. Unique financial statements for development stage enterprises might imply that the nature and results of the transactions entered into by those enterprises are unique, but many established operating enterprises have similar transactions. Further, unique financial statements would not be readily comparable with financial statements issued after an enterprise has emerged from the development stage. Also, the conclusion that the same accounting principles are appropriate for the transactions of development stage enterprises suggests that conventional basic financial statements should be presented.

.43 A development stage enterprise typically will be incurring substantial costs in connection with development stage activities and will not have significant revenue. Development stage activities are likely to extend into two or more financial reporting periods. To reflect the significance of development stage activities, the Board believes that the

basic financial statements presented by a development stage enterprise should be expanded to provide cumulative financial information since its inception, as well as current information. The Board concluded that disclosure of cumulative revenue and expenses and cumulative amounts of funds obtained from various sources to finance the development effort and initial operations will provide useful information about the activities of development stage enterprises without sacrificing the advantages of retaining the familiar format and content of the basic financial statements of established operating enterprises. Those additional disclosures are specified in paragraphs .11—.12.

.44 Some respondents to the Discussion Memorandum and Exposure Draft suggested that the differences between established operating enterprises and development stage enterprises are so fundamental as to require unique financial statements for development stage enterprises. The AICPA Committee concluded that, because of the absence of revenue, a conventional income statement would be inappropriate for a development stage enterprise; unique financial statements were deemed necessary to emphasize accountability for financial resources received and expended and to direct attention to accumulated costs rather than to measurement of performance. To accomplish those objectives, the Committee recommended the following special statements:

Preoperating accountability statement — to show the assets and cumulative cost outlays, the liabilities, and the investment by stockholders.

Statement of preoperating financial activities — to show the sources and uses of financial resources, preferably cumulative since an enterprise's inception along with data for the current period.

Statement of investment by stockholders — to show the classes and numbers of shares authorized, issued, and outstanding and the types and amounts of consideration received for the shares issued.

.45 The AICPA Committee proposed extensive disclosures emphasizing that the enterprise is in the development stage, calling attention to the uncertainties that surround the enterprise and making clear that the financial statements do

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not purport to present financial position and results of operations.

.46 Other respondents to the Discussion Memorandum and to the Exposure Draft took the position that different basic financial statements or additional disclosures are not necessary for a development stage enterprise. Still others asserted that the same basic financial statements are appropriate but should be supplemented by additional disclosures relevant to the distinctive features of a development stage enterprise.

Other Suggestions

.47 The Board considered other presentation and disclosure possibilities for a development stage enterprise (including forecasts, disclosure of liquidation priorities and values, and a description of the business environment) and concluded that they should not be required solely for development stage enterprises. The Board also considered the possibility of a statement of cash receipts and disbursements and concluded that the statement of changes in financial position including amounts on a cumulative basis required by paragraph .11(c) would fulfill that need.

POTENTIAL ECONOMIC IMPACT

.48 Some respondents to the Exposure Draft expressed concern that requiring development stage enterprises to present the same basic financial statements and to apply the same generally accepted accounting principles as established operating enterprises might make it difficult, if not impossible, for development stage enterprises to obtain capital. They suggested that those requirements would likely cause many development stage enterprises to report periodic losses in an income statement and a cumulative deficit in a balance sheet. Because those results would not be fully understood, suppliers of capital would be disinclined to invest in those enterprises.

.49 During the course of developing the Discussion Memorandum and preparing the Exposure Draft, the FASB solicited information about the potential economic impact of applying to development stage enterprises the same generally accepted accounting principles that apply to established

operating enterprises. Responses of financial statement users to the Discussion Memorandum and to the Exposure Draft provided only limited information about the potential economic impact. To obtain additional information, the FASB arranged for discussions with officers of fifteen venture capital enterprises. The consensus of those officers was that whether a development stage enterprise defers or expenses preoperating costs has little effect on (a) the amount of any venture capital to be provided to that enterprise and (b) the terms under which any venture capital is provided. According to those officers, the venture capital investor typically relies on an investigation of the technological, marketing, management, and financial aspects of an enterprise. That investigation provides a basis for estimating potential cash flows and the probabilities of achieving them. Whether a development stage enterprise defers or expenses its preoperating costs does not affect those estimates. Based on their experience, those officers also expressed the opinion that the accounting treatment of preoperating costs would have minimal impact on the availability of short-term credit from commercial banks, but might have impact on the investment and credit decisions of unsophisticated investors.

.50 In January 1975, the U.S. Department of Commerce issued a report of a study entitled "Impact of FASB's Rule Two Accounting for Research and Development Costs on Small/Developing Stage Firms." The study involved interviews with forty lenders and investors, eleven small, high-technology firms, eleven accountants, and selected government agencies. It focused primarily on the impact on investment and credit decisions concerning development stage enterprises if they were required to charge research and development costs to expense when incurred. That issue is related to the issue at hand — that is, the potential economic impact on development stage enterprises of requiring certain costs to be expensed when incurred rather than deferred. The conclusions of the Department of Commerce study were generally consistent with the FASB findings described in paragraph .49 of this Statement. Specifically, the study concluded that "FASB's Statement Two should not have a significant impact on those firms who have heretofore capitalized R&D."[20]

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[20] U. S., Department of Commerce, "Impact of FASB's Rule Two Accounting for Research and Development Costs on Small/Developing Stage Firms" (Washington, D. C.: U. S., Department of Commerce, January 20, 1975), p. 3.

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.51 In summary, the Board has concluded that the cumulative income statement information and the cumulative information about changes in financial position required in paragraph .11 of this Statement will provide the cumulative information about preoperating costs that is typically provided by development stage enterprises currently when using special reporting formats and special accounting practices, such as those cited in paragraph .02. In addition, this Statement requires such information to be presented in financial statements whose formats are familiar and, therefore, less likely to be misinterpreted. As for the concerns of some respondents, the results of FASB discussions and the Department of Commerce study suggest that this Statement will have no significant adverse effect on the ability of development stage enterprises to obtain capital.

ISSUANCE OF SHARES OF STOCK OTHER THAN FOR CASH

.52 Under the provisions of Article 5A of SEC *Regulation S-X*, dollar amounts are not assigned to shares of stock issued by a development stage enterprise for noncash consideration, or to the consideration received, unless the noncash consideration has a "fixed or objectively determinable value."

.53 The proposed AICPA Audit Guide would have required assignment of dollar amounts to shares of stock issued for noncash consideration, and to the consideration received, at the time of issuance.

.54 The Board agrees with the conclusion of the AICPA Committee, and of a number of respondents to the Discussion Memorandum and Exposure Draft who addressed this question, that those transactions should be accounted for when the shares are issued in accordance with the guidelines applicable to acquisition of assets or issuance of shares in general. The transactions are not unique to development stage enterprises and should not be accounted for differently by those enterprises, even if estimates and judgments are required to determine their values.

EFFECTIVE DATE AND TRANSITION

.55 The Board adopted the restatement provisions set forth in paragraphs .14—.16 because, in its view, this approach provides the most useful information about development stage enterprises and about those previously in the development stage in comparing financial data for periods after the effective date of this Statement with data presented for earlier periods.

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AC Section 2062-1

Applying Section 2062 in Financial Statements of Established Operating Enterprises: An Interpretation of Section 2062

[Source: FASB Interpretation No. 7.]

October 1975

INTRODUCTION

.01 The FASB has been asked to explain the applicability of *FASB Statement No. 7* [section 2062], "Accounting and Reporting by Development Stage Enterprises," to an established operating enterprise's financial statements that include the financial statements of a development stage subsidiary or other investee either by consolidation or by the equity method,[1] in terms of the following questions:

a) Must the effect of a change in accounting principle adopted in the separate financial statements of a development stage subsidiary to conform to the provisions of *Statement No. 7* [section 2062] be reflected in the consolidated financial statements of an established operating enterprise that include the financial statements of that subsidiary?

b) If it is appropriate that the established operating enterprise's consolidated financial statements reflect the effect of its development stage subsidiary's change to a new principle of accounting adopted to conform to the provisions of *Statement No. 7* [section 2062], how should the effect of the change be reported in the established operating enterprise's financial statements?

.02 Paragraph 10 of *Statement No. 7* [section 2062.10] states:

> Financial statements issued by a development stage enterprise shall present financial position, changes in financial position, and results of operations in conformity with the generally accepted accounting principles that apply to established operating enterprises. . . . Generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred. Accordingly, capitalization or deferral of costs shall be subject to the same assessment of recoverability that would be

[1] Hereinafter, in this Interpretation, the term *subsidiary* comprehends all *investees* that are accounted for by the equity method as described in *APB Opinion No. 18* [section 5131], "The Equity Method of Accounting for Investments in Common Stock." Likewise, the term *consolidated financial statements* hereinafter comprehends the *equity method of accounting*.

> applicable in an established operating enterprise. For a development stage subsidiary or other investee, the recoverability of costs shall be assessed within the entity for which separate financial statements are being presented.

.03 Paragraph 14 of *Statement No. 7* [section 2062.14] provides for initial application of the Statement as follows:

> This Statement shall be effective for fiscal periods beginning on or after January 1, 1976, although earlier application is encouraged. Thereafter, when financial statements, or financial summaries or other data derived therefrom, are presented for periods prior to the effective date of this Statement, they shall be restated, where necessary, to conform to the provisions of this Statement. Accordingly, any items that would have been accounted for differently by a development stage enterprise if the provisions of paragraph 10 had then been applicable shall be accounted for by prior period adjustment (described in paragraphs 18 and 26 of *APB Opinion No. 9* [sections 2010.17 and 2010.25], "Reporting the Results of Operations").

Further, paragraph 1 of *Statement No. 7* [section 2062.01] states, in part, that "the transition requirements of this Statement are also applicable to certain established operating enterprises" and makes specific reference to paragraphs 14—16 of *Statement No. 7* [section 2062.14—.16] by footnote.

INTERPRETATION

.04 *Statement No. 7* [section 2062] does not address and does not alter generally accepted accounting principles for the preparation of consolidated financial statements. Therefore, *Statement No. 7* [section 2062] does not address the question of whether the effect of a change in accounting principle adopted in the separate financial statements of a development stage subsidiary to conform to the provisions of that Statement must be reflected in an established operating enterprise's consolidated financial statements that include the financial statements of the subsidiary. However, paragraph 10 of the Statement [section 2062.10] specifies that "capitalization or deferral of costs shall be subject to the same assessment of recoverability that would be applicable in an established operating enterprise" and further specifies that "for a development stage subsidiary or other investee, the recoverability of costs shall be assessed within the entity for which separate financial statements are being presented." In specifying that the same assessment of recoverability be made, the Statement does not require that the results of that assessment must necessarily be the same. Further, the Statement does not affect any accepted practice in consolidation of financial statements where the results of an assessment of recoverability of a cost may be different (a) in the broader context of a consolidated enterprise and (b) in the context of a development stage subsidiary standing alone. Under

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any such accepted practice, a cost incurred by a development stage subsidiary could be assessed as recoverable within the consolidated enterprise and be capitalized or deferred in consolidated financial statements even though that cost is assessed as not being recoverable within a development stage subsidiary and, therefore, charged to expense in the separate financial statements of the development stage subsidiary.

.05 Except in the circumstances described in the preceding paragraph, the effect of a development stage subsidiary's change in accounting principle to conform its accounting to the requirements of *Statement No. 7* [section 2062] generally would be reflected in an established operating enterprise's consolidated financial statements that include that subsidiary. When a development stage subsidiary adopts a new accounting principle to conform its accounting to the requirements of *Statement No. 7* [section 2062] and the effect of that subsidiary's accounting change is also reflected in an established operating enterprise's consolidated financial statements that include that subsidiary, the provisions of paragraph 14 of *Statement No. 7* [section 2062.14] apply. In that situation, the established operating enterprise's consolidated financial statements for periods prior to the period in which the subsidiary's accounting change is made and financial summaries and other data derived therefrom shall be restated by prior period adjustment. It should be noted that *Statement No. 7* [section 2062] does not address the question of how an established operating enterprise should report accounting changes adopted with respect to the revenue and costs related to activities of the parent company or any subsidiaries that are not in the development stage; that question is covered by *APB Opinion No. 20* [section 1051], "Accounting Changes."

EFFECTIVE DATE

.06 This Interpretation shall be effective for fiscal periods beginning on or after January 1, 1976, although earlier application is encouraged, except that it shall not be applied prior to initial application of *Statement No. 7* [section 2062].

The next page is 8241.

AC Section 2071

Interim Financial Reporting

[Source: APB Opinion No. 28, as amended.]

Effective for interim financial information issued for all interim periods relating to fiscal years beginning after December 31, 1973, unless otherwise indicated

DISCUSSION

.01 The purpose of this section is to clarify the application of accounting principles and reporting practices to interim financial information, including interim financial statements and summarized interim financial data of publicly traded companies issued for external reporting purposes.

.02 Interim financial information may include current data during a fiscal year on financial position, results of operations and changes in financial position. This information may be issued on a monthly or quarterly basis or at other intervals and may take the form of either complete financial statements or summarized financial data. Interim financial information often is provided for each interim period or on a cumulative year-to-date basis, or both, and for the corresponding periods of the preceding year.

.03 APB Opinions and Accounting Research Bulletins make few specific references to the applicability of generally accepted accounting principles to financial statements for interim periods. A wide variety of practice exists in the application of accounting principles to interim financial information. This section indicates the applicability of generally accepted accounting principles to interim financial information and indicates types of disclosures necessary to report on a meaningful basis for a period of less than a full year.

.04 The determination of the results of operations on a meaningful basis for intervals of less than a full year presents inherent difficulties. The revenues of some businesses fluctuate widely among interim periods because of

seasonal factors, while in other businesses heavy fixed costs incurred in one interim period may benefit other periods. In these situations, financial information for periods of less than a full year may be of limited usefulness. In other situations costs and expenses related to a full year's activities are incurred at infrequent intervals during the year and need to be allocated to products in process or to other interim periods to avoid distortion of interim financial results. In view of the limited time available to develop complete information, many costs and expenses are estimated in interim periods. For example, it may not be practical to perform extensive reviews of individual inventory items, costs on individual long-term contracts and precise income tax calculations for each interim period. Subsequent refinement or correction of these estimates may distort the results of operations of later interim periods. Similarly, the effects of disposal of a segment of a business and extraordinary, unusual or infrequently occurring events and transactions on the results of operations in an interim period will often be more pronounced than they will be on the results for the annual period. Special attention must be given to disclosure of the impact of these items on financial information for interim periods.

.05 The variety of practice that exists in the presentation of interim financial information is partly attributable to differing views as to the principal objective of interim financial information.

a. Some view each interim period as a basic accounting period and conclude that the results of operations for each interim period should be determined in essentially the same manner as if the interim period were an annual accounting period. Under this view deferrals, accruals, and estimations at the end of each interim period are determined by following essentially the same principles and judgments that apply to annual periods.

b. Others view each interim period primarily as being an integral part of the annual period. Under this view deferrals, accruals, and estimations at the end of each interim period are affected by judgments made at the interim date as to results of operations

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for the balance of the annual period. Thus, an expense item that might be considered as falling wholly within an annual accounting period (no fiscal year-end accrual or deferral) could be allocated among interim periods based on estimated time, sales volume, productive activity, or some other basis.

.06 Despite these differing views and limitations, periodic and timely financial information during a fiscal year is useful to investors and others. The principal objectives of this section are to provide guidance on accounting and disclosure issues peculiar to interim reporting and to set forth minimum disclosure requirements for interim financial reports of publicly traded companies.[1] The section is not intended to deal with unresolved matters of accounting related to annual reporting.

OPINION

Applicability

.07 The Board has reviewed the applicability of APB Opinions and Accounting Research Bulletins in relation to the current practices followed in the preparation and reporting of interim financial information. The Board believes the accounting principles and reporting practices in the Opinions and Bulletins should apply to interim financial information in the manner set forth in this section. The guides expressed in this section are applicable whenever companies issue interim financial information.

.08 This section (a) outlines (Part I, paragraphs .09-.29) the application of generally accepted accounting principles to the determination of income when interim financial information is presented, (b) provides (paragraphs .19 and .20) for the use of estimated effective income tax rates (thus modifying section 4091.05, *Accounting for Income Taxes*), and (c) specifies (Part II, paragraphs .30-.33) certain disclosure requirements for summarized financial information issued by publicly traded companies.

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[1] A publicly traded company for purposes of this section includes any company whose securities trade in a public market on either (1) a stock exchange (domestic or foreign) or (2) in the over-the-counter market (including securities quoted only locally or regionally). When a company makes a filing with a regulatory agency in preparation for sale of its securities in a public market it is considered a publicly traded company for this purpose.

PART I

Standards for Determining Interim Financial Information

.09 Interim financial information is essential to provide investors and others with timely information as to the progress of the enterprise. The usefulness of such information rests on the relationship that it has to the annual results of operations. Accordingly, the Board has concluded that each interim period should be viewed primarily as an integral part of an annual period.

.10 In general, the results for each interim period should be based on the accounting principles and practices used by an enterprise in the preparation of its latest annual financial statements unless a change in an accounting practice or policy has been adopted in the current year (paragraphs .23-.29). However, the Board has concluded that certain accounting principles and practices followed for annual reporting purposes may require modification at interim reporting dates so that the reported results for the interim period may better relate to the results of operations for the annual period. Paragraphs .12-.20 set forth the modifications that are necessary or desirable at interim dates in accounting principles or practices followed for annual periods.

Revenue

.11 Revenue from products sold or services rendered should be recognized as earned during an interim period on the same basis as followed for the full year. For example, revenues from long-term construction-type contracts accounted for under the percentage-of-completion method should be recognized in interim periods on the same basis followed for the full year. Losses projected on such contracts should be recognized in full during the interim period in which the existence of such losses becomes evident.

Costs and Expenses

.12 Costs and expenses for interim reporting purposes may be classified as:

a. Costs associated with revenue—those costs that are associated directly with or allocated to the products sold or to the services rendered and which are charged against income in those interim periods in which the related revenue is recognized.

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b. All other costs and expenses—those costs and expenses that are not allocated to the products sold or to the services rendered and which are charged against income in interim fiscal periods as incurred, or are allocated among interim periods based on an estimate of time expired, benefit received, or other activity associated with the periods.

Costs Associated with Revenue

.13 Those costs and expenses that are associated directly with or allocated to the products sold or to the services rendered for annual reporting purposes (including, for example, material costs, wages and salaries and related fringe benefits, manufacturing overhead, and warranties) should be similarly treated for interim reporting purposes.

.14 Practices vary in determining costs of inventory. For example, cost of goods produced may be determined based on standard or actual cost, while cost of inventory may be determined on an average, FIFO, or LIFO cost basis. While companies should generally use the same inventory pricing methods and make provisions for write-downs to market at interim dates on the same basis as used at annual inventory dates, the following exceptions are appropriate at interim reporting dates:

a. Some companies use estimated gross profit rates to determine the cost of goods sold during interim periods or use other methods different from those used at annual inventory dates. These companies should disclose the method used at the interim date and any significant adjustments that result from reconciliations with the annual physical inventory.

b. Companies that use the LIFO method may encounter a liquidation of base period inventories at an interim date that is expected to be replaced by the end of the annual period. In such cases the inventory at the interim reporting date should not give effect to the LIFO liquidation, and cost of sales for the interim reporting period should include the expected cost of replacement of the liquidated LIFO base.

c. Inventory losses from market declines should not be deferred beyond the interim period in which the

decline occurs. Recoveries of such losses on the same inventory in later interim periods of the same fiscal year through market price recoveries should be recognized as gains in the later interim period. Such gains should not exceed previously recognized losses. Some market declines at interim dates, however, can reasonably be expected to be restored in the fiscal year. Such *temporary* market declines need not be recognized at the interim date since no loss is expected to be incurred in the fiscal year.

d. Companies that use standard cost accounting systems for determining inventory and product costs should generally follow the same procedures in reporting purchase price, wage rate, usage or efficiency variances from standard cost at the end of an interim period as followed at the end of a fiscal year. Purchase price variances or volume or capacity cost variances that are planned and expected to be absorbed by the end of the annual period, should ordinarily be deferred at interim reporting dates. The effect of unplanned or unanticipated purchase price or volume variances, however, should be reported at the end of an interim period following the same procedures used at the end of a fiscal year.

All Other Costs and Expenses

.15 Charges are made to income for all other costs and expenses in annual reporting periods based upon (a) direct expenditures made in the period (salaries and wages), (b) accruals for estimated expenditures to be made at a later date (vacation pay) or (c) amortization of expenditures that affect more than one annual period (insurance premiums, interest, rents). The objective in all cases is to achieve a fair measure of results of operations for the annual period and to present fairly the financial position at the end of the annual period. The Board has concluded that the following standards should apply in accounting for costs and expenses other than product costs in interim periods:

a. Costs and expenses other than product costs should be charged to income in interim periods as incurred, or be allocated among interim periods based on an estimate of time expired, benefit received or activity

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associated with the periods. Procedures adopted for assigning specific cost and expense items to an interim period should be consistent with the bases followed by the company in reporting results of operations at annual reporting dates. However, when a specific cost or expense item charged to expense for annual reporting purposes benefits more than one interim period, the cost or expense item may be allocated to those interim periods. (See paragraph .16.)

b. Some costs and expenses incurred in an interim period, however, cannot be readily identified with the activities or benefits of other interim periods and should be charged to the interim period in which incurred. Disclosure should be made as to the nature and amount of such costs unless items of a comparable nature are included in both the current interim period and in the corresponding interim period of the preceding year.

c. Arbitrary assignment of the amount of such costs to an interim period should not be made.

d. Gains and losses that arise in any interim period similar to those that would not be deferred at year end should not be deferred to later interim periods within the same fiscal year.

.16 A complete listing of examples of application of the standards set forth in paragraph .15 is not practical; however, the following examples of applications may be helpful:

a. When a cost that is expensed for annual reporting purposes clearly benefits two or more interim periods (e. g., annual major repairs), each interim period should be charged for an appropriate portion of the annual cost by the use of accruals or deferrals.

b. When quantity discounts are allowed customers based upon annual sales volume, the amount of such discounts charged to each interim period should be based on the sales to customers during the interim period in relation to estimated annual sales.

c. Property taxes (and similar costs such as interest and rent) may be accrued or deferred at annual reporting date, to achieve a full year's charge of taxes to costs and expenses. Similar procedures should be adopted at each interim reporting date to provide an appropriate cost in each period.

d. Advertising costs may be deferred within a fiscal year if the benefits of an expenditure made clearly extend beyond the interim period in which the expenditure is made. Advertising costs may be accrued and assigned to interim periods in relation to sales prior to the time the service is received if the advertising program is clearly implicit in the sales arrangement.

.17 The amounts of certain costs and expenses are frequently subjected to year-end adjustments even though they can be reasonably approximated at interim dates. To the extent possible such adjustments should be estimated and the estimated costs and expenses assigned to interim periods so that the interim periods bear a reasonable portion of the anticipated annual amount. Examples of such items include inventory shrinkage, allowance for uncollectible accounts, allowance for quantity discounts, and discretionary year-end bonuses.

Seasonal Revenue, Costs, or Expenses

.18 Revenues of certain businesses are subject to material seasonal variations. To avoid the possibility that interim results with material seasonal variations may be taken as fairly indicative of the estimated results for a full fiscal year, such businesses should disclose the seasonal nature of their activities, and consider supplementing their interim reports with information for twelve-month periods ended at the interim date for the current and preceding years.

Income Tax Provisions

.19 In reporting interim financial information, income tax provisions should be determined under the procedures set forth in sections 4091, 4095, and 4096. At the end of each interim period the company should make its best estimate of the effective tax rate expected to be applicable for

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the full fiscal year. The rate so determined should be used in providing for income taxes on a current year-to-date basis. The effective tax rate should reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this effective tax rate no effect should be included for the tax related to significant unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year.[2]

.20 The tax effects of losses that arise in the early portion of a fiscal year (in the event carryback of such losses is not possible) should be recognized only when realization is assured beyond any reasonable doubt (section 4091.44). An established seasonal pattern of loss in early interim periods offset by income in later interim periods should constitute evidence that realization is assured beyond reasonable doubt, unless other evidence indicates the established seasonal pattern will not prevail. The tax effects of losses incurred in early interim periods may be recognized in a later interim period of a fiscal year if their realization, although initially uncertain, later becomes assured beyond reasonable doubt. When the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision should be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized.[3] Changes resulting from new tax legislation should be reflected after the effective dates prescribed in the statutes.

Disposal of a Segment of a Business and Extraordinary, Unusual, Infrequently Occurring and Contingent Items

.21 Extraordinary items should be disclosed separately and included in the determination of net income for the interim period in which they occur. In determining materiality, extraordinary items should be related to the estimated income for the full fiscal year. Effects of disposals

[2] Disclosure should be made of the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business (see section 4091.62).

[3] The tax benefits of interim losses accounted for in this manner would *not* be reported as extraordinary items in the results of operations of the interim period as is provided for in annual periods in section 4091.44.

of a segment of a business and unusual and infrequently occurring transactions and events that are material with respect to the operating results of the interim period but that are not designated as extraordinary items in the interim statements should be reported separately. In addition, matters such as unusual seasonal results, business combinations treated for accounting purposes as poolings of interests and acquisition of a significant business in a purchase should be disclosed to provide information needed for a proper understanding of interim financial reports. Extraordinary items, gains or losses from disposal of a segment of a business, and unusual or infrequently occurring items should not be prorated over the balance of the fiscal year.

.22 Contingencies and other uncertainties that could be expected to affect the fairness of presentation of financial data at an interim date should be disclosed in interim reports in the same manner required for annual reports.[4] Such disclosures should be repeated in interim and annual reports until the contingencies have been removed, resolved, or have become immaterial.

Accounting Changes

.23 Each report of interim financial information should indicate any change in accounting principles or practices from those applied in (a) the comparable interim period of the prior annual period, (b) the preceding interim periods in the current annual period and (c) the prior annual report.

.24 Changes in an interim or annual accounting practice or policy made in an interim period should be reported in the period in which the change is made, in accordance with the provisions of section 1051, *Accounting Changes.*

.25 Certain changes in accounting principle, such as those described in sections 1051.04 and 1051.27, require retroactive restatement of previously issued financial statements. Section 2010.25, *Reporting the Results of Operations,* requires similar treatment for prior period adjustments. Previously issued financial statements must also be restated for a change in the reporting entity (see section

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[4] The significance of a contingency or uncertainty should be judged in relation to annual financial statements. Disclosures of such items should include, but not be limited to, those matters that form the basis of a qualification of an independent auditor's report. (See section 4311.)

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1051.34-.35) and for correction of an error (see section 1051.36-.37). Previously issued interim financial information should be similarly restated. Sections 2010 and 1051 specify the required disclosures.

.26 The effect of a change in an accounting estimate, including a change in the estimated effective annual tax rate, should be accounted for in the period in which the change in estimate is made. No restatement of previously reported interim information should be made for changes in estimates, but the effect on earnings of a change in estimate made in a current interim period should be reported in the current and subsequent interim periods, if material in relation to any period presented and should continue to be reported in the interim financial information of the subsequent year for as many periods as necessary to avoid misleading comparisons. Such disclosure should conform with section 1051.33.

.27 [Superseded for cumulative effect type accounting changes by FASB Statement No. 3, effective for interim periods ending on or after December 31, 1974.] (See section 2072.)

.28 The Board recommends that, whenever possible, companies adopt any accounting changes during the first interim period of a fiscal year. Changes in accounting principles and practices adopted after the first interim period in a fiscal year tend to obscure operating results and complicate disclosure of interim financial information.

.29 In determining materiality for the purpose of reporting the cumulative effect of an accounting change or correction of an error, amounts should be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.

PART II

Disclosure of Summarized Interim Financial Data by Publicly Traded Companies

.30 The Board recognizes that many publicly traded companies[6] report summarized financial information to

[6] See footnote 1.

their securityholders at periodic interim dates in considerably less detail than that provided in annual financial statements. While this information provides securityholders with more timely information than would result if complete financial statements were issued at the end of each interim period, the timeliness of presentation may be partially offset by a reduction in detail in the information provided. As a result, the Board recognizes that certain guides as to minimum disclosure are desirable. When publicly traded companies report summarized financial information to their securityholders at interim dates (including reports on fourth quarters), the following data should be reported, as a minimum:[7]

a. Sales or gross revenues, provision for income taxes, extraordinary items (including related income tax effects), cumulative effect of a change in accounting principles or practices, and net income.

b. Primary and fully diluted earnings per share data for each period presented, determined in accordance with the provisions of section 2011, *Earnings Per Share.*

c. Seasonal revenue, costs or expenses (paragraph .18).

d. Significant changes in estimates or provisions for income taxes (paragraph .19).

e. Disposal of a segment of a business and extraordinary, unusual or infrequently occurring items (paragraph .21).

f. Contingent items (paragraph .22).

g. Changes in accounting principles or estimates (paragraphs .23-.29).

h. Significant changes in financial position (paragraph .33).

When summarized financial data are regularly reported on a quarterly basis, the foregoing information with respect to the current quarter and the current year-to-date or the last

[7] It should be recognized that the minimum disclosures of summarized interim financial data required of publicly traded companies by Part II of this section do not constitute a fair presentation of financial position and results of operations in conformity with generally accepted accounting principles.

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twelve months to date should be furnished together with comparable data for the preceding year.

.31 When interim financial data and disclosures are not separately reported for the fourth quarter, securityholders often make inferences about that quarter by subtracting data based on the third quarter interim report from the annual results. In the absence of a separate fourth quarter report or disclosure of the results (as outlined in paragraph .30) for that quarter in the annual report, disposals of segments of a business and extraordinary, unusual, or infrequently occurring items recognized in the fourth quarter, as well as the aggregate effect of year-end adjustments which are material to the results of that quarter (see paragraphs .04 and .17), and an accounting change made in the fourth quarter (see section 2072.14) should be disclosed in the annual report in a note to the annual financial statements. [As amended, effective for interim periods ending on or after December 31, 1974 by FASB Statement No. 3.]

.32 Disclosure of the impact on the financial results for interim periods of the matters discussed in paragraphs .21-.29 is desirable for as many subsequent periods as necessary to keep the reader fully informed. The Board believes there is a presumption that users of summarized interim financial data will have read the latest published annual report, including the financial disclosures required by generally accepted accounting principles and management's commentary concerning the annual financial results, and that the summarized interim data will be viewed in that context. In this connection, the Board encourages management to provide commentary relating to the effects of significant events upon the interim financial results.

.33 The Board encourages publicly traded companies to publish balance sheet and funds flow data at interim dates since these data often assist securityholders in their understanding and interpretation of the income data reported. When condensed interim balance sheet information or funds flow data are not presented at interim reporting dates, significant changes since the last reporting period with respect to liquid assets, net working capital, long-term liabilities, or stockholders' equity should be disclosed.

EFFECTIVE DATE

.34 This section shall be effective for interim financial information issued for all interim periods relating to fiscal years beginning after December 31, 1973. However, the Board encourages earlier application of the provisions of this section.

.35 When interim financial data are presented for prior interim periods for comparative purposes, these data should be restated on a basis consistent with procedures newly adopted, or the effect on the prior interim period data had the newly adopted procedures been applicable for that period should be disclosed.

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AC Section 2071-1

Accounting for Income Taxes in Interim Periods: An Interpretation of Section 2071

[Source: FASB Interpretation No. 18.]

March 1977

INTRODUCTION AND BACKGROUND INFORMATION

.01 The FASB has been asked to clarify the application of *APB Opinion No. 28* [section 2071], "Interim Financial Reporting," with respect to accounting for income taxes in interim periods. In general, that Opinion requires that an estimated annual effective tax rate be used to determine interim period income tax provisions. Application of the general guideline to specific situations has resulted in differences in accounting for similar situations by different enterprises.

.02 This Interpretation describes (a) the general computation of interim period income taxes (paragraphs .08 and .09), (b) the application of the general computation to specific situations (paragraphs .10-.15), (c) the computation of interim period income taxes applicable to significant unusual or infrequently occurring items, discontinued operations, extraordinary items, and cumulative effects of changes in accounting principles (paragraphs .16-.21), (d) special computations applicable to operations taxable in multiple jurisdictions (paragraph .22), (e) guidelines for reflecting the effects of new tax legislation in interim period income tax provisions (paragraphs .23 and .24), and (f) disclosure requirements (paragraph .25). Appendix A, "Excerpts from APB Opinions," quotes from *APB Opinion No. 28* [section 2071] on accounting for income taxes in interim financial reports and from the paragraphs of *APB Opinion No. 11* [section 4091], "Accounting for Income Taxes," that prescribe the annual accounting for income taxes in certain situations. The computations described in paragraphs .10-.24 are illustrated in Appendix C, "Examples of Computations of Interim Period Income Taxes."

.03 An Exposure Draft of a proposed Interpretation on "Accounting for Income Taxes in Interim Periods" was issued

October 7, 1976. The Board received 99 letters of comment in response to the Exposure Draft. This Interpretation incorporates a number of changes suggested by those respondents. Appendix E, "Summary of Consideration of Comments on Exposure Draft," describes certain of the comments and the FASB's consideration of them.

.04 The Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit'," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect . . . of the rate-making process," and discusses the application of generally accepted accounting principles to regulated industries. FASB Statements and Interpretations should therefore be applied to regulated companies that are subject to the rate-making process in accordance with the provisions of the Addendum.

INTERPRETATION

Definition of Terms

.05 As a matter of convenience of expression, certain terms are defined in this Interpretation as follows:

a. *"Ordinary" income (or loss)* refers to "income (or loss) from continuing operations before income taxes (or benefits)" excluding significant "unusual or infrequently occurring items." Extraordinary items, discontinued operations, and cumulative effects of changes in accounting principles are also excluded from this term.[1] The term is *not* used in the income tax context of ordinary income v. capital gain.

b. *Tax (or benefit)* is the total income tax expense (or benefit), including the provision (or benefit) for income taxes both currently payable and deferred.

[1] The terms used in this definition are described in *APB Opinion No. 20* [section 1051], "Accounting Changes," and in *APB Opinion No. 30* [section 2012], "Reporting the Results of Operations." See paragraph 8 of *APB Opinion No. 30* [section 2012.08] for *income (or loss) from continuing operations before income taxes (or benefits)* and *discontinued operations,* paragraph 10 [section 2012.10] for *extraordinary items,* and paragraph 26 [section 2012.26] for *unusual items* and *infrequently occurring items.* See paragraph 20 of *APB Opinion No. 20* [section 1051.20] for *cumulative effects of changes in accounting principles.*

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Concept of APB Opinion No. 28 [section 2071]

.06 *APB Opinion No. 28* [section 2071] specifies that the tax (or benefit) for an interim period shall be determined under the provisions of *APB Opinion No. 11* [section 4091], *APB Opinion No. 23* [section 4095], "Accounting for Income Taxes—Special Areas," and *APB Opinion No. 24* [section 4096], "Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)."[2] The tax (or benefit) related to "ordinary" income (or loss) shall be computed at an estimated annual effective tax rate and the tax (or benefit) related to all other items shall be individually computed and recognized when the items occur. Application of this general guidance to specific situations is described in the following paragraphs and illustrated in Appendix C.

Tax (or Benefit) Applicable to "Ordinary" Income (or Loss)

.07 Paragraphs .08 and .09 describe the computation of interim period tax (or benefit) related to "ordinary" income (or loss). Paragraphs .10-.15 describe the application of paragraphs .08 and .09 to specific situations. Paragraphs .14 and .15 describe special limitations that apply to the computations in paragraphs .08 and .09 if an enterprise has a year-to-date "ordinary" loss or anticipates an "ordinary" loss for the fiscal year.

.08 *Estimated annual effective tax rate.*[3] Paragraph .19 of *APB Opinion No. 28*[4] [section 2071.19] requires that an enterprise determine an estimated annual effective tax rate.[5] That rate "should reflect anticipated investment tax credits, foreign tax

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[2] *APB Opinions No. 23 and 24* [sections 4095 and 4096] are not specifically described herein because no questions were raised regarding application of those Opinions for interim periods.

[3] See also paragraph .22 below when the enterprise has operations taxable in multiple jurisdictions.

[4] See Appendix A, paragraph .28.

[5] Enterprises in some industries report certain items of "ordinary" income net of their related tax effect. For example, the AICPA Industry Audit Guide, "Audits of Stock Life Insurance Companies," illustrates a caption "Realized investment gains and losses, net of related income taxes of $ . . ." in its suggested format of a stock life insurance company's statement of income. If an enterprise follows such an accepted industry practice, the item that will be reported net of tax and its related tax (or benefit) shall be excluded from the computation of the estimated annual effective tax rate and interim period tax (or benefit). A separate estimated annual effective tax rate shall be computed for the item, and applied to that item in accordance with paragraphs .09-.15 below.

rates, percentage depletion, capital gains rates, and other available tax planning alternatives."[6] The rate is revised, if necessary, as of the end of each successive interim period during the fiscal year to the enterprise's best *current* estimate of its annual effective tax rate. In some cases, the rate will be the statutory rate modified as may be appropriate in particular circumstances. In other cases, the rate will be the enterprise's estimate of the tax (or benefit) that will be provided for the fiscal year, stated as a percentage of its estimated "ordinary" income (or loss) for the fiscal year (see paragraphs .14 and .15 if an "ordinary" loss is anticipated for the fiscal year).[7]

.09 *Computation of interim period tax (or benefit).* The estimated annual effective tax rate, described in paragraph .08 above, shall be applied to the year-to-date "ordinary" income (or loss) at the end of each interim period to compute the year-to-date tax (or benefit) applicable to "ordinary" income (or loss).[8] The interim period tax (or benefit) related to "ordi-

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[6] Certain investment tax credits may be excluded from the estimated annual effective tax rate. If an enterprise includes allowable investment tax credits as part of its provision for income taxes over the productive life of acquired property and not entirely in the year the property is placed in service, amortization of deferred investment tax credits need not be taken into account in estimating the annual effective tax rate; however, if the investment tax credits are taken into account in the estimated annual effective tax rate, the amount taken into account shall be the amount of amortization that is anticipated to be included in income in the current year (see paragraphs 13 and 15 of *APB Opinion No. 2* [sections 4094.11 and 4094.20]). Further, paragraphs 43 and 44 of *FASB Statement No. 13* [section 4053.043-.044], "Accounting for Leases," specify that investment tax credits related to leases that are accounted for as leveraged leases shall be deferred and accounted for as return on the net investment in the leveraged leases in the years in which the net investment is positive. Footnote 25 of Statement No. 13 [section 4053.044] explains that the use of the term "years" is not intended to preclude application of the accounting described to shorter periods. If an enterprise accounts for investment tax credits related to leveraged leases in accordance with paragraphs 43 and 44 of Statement No. 13 [section 4053.043-.044] for interim periods, those investment tax credits shall not be taken into account in estimating the annual effective tax rate.

[7] Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on evaluations of possible future events and transactions and may be subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. If an enterprise is unable to estimate a part of its "ordinary" income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

[8] One result of the year-to-date computation is that, if the tax benefit of an "ordinary" loss that occurs in the early portions of the fiscal year is

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nary" income (or loss) shall be the difference between the amount so computed and the amounts reported for previous interim periods of the fiscal year.

"Ordinary" income anticipated for fiscal year

.10 *Year-to-date "ordinary" income.* If an enterprise has "ordinary" income for the year-to-date at the end of an interim period and anticipates "ordinary" income for the fiscal year, the interim period tax shall be computed as described in paragraph .09 above.

.11 *Year-to-date "ordinary" loss.* If an enterprise has an "ordinary" loss for the year-to-date at the end of an interim period and anticipates "ordinary" income for the fiscal year, the interim period tax benefit shall be computed as described in paragraph .09 above, except that the year-to-date tax benefit recognized shall be limited to the amount determined in accordance with paragraphs .14 and .15 below.

"Ordinary" loss anticipated for fiscal year

.12 *Year-to-date "ordinary" income.* If an enterprise has "ordinary" income for the year-to-date at the end of an interim period and anticipates an "ordinary" loss for the fiscal year, the interim period tax shall be computed as described in paragraph .09 above. The estimated tax benefit for the fiscal year, used to determine the estimated annual effective tax rate described in paragraph .08 above, shall not exceed the tax benefit determined in accordance with paragraphs .14 and .15 below.

.13 *Year-to-date "ordinary" loss.* If an enterprise has an "ordinary" loss for the year-to-date at the end of an interim period and anticipates an "ordinary" loss for the fiscal year, the interim period tax benefit shall be computed as described in paragraph .09 above. The estimated tax benefit for the fiscal year, used to determine the estimated annual effective tax rate described in paragraph .08 above, shall not exceed the tax benefit determined in accordance with paragraphs .14 and .15 below. In addition to that limitation in the effective rate computation, if the year-to-date "ordinary" loss exceeds the anticipated "ordi-

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not recognized because realization of the tax benefit is not assured, tax is not provided for subsequent "ordinary" income until the unrecognized tax benefit of the earlier "ordinary" loss is offset (see Appendix A, paragraph .32).

nary" loss for the fiscal year, the tax benefit recognized for the year-to-date shall not exceed the tax benefit determined, based on the year-to-date "ordinary" loss, in accordance with paragraphs .14 and .15 below.

Limitations applicable to losses

.14 *Recognition of the tax benefit of a loss.* Paragraphs 44 and 45 of *APB Opinion No. 11*[9] [section 4091.43-.44] require that the tax benefit of a loss shall not be recognized until it is realized, unless future realization is assured beyond any reasonable doubt at the time the loss occurs. Therefore, the estimated tax benefit of an "ordinary" loss for the fiscal year, used to determine the estimated annual effective tax rate described in paragraph .08 above, and the year-to-date tax benefit of a loss recognized at an interim date shall be limited to the tax benefit realized or assured of future realization beyond any reasonable doubt. Paragraph 47 of *APB Opinion No. 11*[10] [section 4091.46] describes circumstances that may assure future realization of the tax benefit of a loss for a fiscal year beyond any reasonable doubt. Assurance beyond any reasonable doubt of future realization of the tax benefit of a loss at an interim date may also result from established seasonal patterns, as described in paragraph 20 of *APB Opinion No. 28*[11] [section 2071.20]. (See also paragraph .15 below.)

.15 *Reversal of net deferred tax credits.* If an enterprise anticipates an "ordinary" loss for the fiscal year or has a year-to-date "ordinary" loss in excess of the anticipated "ordinary" loss for the fiscal year and all or a part of the tax benefit of the loss will not be realized or its realization is not assured beyond any reasonable doubt, existing deferred tax credits arising from timing differences shall be adjusted as required by paragraph 48 of *APB Opinion No. 11*[12] [section 4091.47]. The amount of the adjustment shall not exceed the lower of (a) the otherwise unrecognized tax benefit of the loss or (b) the amount of the net deferred tax credits that would otherwise be amortized during the carryforward period attributable to the loss. If the adjustment relates to an estimated "ordinary" loss for the fiscal year, the amount of the adjustment shall be considered additional current year tax benefit in the determination of the esti-

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[9] See Appendix A, paragraphs .29 and .30.
[10] See Appendix A, paragraph .31.
[11] See Appendix A, paragraph .32.
[12] See Appendix A, paragraph .33.

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mated annual effective tax rate described in paragraph .08 above.[13] If the adjustment relates to a year-to-date "ordinary" loss, the amount of the adjustment shall be considered additional tax benefit in computing the maximum tax benefit that shall be recognized for the year-to-date.[14]

Tax (or Benefit) Applicable to Significant Unusual or Infrequently Occurring Items, Discontinued Operations, or Extraordinary Items

.16 *Basis of tax provision.* Paragraph 19 of *APB Opinion No. 28*[15] [section 2071.19] excludes taxes related to "significant unusual or extraordinary items that will be separately reported or reported net of their related tax effect"[16] from the estimated annual effective tax rate calculation. Paragraph 21 of *APB Opinion No. 28*[17] [section 2071.21] requires that those items be recognized in the interim period in which they occur. Paragraph 52 of *APB Opinion No. 11*[18] [section 4091.51] describes the method of applying tax allocation within a period. Under paragraph 52 of Opinion No. 11 [section 4091.51] the difference between the tax computed on income including an item described in footnote 16 below and the tax computed on income excluding that item is the tax related to the item. This computation shall be made using the estimated fiscal year "ordinary" income and the items described in footnote 16 below for the year-to-date.

.17 *Financial statement presentation.* Extraordinary items and discontinued operations that will be presented net of related tax effects in the financial statements for the fiscal year shall be presented net of related tax effects in interim financial statements. Unusual or infrequently occurring items that will be separately disclosed in the financial statements for the fiscal year shall be separately disclosed as a component of pretax income from continuing operations, and the tax (or benefit) related to such items shall be included in the tax (or benefit)

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[13] See Appendix A, paragraph .34.

[14] Paragraph 48 of *APB Opinion No. 11* [section 4091.47] describes the reinstatement of previously eliminated deferred tax credits when the tax benefit of the loss is subsequently realized.

[15] See Appendix A, paragraph .28.

[16] In the context of paragraph 21 of *APB Opinion No. 28* [section 2071.21] (see Appendix A, paragraph .35), which is consistent with *APB Opinion No. 30* [section 2012], this description includes unusual items, infrequently occurring items, discontinued operations, and extraordinary items.

[17] See Appendix A, paragraph .35.

[18] See Appendix A, paragraph .36.

related to continuing operations. Paragraphs .18 and .19 describe the application of the above to specific situations.

.18 *Recognition of the tax benefit of a loss.* If an enterprise has a significant unusual, infrequently occurring, or extraordinary loss or a loss from discontinued operations, the tax benefit of that loss shall not be recognized until it is realized or realization is assured beyond any reasonable doubt. Realization is assured beyond any reasonable doubt (a) by offsetting year-to-date "ordinary" income, (b) by offsetting taxable income from an unusual, infrequently occurring, or extraordinary item, or from discontinued operations, or items credited directly to stockholders' equity accounts, or (c) if the loss can be carried back (after any anticipated fiscal year "ordinary" loss is carried back). Realization beyond any reasonable doubt would also appear to be assured by future taxable income that is virtually certain to occur soon enough to provide realization during the carryforward period, including anticipated "ordinary" income for the current year expected to result from an established seasonal pattern of loss in early interim periods offset by income in later interim periods.[19] If previously recorded net deferred tax credits that would be amortized during the carryforward period of the loss are present and all or a portion of the tax benefit of the loss is not realized and future realization is not assured beyond any reasonable doubt, see paragraph .15 above. If all or a part of the tax benefit is not realized and future realization is not assured beyond any reasonable doubt in the interim period of occurrence but becomes assured beyond any reasonable doubt in a subsequent interim period of the same fiscal year, the previously unrecognized tax benefit shall be reported in that subsequent interim period in the same manner that it would have been reported if realization had been assured beyond any reasonable doubt in the interim period of occurrence, i. e., as a tax benefit relating to continuing operations, discontinued operations, or an extraordinary item.

.19 *Discontinued operations.* The computations described in paragraphs .16-.18 shall be the basis for the tax (or benefit) related to both (a) the income (or loss) from operations of the discontinued segment[20] prior to the measurement date and

[19] See paragraph 47 of *APB Opinion No. 11* [section 4091.46] (see Appendix A, paragraph .31) and paragraph 20 of *APB Opinion No. 28* [section 2071.20] (see Appendix A, paragraph .32).

[20] The term "discontinued segment" refers to a discontinued segment of the business as described in paragraph 13 of *APB Opinion No. 30* [section 2012.13].

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(b) the gain (or loss) on disposal of discontinued operations (including any provision for operating loss subsequent to the measurement date). Income (or loss) from operations of the discontinued segment prior to the interim period in which the measurement date occurs will have been included in "ordinary" income (or loss) of prior periods and thus will have been included in the estimated annual effective tax rate and tax (or benefit) calculations described in paragraphs .08-.15 above. The *total* tax (or benefit) provided in the prior interim periods shall not be recomputed but shall be divided into two components, applicable to the remaining "ordinary" income (or loss) and to the income (or loss) from operations of the discontinued segment as follows. A revised estimated annual effective tax rate and resulting tax (or benefit) shall be computed, in accordance with paragraphs .08-.15 above, for the remaining "ordinary" income (or loss), based on the estimates applicable to such operations used in the original calculations for each prior interim period. The tax (or benefit) related to the operations of the discontinued segment shall be the total of (a) the difference between the tax (or benefit) originally computed for "ordinary" income (or loss) and the recomputed amount for the remaining "ordinary" income (or loss) and (b) the tax computed in accordance with paragraphs .16-.18 above for any unusual or infrequently occurring items of the discontinued segment.

Using a Prior Year Operating Loss Carryforward

.20 Paragraph 61 of *APB Opinion No. 11* [21] [section 4091.60] requires that the tax benefit of an operating loss carryforward recognized in a subsequent year be reported as an extraordinary item. Paragraph 19 of *APB Opinion No. 28* [22] [section 2071.19] excludes extraordinary items from the effective tax rate computation, and paragraph 21 of *APB Opinion No. 28* [23] [section 2071.21] specifies that extraordinary items should not be prorated over the balance of the year. Accordingly, the tax benefit of a prior year operating loss carryforward shall be recognized as an extraordinary item in each interim period to the extent that income in the period and for the year-to-date is available to offset the operating loss carryforward.

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[21] See Appendix A, paragraph .38.
[22] See Appendix A, paragraph .28.
[23] See Appendix A, paragraph .35.

Cumulative Effects of Changes in Accounting Principles

.21 *FASB Statement No. 3* [section 2072], "Reporting Accounting Changes in Interim Financial Statements," specifies that the cumulative effect of a change in accounting principle on retained earnings at the beginning of the year shall be reported in the first interim period of the fiscal year. *APB Opinion No. 20* [section 1051], "Accounting Changes," specifies that the related income tax effect of a cumulative effect type accounting change shall be computed as though the new accounting principle had been applied retroactively for all prior periods that would have been affected.

Operations Taxable in Multiple Jurisdictions

.22 If an enterprise that is subject to tax in multiple jurisdictions pays taxes based on identified income in one or more individual jurisdictions, interim period tax (or benefit) related to consolidated "ordinary" income (or loss) for the year-to-date shall be computed in accordance with paragraphs .08-.15 above using one overall estimated annual effective tax rate except that:

a. If in a separate jurisdiction an enterprise anticipates an "ordinary" loss for the fiscal year or has an "ordinary" loss for the year-to-date for which, in accordance with paragraphs .14 and .15 above, no tax benefit can be recognized, the enterprise shall exclude "ordinary" income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). A separate estimated annual effective tax rate shall be computed for that jurisdiction and applied to "ordinary" income (or loss) in that jurisdiction in accordance with paragraphs .09-.15 above.

b. If an enterprise is unable to estimate an annual effective tax rate in a foreign jurisdiction in dollars or is otherwise unable to make a reliable estimate of its "ordinary" income (or loss) or of the related tax (or benefit) for the fiscal year in a jurisdiction, the enterprise shall exclude "ordinary" income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). The tax (or benefit) related to "ordinary" income

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(or loss) in that jurisdiction[24] shall be recognized in the interim period in which the "ordinary" income (or loss) is reported.

Effect of New Tax Legislation

.23 Paragraph 20 of *APB Opinion No. 28*[25] [section 2071.20] states that changes resulting from new tax legislation shall be "reflected after the effective dates prescribed in the statutes." If new tax legislation prescribes changes that become effective during an enterprise's fiscal year, the tax effect of those changes shall be reflected in the computation of the estimated annual effective tax rate beginning with the first interim period that ends after the new legislation becomes effective. Paragraph .24 describes the determination of when new legislation becomes effective.

.24 *Effective date.* Legislation generally becomes effective on the date prescribed in the statutes. However, tax legislation may prescribe changes that become effective during an enterprise's fiscal year that are administratively implemented by applying a portion of the change to the full fiscal year. For example, if the statutory tax rate applicable to calendar-year corporations were increased from 48 percent to 52 percent, effective January 1, the increased statutory rate might be administratively applied to a corporation with a fiscal year ending at June 30 in the year of the change by applying a 50 percent rate to its taxable income for the fiscal year, rather than 48 percent for the first six months and 52 percent for the last six months. In that case the legislation becomes effective for that enterprise at the beginning of the enterprise's fiscal year.

Disclosure

.25 Application of the provisions of *APB Opinion No. 28* [section 2071] that are described in this Interpretation may result in a significant variation in the customary relationship between income tax expense and pretax accounting income. The reasons for significant variations in the customary relationship between income tax expense and pretax accounting

[24] The tax (or benefit) related to "ordinary" income (or loss) in a jurisdiction may not be limited to tax (or benefit) in that jurisdiction. It might also include tax (or benefit) in another jurisdiction that results from providing taxes on unremitted earnings, foreign tax credits, etc.
[25] See Appendix A, paragraph .39.

income shall be disclosed if they are not otherwise apparent from the financial statements or from the nature of the enterprise's business.[26]

Effective Date and Transition

.26 The provisions of this Interpretation shall be effective for financial statements issued after March 31, 1977 for interim periods in fiscal years beginning after December 15, 1976. Earlier application is encouraged for any interim financial statements that have not been previously issued. This Interpretation shall not be applied retroactively for previously issued interim financial statements.

[26] See Appendix A, paragraph .37.

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Appendix A

EXCERPTS FROM APB OPINIONS

.27 This Appendix contains relevant excerpts from APB Opinions that relate to this Interpretation. It repeats the general guidance of *APB Opinion No. 28* [section 2071] on accounting for income taxes in interim financial reports and the specific paragraphs of *APB Opinion No. 11* [section 4091] that prescribe the annual accounting for income taxes in certain situations.

General Guidelines

.28 Paragraph 19 of *APB Opinion No. 28* [section 2071.19] contains the following general guidelines for the computation of income tax provisions for interim periods:

> In reporting interim financial information, income tax provisions should be determined under the procedures set forth in APB Opinion Nos. 11, 23, and 24. At the end of each interim period the company should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. The rate so determined should be used in providing for income taxes on a current year-to-date basis. The effective tax rate should reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives.

The paragraph continues with the following regarding the tax effects of unusual or extraordinary items:

> However, in arriving at this effective tax rate no effect should be included for the tax related to significant unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year. . . .

Recognition of the Tax Benefit of a Loss

.29 Paragraph 44 of *APB Opinion No. 11* [4091.43] states the following with respect to tax benefits of loss carrybacks:

> The tax effects of any realizable loss carry*backs* should be recognized in the determination of net income (loss) of the loss periods. The tax loss gives rise to a refund (or claim for refund) of past taxes, which is both measurable and currently realizable; therefore the tax effect of the loss is

properly recognizable in the determination of net income (loss) for the loss period. (Emphasis in original.)

.30 Paragraph 45 of *APB Opinion No. 11* [section 4091.44] states the following with respect to tax benefits of loss carryforwards:

> The tax effects of loss carry*forwards* also relate to the determination of net income (loss) of the loss periods. However, a significant question generally exists as to realization of the tax effects of the carry*forwards*, since realization is dependent upon future taxable income. Accordingly, the Board [APB] has concluded that the tax benefits of loss carry*forwards* should not be recognized until they are actually realized, except in unusual circumstances when realization is *assured beyond any reasonable doubt* at the time the loss carry*forwards* arise. (Emphasis in original.)

.31 Paragraph 47 of *APB Opinion No. 11* [section 4091.46] describes the circumstances that may assure future realization of the tax benefit of a loss carryforward beyond any reasonable doubt as follows:

> Realization of the tax benefit of a loss carry*forward* would appear to be assured beyond any reasonable doubt when both of the following conditions exist: (a) the loss results from an identifiable, isolated and nonrecurring cause and the company either has been continuously profitable over a long period or has suffered occasional losses which were more than offset by taxable income in subsequent years, and (b) future taxable income is virtually certain to be large enough to offset the loss carry*forward* and will occur soon enough to provide realization during the carry*forward* period. (Emphasis in original.)

.32 Paragraph 20 of *APB Opinion No. 28* [section 2071.20] states the following with respect to losses that arise in the early portion of a fiscal year:

> The tax effects of losses that arise in the early portion of a fiscal year (in the event carryback of such losses is not possible) should be recognized only when realization is assured beyond any reasonable doubt (paragraph 45 of APB Opinion No. 11). An established seasonal pattern of loss in early interim periods offset by income in later interim periods should constitute evidence that realization is assured beyond reasonable doubt, unless other evidence indicates the established seasonal pattern will not prevail. The tax effects of losses incurred in early interim periods may be recognized in a later interim period of a fiscal year if their realization, although initially uncertain, later becomes assured beyond reasonable doubt. When the tax effects of losses that arise in the early portions of a fiscal

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> year are not recognized in that interim period, no tax provision should be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized. . . .

Reversal of Net Deferred Tax Credits

.33 Paragraph 48 of *APB Opinion No. 11* [section 4091.47] states the following with respect to reversal in a loss year of existing net deferred tax credits arising from timing differences:

> Net deferred tax credits arising from timing differences may exist at the time loss carry*forwards* arise. In the usual case when the tax effect of a loss carry*forward* is not recognized in the loss period, adjustments of the existing net deferred tax credits may be necessary in that period or in subsequent periods. In this situation net deferred tax credits should be eliminated to the extent of the lower of (a) the tax effect of the loss carry*forward*, or (b) the amortization of the net deferred tax credits that would otherwise have occurred during the carry*forward* period. (Emphasis in original.)

.34 Paragraph 46 of *APB Opinion No. 11* [section 4091.45] suggests that existing net deferred tax credits arising from timing differences that will be amortized during the carryforward period of a current year operating loss carryforward should be accounted for the same as if there were assurance of realization of the tax benefits of the loss carryforward beyond any reasonable doubt when it states:

> In those rare cases in which realization of the tax benefits of loss carry*forwards* is assured beyond any reasonable doubt, the potential benefits should be associated with the periods of loss and should be recognized in the determination of results of operations for those periods. Realization is considered to be assured beyond any reasonable doubt when conditions such as those set forth in paragraph 47 are present. (Also see paragraph 48.) (Emphasis in original.)

Tax (or Benefit) Applicable to Significant Unusual or Infrequently Occurring Items, Discontinued Operations, or Extraordinary Items

.35 Paragraph 21 of *APB Opinion No. 28* [section 2071.21] states the following with respect to significant unusual or infrequently occurring items, discontinued operations, or extraordinary items:

> Extraordinary items should be disclosed separately and included in the determination of net income for the interim period in which they occur. In determining materiality,

> extraordinary items should be related to the estimated income for the full fiscal year. Effects of disposals of a segment of a business and unusual and infrequently occurring transactions and events that are material with respect to the operating results of the interim period but that are not designated as extraordinary items in the interim statements should be reported separately. . . . Extraordinary items, gains or losses from disposal of a segment of a business, and unusual or infrequently occurring items should not be prorated over the balance of the fiscal year.

Tax Allocation within a Period

.36 Paragraph 52 of *APB Opinion No. 11* [section 4091.51] states the following concerning tax allocation within a period:

> The Board [APB] has concluded that tax allocation within a period should be applied to obtain an appropriate relationship between income tax expense and (a) income before extraordinary items, (b) extraordinary items, (c) adjustments of prior periods (or of the opening balance of retained earnings) and (d) direct entries to other stockholders' equity accounts. The income tax expense attributable to income before extraordinary items is computed by determining the income tax expense related to revenue and expense transactions entering into the determination of such income, without giving effect to the tax consequences of the items excluded from the determination of income before extraordinary items. The income tax expense attributable to other items is determined by the tax consequences of transactions involving these items. If an operating loss exists before extraordinary items, the tax consequences of such loss should be associated with the loss.

Disclosure

.37 Footnote 2 to paragraph 19 *of APB Opinion No. 28* [section 2071.19] states the following concerning the annual effective tax rate:

> Disclosure should be made of the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business (see APB Opinion No. 11, paragraph 63).

Paragraph 63 of *APB Opinion No. 11* [section 4091.62] requires disclosure of:

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> Reasons for significant variations in the customary relationships between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

Using a Prior Year Operating Loss Carryforward

.38 Paragraph 61 of *APB Opinion No. 11* [section 4091.60] specifies:

> When the tax benefit of an operating loss carry*forward* is realized in full or in part in a subsequent period, and has not been previously recognized in the loss period, the tax benefit should be reported as an extraordinary item . . . in the results of operations of the period in which realized. (Emphasis in original.)

Effect of New Tax Legislation

.39 Paragraph 20 of *APB Opinion No. 28* [section 2071.20] also contains the following guidance with respect to the effect of new tax legislation:

> Changes resulting from new tax legislation should be reflected after the effective dates prescribed in the statutes.

Appendix B

CROSS REFERENCE TABLE

.40 This Appendix provides a cross reference from the paragraphs of this Interpretation to the paragraphs in Appendixes C and D that illustrate the application of those paragraphs.

Interpretation Paragraph Numbers		Example at Paragraph Numbers
.08	Estimated annual effective tax rate	.43, .49, .53, .54
	Changes in estimates	.48
.09	Computation of interim period tax (or benefit) applicable to "ordinary" income (or loss):	
	"Ordinary" income anticipated for fiscal year:	
.10	Year-to-date "ordinary" income	.44, .45
.11	Year-to-date "ordinary" loss	.46, .47
	"Ordinary" loss anticipated for fiscal year:	
.12	Year-to-date "ordinary" income	.51, .54
.13	Year-to-date "ordinary" loss	.50, .52, .53
.14	Recognition of the tax benefit of a loss	.50, .52, .53, .54
	Year-to-date loss—special computation	.46, .47, .51
.15	Reversal of net deferred tax credits	.55
.16	Tax (or benefit) applicable to significant unusual, infrequently occurring, or extraordinary items	.57, .58
.17	Financial statement presentation	.71
.18	Recognition of the tax benefit of a loss	.57, .58
.19	Tax (or benefit) applicable to discontinued operations	.62
.20	Using a prior year operating loss carryforward	.59, .60, .61
.21	Cumulative effects of changes in accounting principles	.63, .64
.22	Operations taxable in multiple jurisdictions	.65
.22a	"Ordinary" loss, realization not assured	.66
.22b	Unable to estimate in a jurisdiction	.67
	Effect of new tax legislation:	
.23	Effective in a future interim period	.69
.23	Effective in a past interim period	.70

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Appendix C

EXAMPLES OF COMPUTATIONS OF INTERIM PERIOD INCOME TAXES

.41 This Appendix provides examples of application of this Interpretation for some specific situations. In general, the examples illustrate matters unique to accounting for income taxes at interim dates. The examples do not include consideration of the nature of tax credits and permanent differences or illustrate all possible combinations of circumstances.

.42 Specific situations illustrated in this Appendix are:

	Paragraph Numbers
Accounting for income taxes applicable to "ordinary" income (or loss) at an interim date if "ordinary" income is anticipated for the fiscal year:	
Facts, paragraphs .44 - .47	.43
"Ordinary" income in all interim periods	.44
"Ordinary" income and losses in interim periods:	
Year-to-date "ordinary" income	.45
Year-to-date "ordinary" losses, realization assured	.46
Year-to-date "ordinary" losses, realization not assured	.47
Changes in estimates	.48
Accounting for income taxes applicable to "ordinary" income (or loss) at an interim date if an "ordinary" loss is anticipated for the fiscal year:	
Facts, paragraphs .50 - .54	.49
Realization of the tax benefit of the loss is assured:	
"Ordinary" losses in all interim periods	.50
"Ordinary" income and losses in interim periods	.51
Realization of the tax benefit of the loss is not assured	.52
Partial realization of the tax benefit of the loss is assured:	
"Ordinary" losses in all interim periods	.53
"Ordinary" income and losses in interim periods	.54
Reversal of net deferred tax credits	.55

Paragraph Numbers

Accounting for income taxes applicable to unusual, infrequently occurring, or extraordinary items:
"Ordinary" income expected for the fiscal year:
Explanation of paragraphs .57 and .58 ... .56
Unusual, infrequently occurring, or extraordinary loss with:
Realization of the tax benefit assured at date of occurrence ... .57
Realization of the tax benefit not assured at date of occurrence ... .58
Using a prior year operating loss carryforward:
Explanation of paragraphs .60 and .61 ... .59
Loss carryforward exceeds expected "ordinary" income ... .60
Loss carryforward is less than expected "ordinary" income ... .61

Accounting for income taxes applicable to income (or loss) from discontinued operations at an interim date ... .62

Accounting for income taxes applicable to the cumulative effect of a change in accounting principle:
Cumulative effect of the change on retained earnings at the beginning of the fiscal year ... .63
Effect of the change on prechange interim periods of the current fiscal year ... .64

Accounting for income taxes applicable to "ordinary" income if an enterprise is subject to tax in multiple jurisdictions:
"Ordinary" income in all jurisdictions ... .65
"Ordinary" loss in a jurisdiction; realization of the tax benefit not assured ... .66
"Ordinary" income or tax cannot be estimated in one jurisdiction ... .67
Effect of new tax legislation:
Facts, paragraphs .69 and .70 ... .68
Legislation effective in a future interim period ... .69
Legislation effective in a previous interim period ... .70

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Accounting for Income Taxes Applicable to "Ordinary" Income (or Loss) at an Interim Date If "Ordinary" Income Is Anticipated for the Fiscal Year

.43 The following assumed facts are applicable to the examples of application of this Interpretation in paragraphs .44-.47.

For the full fiscal year, an enterprise anticipates "ordinary" income of $100,000. All income is taxable in one jurisdiction at a 50 percent rate. Anticipated tax credits for the fiscal year total $10,000. No permanent differences are anticipated. No changes in estimated "ordinary" income, tax rates, or tax credits occur during the year.

Computation of the estimated annual effective tax rate applicable to "ordinary" income is as follows:

Tax at statutory rate ($100,000 at 50%)	$ 50,000
Less anticipated tax credits	(10,000)
Net tax to be provided	$ 40,000
Estimated annual effective tax rate ($40,000 ÷ $100,000)	40%

Tax credits are generally subject to limitations, usually based on the amount of tax payable before the credits. In computing the estimated annual effective tax rate, anticipated tax credits are limited to the amounts that are expected to be realized or are expected to be assured of future realization beyond any reasonable doubt at year-end. An exception to this general rule occurs in the computation of deferred taxes resulting from timing differences. If tax credits are not realized but the credits would have been realized if timing differences were not present, the credits are accounted for as a tax benefit and included in the estimated annual effective tax rate. If an enterprise is unable to estimate the amount of its tax credits for the year, see footnote 7 to paragraph .08.

.44 Assume the facts stated in paragraph .43. The enterprise has "ordinary" income in all interim periods. Quarterly tax computations are:

Reporting period	"Ordinary" income		Estimated annual effective tax rate	Tax		
	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
First quarter	$ 20,000	$ 20,000	40%	$ 8,000	$ —	$ 8,000
Second quarter	20,000	40,000	40%	16,000	8,000	8,000
Third quarter	20,000	60,000	40%	24,000	16,000	8,000
Fourth quarter	40,000	100,000	40%	40,000	24,000	16,000
Fiscal year	$100,000					$40,000

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.45 Assume the facts stated in paragraph .43. The enterprise has "ordinary" income and losses in interim periods; there is not an "ordinary" loss for the fiscal year-to-date at the end of any interim period. Quarterly tax computations are:

Reporting period	"Ordinary" income (loss) Reporting period	"Ordinary" income (loss) Year-to-date	Estimated annual effective tax rate	Tax (or benefit) Year-to-date	Tax (or benefit) Less previously provided	Tax (or benefit) Reporting period
First quarter	$ 40,000	$ 40,000	40%	$16,000	$ —	$16,000
Second quarter	40,000	80,000	40%	32,000	16,000	16,000
Third quarter	(20,000)	60,000	40%	24,000	32,000	(8,000)
Fourth quarter	40,000	100,000	40%	40,000	24,000	16,000
Fiscal year	$100,000					$40,000

.46 Assume the facts stated in paragraph .43. The enterprise has "ordinary" income and losses in interim periods, and there is an "ordinary" loss for the year-to-date at the end of an interim period. Established seasonal patterns assure the realization of the tax benefit of the year-to-date loss and realization of anticipated tax credits beyond any reasonable doubt. Quarterly tax computations are:

	"Ordinary" income (loss)		Estimated annual effective tax rate	Tax (or benefit)		
Reporting period	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
First quarter	$ (20,000)	$ (20,000)	40%	$ (8,000)	$ —	$ (8,000)
Second quarter	10,000	(10,000)	40%	(4,000)	(8,000)	4,000
Third quarter	15,000	5,000	40%	2,000	(4,000)	6,000
Fourth quarter	95,000	100,000	40%	40,000	2,000	38,000
Fiscal year	$100,000					$40,000

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.47 Assume the facts stated in paragraph .43. The enterprise has "ordinary" income and losses in interim periods, and there is a year-to-date "ordinary" loss during the year. There is no established seasonal pattern, and realization of the tax benefit of the year-to-date loss and realization of the anticipated tax credits are not otherwise assured beyond any reasonable doubt. Quarterly tax computations are:

	"Ordinary" income (loss)		Estimated annual effective tax rate	Tax		
Reporting period	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
First quarter	$ (20,000)	$ (20,000)	—*	$ —	$ —	$ —
Second quarter	10,000	(10,000)	—*	—	—	—
Third quarter	15,000	5,000	40%	2,000	—	2,000
Fourth quarter	95,000	100,000	40%	40,000	2,000	38,000
Fiscal year	$100,000					$40,000

*No benefit is recognized because realization of the tax benefit of the year-to-date loss is not assured beyond any reasonable doubt.

.48 During the fiscal year, all of an enterprise's operations are taxable in one jurisdiction at a 50 percent rate. No permanent differences are anticipated. Estimates of "ordinary" income for the year and of anticipated credits at the end of each interim period are as shown below. Changes in the estimated annual effective tax rate result from changes in the ratio of anticipated tax credits to tax computed at the statutory rate. Changes consist of an unanticipated strike that reduced income in the second quarter, an increase in the capital budget resulting in an increase in anticipated investment tax credit in the third quarter, and better than anticipated sales and income in the fourth quarter. The enterprise has "ordinary" income in all interim periods. Computations of the estimated annual effective tax rate based on the estimate made at the end of each quarter are:

	Estimated, end of			Actual
	First quarter	Second quarter	Third quarter	fiscal year
Estimated "ordinary" income for the fiscal year	$100,000	$80,000	$80,000	$100,000
Tax at 50% statutory rate	$ 50,000	$40,000	$40,000	$ 50,000
Less anticipated credits	(5,000)	(5,000)	(10,000)	(10,000)
Net tax to be provided	$ 45,000	$35,000	$30,000	$ 40,000
Estimated annual effective tax rate	45%	43.75%	37.5%	40%

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Quarterly tax computations are:

Reporting period	"Ordinary" income		Estimated annual effective tax rate	Tax		
	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
First quarter	$ 25,000	$ 25,000	45%	$11,250	$ —	$11,250
Second quarter	5,000	30,000	43.75%	13,125	11,250	1,875
Third quarter	25,000	55,000	37.5%	20,625	13,125	7,500
Fourth quarter	45,000	100,000	40%	40,000	20,625	19,375
Fiscal year	$100,000					$40,000

Accounting for Income Taxes Applicable to "Ordinary" Income (or Loss) at an Interim Date If an "Ordinary" Loss Is Anticipated for the Fiscal Year

.49 The following assumed facts are applicable to the examples of application of this Interpretation in paragraphs .50-.54.

For the full fiscal year, an enterprise anticipates an "ordinary" loss of $100,000. The enterprise operates entirely in one jurisdiction where the tax rate is 50 percent. Anticipated tax credits for the fiscal year total $10,000. No permanent differences are anticipated.

If realization of the tax benefit of the loss and realization of tax credits were assured beyond any reasonable doubt, computation of the estimated annual effective tax rate applicable to the "ordinary" loss would be as follows:

Tax benefit at statutory rate ($100,000 at 50%)	$(50,000)
Tax credits	(10,000)
Net tax benefit	$(60,000)
Estimated annual effective tax rate ($60,000 ÷ $100,000)	60%

The examples in paragraphs .50-.54 state varying assumptions with respect to assurance of realization of the components of the net tax benefit. When the realization of a component of the benefit is not assured beyond any reasonable doubt, that component is not included in the computation of the estimated annual effective tax rate.

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.50 Assume the facts stated in paragraph .49. The enterprise has "ordinary" losses in all interim periods. Realization of the full tax benefit of the anticipated "ordinary" loss and realization of anticipated tax credits are assured beyond any reasonable doubt because they will be carried back. Quarterly tax computations are:

Reporting period	"Ordinary" loss		Estimated annual effective tax rate	Tax benefit		
	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
First quarter	$ (20,000)	$ (20,000)	60%	$(12,000)	$ —	$(12,000)
Second quarter	(20,000)	(40,000)	60%	(24,000)	(12,000)	(12,000)
Third quarter	(20,000)	(60,000)	60%	(36,000)	(24,000)	(12,000)
Fourth quarter	(40,000)	(100,000)	60%	(60,000)	(36,000)	(24,000)
Fiscal year	$(100,000)					$(60,000)

The next page is 8255-31.

.51 Assume the facts stated in paragraph .49. The enterprise has "ordinary" income and losses in interim periods and for the year-to-date. Realization of the full tax benefit of the anticipated "ordinary" loss and realization of the anticipated tax credits are assured beyond any reasonable doubt because they will be carried back. Realization of the full tax benefit of the maximum year-to-date "ordinary" loss is also assured beyond any reasonable doubt. Quarterly tax computations are:

	"Ordinary" income (loss)		Estimated	Tax (or benefit)			
			annual	Year-to-date		Less	
	Reporting	Year-to-	effective			previously	Reporting
Reporting period	period	date	tax rate	Computed	Limited to	provided	period
First quarter	$ 20,000	$ 20,000	60%	$ 12,000		$ —	$ 12,000
Second quarter	(80,000)	(60,000)	60%	(36,000)		12,000	(48,000)
Third quarter	(80,000)	(140,000)	60%	(84,000)	$(80,000)*	(36,000)	(44,000)
Fourth quarter	40,000	(100,000)	60%	(60,000)		(80,000)	20,000
Fiscal year	$(100,000)						$(60,000)

*Because the year-to-date "ordinary" loss exceeds the anticipated "ordinary" loss for the fiscal year, the tax benefit recognized for the year-to-date is limited to the amount that would be recognized if the year-to-date "ordinary" loss were the anticipated "ordinary" loss for the fiscal year. The limitation is computed as follows:

Year-to-date "ordinary" loss times the statutory rate ($140,000 at 50%)	$(70,000)
Estimated tax credits for the year	(10,000)
Year-to-date benefit limited to	$(80,000)

.52 In the examples in paragraphs .50 and .51, if neither realization of the tax benefit of the anticipated loss for the fiscal year nor realization of anticipated tax credits were assured beyond any reasonable doubt, the estimated annual effective tax rate for the year would be zero and no tax (or benefit) would be recognized in any quarter. That conclusion is not affected by changes in the mix of income and loss in interim periods during a fiscal year. However, see footnote 7 to paragraph .08 above.

.53 Assume the facts stated in paragraph .49. The enterprise has an "ordinary" loss in all interim periods. Realization of the tax benefit of the loss is assured beyond any reasonable doubt only to the extent of $40,000 of prior income available to be offset by carryback ($20,000 of tax at the 50 percent statutory rate). Therefore the estimated annual effective tax rate is 20 percent ($20,000 benefit assured divided by $100,000 estimated fiscal year "ordinary" loss). Quarterly tax computations are:

	"Ordinary" loss		Estimated annual effective tax rate	Tax benefit		
Reporting period	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
First quarter	$ (20,000)	$ (20,000)	20%	$ (4,000)	$ —	$ (4,000)
Second quarter	(20,000)	(40,000)	20%	(8,000)	(4,000)	(4,000)
Third quarter	(20,000)	(60,000)	20%	(12,000)	(8,000)	(4,000)
Fourth quarter	(40,000)	(100,000)	20%	(20,000)	(12,000)	(8,000)
Fiscal year	$(100,000)					$(20,000)

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.54 Assume the facts stated in paragraph .49. The enterprise has "ordinary" income and losses in interim periods and for the year-to-date. Realization of the tax benefit of the anticipated "ordinary" loss is assured beyond any reasonable doubt only to the extent of $40,000 of prior income available to be offset by carryback ($20,000 of tax at the 50 percent statutory rate). Therefore the estimated annual effective tax rate is 20 percent ($20,000 benefit assured divided by $100,000 estimated fiscal year "ordinary" loss), and the benefit that can be recognized for the year-to-date is limited to $20,000 (the benefit that is assured of realization). Quarterly tax computations are:

	"Ordinary" income (loss)		Estimated	Tax (or benefit)			
			annual	Year-to-date		Less	
Reporting period	Reporting period	Year-to-date	effective tax rate	Computed	Limited to	previously provided	Reporting period
First quarter	$ 20,000	$ 20,000	20%	$ 4,000		$ —	$ 4,000
Second quarter	(80,000)	(60,000)	20%	(12,000)		4,000	(16,000)
Third quarter	(80,000)	(140,000)	20%	(28,000)	$(20,000)	(12,000)	(8,000)
Fourth quarter	40,000	(100,000)	20%	(20,000)		(20,000)	—
Fiscal year	$(100,000)						$(20,000)

.55 The enterprise anticipates a fiscal year "ordinary" loss. The loss cannot be carried back, and future profits are not assured beyond any reasonable doubt. Net deferred tax credits arising from timing differences are present. A portion of the timing differences relating to those credits will reverse within the loss carryforward period. Computation of the estimated annual effective tax rate to be used is as follows:

Estimated fiscal year "ordinary" loss		$(100,000)
The tax benefit to be recognized is the lesser of:		
Tax effect of the loss carryforward ($100,000 at 50% statutory rate)	$50,000	
Amount of the net deferred tax credits that would otherwise have been amortized during the carryforward period	$24,000	
Estimated annual effective tax rate ($24,000 ÷ $100,000)		24%

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Quarterly tax computations are:

	"Ordinary" loss		Estimated annual effective tax rate	Tax benefit		
Reporting period	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
First quarter	$ (20,000)	$ (20,000)	24%	$ (4,800)	$ —	$ (4,800)
Second quarter	(20,000)	(40,000)	24%	(9,600)	(4,800)	(4,800)
Third quarter	(20,000)	(60,000)	24%	(14,400)	(9,600)	(4,800)
Fourth quarter	(40,000)	(100,000)	24%	(24,000)	(14,400)	(9,600)
Fiscal year	$(100,000)					$(24,000)

Note: Changes in the timing of the loss by quarter would not change the above computation.

Accounting for Income Taxes Applicable to Unusual, Infrequently Occurring, or Extraordinary Items

.56 The examples of computations in paragraphs .57 and .58 illustrate the computation of the tax (or benefit) applicable to unusual, infrequently occurring, or extraordinary items when "ordinary" income is anticipated for the fiscal year. These examples are based on the facts and computations given in paragraphs .43-.47 plus additional information supplied in paragraphs .57 and .58. The computation of the tax (or benefit) applicable to the "ordinary" income is not affected by the occurrence of an unusual, infrequently occurring, or extraordinary item; therefore, each example refers to one or more of the examples of that computation in paragraphs .44-.47 and does not reproduce the computation and the facts assumed. The income statement display for tax (or benefit) applicable to unusual, infrequently occurring, or extraordinary items is illustrated in Appendix D.

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.57 As explained in paragraph .56, this example is based on the computations of tax applicable to "ordinary" income that are illustrated in paragraph .44 above. In addition, the enterprise experiences a tax-deductible unusual, infrequently occurring, or extraordinary loss of $50,000 (tax benefit $25,000) in the second quarter. Because the loss can be carried back, the benefit of the loss is assured beyond any reasonable doubt at the time of occurrence. Quarterly tax provisions are:

			Tax (or benefit) applicable to	
Reporting period	"Ordinary" income	Unusual, infrequently occurring, or extraordinary loss	"Ordinary" income	Unusual, infrequently occurring, or extraordinary loss
First quarter	$ 20,000		$ 8,000	
Second quarter	20,000	$(50,000)	8,000	$(25,000)
Third quarter	20,000		8,000	
Fourth quarter	40,000		16,000	
Fiscal year	$100,000	$(50,000)	$40,000	$(25,000)

Note: Changes in assumptions would not change the timing of the recognition of the tax benefit applicable to the unusual, infrequently occurring, or extraordinary item as long as realization is assured beyond any reasonable doubt.

.58 As explained in paragraph .56, this example is based on the computations of tax applicable to "ordinary" income that are illustrated in paragraphs .44 and .45 above. In addition, the enterprise experiences a tax-deductible unusual, infrequently occurring, or extraordinary loss of $50,000 (potential benefit $25,000) in the second quarter. The loss cannot be carried back, and the current projection of "ordinary" income is not considered sufficiently reliable to assure realization of the tax benefit of the year-to-date loss beyond any reasonable doubt. As a result, realization of the tax benefit of the unusual, infrequently occurring, or extraordinary loss is not assured beyond any reasonable doubt except to the extent of offsetting "ordinary" income for the year-to-date. Quarterly tax provisions under two different assumptions for the occurrence of "ordinary" income are:

			Tax (or benefit) applicable to				
			"Ordinary" income (loss)		Unusual, infrequently occurring, or extraordinary loss		
Assumptions and reporting period	"Ordinary" income (loss)	Unusual, infrequently occurring, or extraordinary loss	Reporting period	Year-to-date	Year-to-date	Less previously provided	Reporting period
Income in all quarters:							
First quarter	$ 20,000		$ 8,000	$ 8,000			
Second quarter	20,000	$(50,000)	8,000	16,000	$(16,000)	$ —	$(16,000)
Third quarter	20,000		8,000	24,000	(24,000)	(16,000)	(8,000)
Fourth quarter	40,000		16,000	40,000	(25,000)	(24,000)	(1,000)
Fiscal year	$100,000	$(50,000)	$40,000				$(25,000)

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Income and loss quarters:							
First quarter	$ 40,000		$16,000	$16,000			
Second quarter	40,000	$(50,000)	16,000	32,000	$(25,000)	$ —	$(25,000)
Third quarter	(20,000)		(8,000)	24,000	(24,000)	(25,000)	1,000
Fourth quarter	40,000		16,000	40,000	(25,000)	(24,000)	(1,000)
Fiscal year	$100,000	$(50,000)	$40,000				$(25,000)

Using a Prior Year Operating Loss Carryforward

.59 The examples of computations in paragraphs .60 and .61 illustrate the computation of the tax benefit that results from using a prior year operating loss carryforward. The examples are based on the following assumed facts.

For the full fiscal year, an enterprise anticipates "ordinary" income of $100,000. All income is taxable in one jurisdiction at a 50 percent rate. No tax credits or permanent differences are anticipated. If an operating loss carryforward is available, the estimated tax (or benefit) applicable to "ordinary" income (or loss) for the year is divided by the estimated "ordinary" income (or loss) for the year to arrive at an estimated annual effective tax rate. That rate is 50 percent in these examples. The estimated annual effective tax rate is applied to "ordinary" income (or loss) for the year-to-date to determine the year-to-date tax (or benefit) applicable to "ordinary" income (or loss), similar to the computations that are illustrated in paragraphs .44-.47.

.60 Assume the facts stated in paragraph .59. In addition, an operating loss carryforward is available that exceeds the estimated "ordinary" income for the year. Because *APB Opinion No. 28* [section 2071] requires that an extraordinary item be recognized in the interim period of its occurrence and not spread over the year, the extraordinary credit recognized for the year-to-date at the end of each interim period is the amount that is realized by offsetting year-to-date taxable income. Quarterly tax provisions under various assumptions for the occurrence of "ordinary" income are:

		Tax (or benefit)		Extraordinary charge (or credit)*		
Assumptions and reporting period	"Ordinary" income (loss)	Reporting period	Year-to-date	Year-to-date	Less previously provided	Reporting period
Income in all quarters:						
First quarter	$ 20,000	$10,000	$10,000	$(10,000)	$ —	$(10,000)
Second quarter	20,000	10,000	20,000	(20,000)	(10,000)	(10,000)
Third quarter	20,000	10,000	30,000	(30,000)	(20,000)	(10,000)
Fourth quarter	40,000	20,000	50,000	(50,000)	(30,000)	(20,000)
Fiscal year	$100,000	$50,000				$(50,000)

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Income and loss quarters; no year-to-date losses:						
First quarter	$ 40,000	$20,000	$20,000	$(20,000)	$ —	$(20,000)
Second quarter	40,000	20,000	40,000	(40,000)	(20,000)	(20,000)
Third quarter	(20,000)	(10,000)	30,000	(30,000)	(40,000)	10,000
Fourth quarter	40,000	20,000	50,000	(50,000)	(30,000)	(20,000)
Fiscal year	$100,000	$50,000				$(50,000)

*Tax benefit resulting from using the operating loss carryforward.

Assumptions and reporting period	"Ordinary" income (loss)	Tax (or benefit)		Extraordinary charge (or credit)*		
		Reporting period	Year-to-date	Year-to-date	Less previously provided	Reporting period
Income and loss quarters and including year-to-date loss (realization of the tax benefit of the year-to-date "ordinary" loss and realization of anticipated tax credits are assured beyond any reasonable doubt by seasonal patterns):						
First quarter	$ (20,000)	$(10,000)	$(10,000)	$ —	$ —	$ —
Second quarter	10,000	5,000	(5,000)	—	—	—
Third quarter	15,000	7,500	2,500	(2,500)	—	(2,500)
Fourth quarter	95,000	47,500	50,000	(50,000)	(2,500)	(47,500)
Fiscal year	$100,000	$ 50,000				$(50,000)

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Income and loss quarters, including year-to-date loss (realization of the tax benefit of the year-to-date "ordinary" loss and realization of anticipated tax credits are not assured beyond any reasonable doubt):

First quarter	$ (20,000)	$ —	$ —	$ —	$ —	$ —
Second quarter	10,000	—	—	—	—	—
Third quarter	15,000	2,500	2,500	(2,500)	—	(2,500)
Fourth quarter	95,000	47,500	50,000	(50,000)	(2,500)	(47,500)
Fiscal year	$100,000	$ 50,000				$(50,000)

*Tax benefit resulting from using the operating loss carryforward.

.61 Assume the facts stated in paragraph .59. In addition, an operating loss carryforward of $30,000 (tax benefit $15,000 at the 50 percent statutory rate) is available. Because *APB Opinion No. 28* [section 2071] requires that an extraordinary item be recognized in the interim period of its occurrence and not spread over the year, the extraordinary credit recognized for the year-to-date at the end of each interim period is the amount that is realized by offsetting year-to-date taxable income. Quarterly tax provisions are:

		Tax provision		Extraordinary credit		
Reporting period	"Ordinary" income	Reporting period	Year-to-date	Year-to-date	Less previously provided	Reporting period
First quarter	$ 20,000	$10,000	$10,000	$(10,000)	$ —	$(10,000)
Second quarter	20,000	10,000	20,000	(15,000)	(10,000)	(5,000)
Third quarter	20,000	10,000	30,000	(15,000)	(15,000)	—
Fourth quarter	40,000	20,000	50,000	(15,000)	(15,000)	—
Fiscal year	$100,000	$50,000				$(15,000)

Note: Differing patterns of occurrence of "ordinary" income and loss would result in computations similar to those in paragraph .60.

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Accounting for Income Taxes Applicable to Income (or Loss) from Discontinued Operations at an Interim Date

.62 An enterprise anticipates "ordinary" income for the year of $100,000 and tax credits of $10,000. The enterprise has "ordinary" income in all interim periods. The estimated annual effective tax rate is 40 percent, computed as follows:

Estimated pretax income	$100,000
Tax at 50% statutory rate	$ 50,000
Less anticipated credits	(10,000)
Net tax to be provided	$ 40,000
Estimated annual effective tax rate	40%

Quarterly tax computations for the first two quarters are:

	"Ordinary" income		Estimated annual effective tax rate	Tax		
Reporting period	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
First quarter	$ 20,000	$20,000	40%	$ 8,000	$ —	$ 8,000
Second quarter	25,000	45,000	40%	18,000	8,000	10,000

In the third quarter a decision is made to discontinue the operations of Division X, a segment of the business that has recently operated at a loss (before income taxes). The pretax income (and losses) of the continuing operations of the enterprise and of Division X through the third quarter and the estimated fourth quarter results are as follows:

Reporting period	Revised "ordinary" income from continuing operations	Division X: Loss from operations	Division X: Provision for loss on disposal
First quarter	$ 25,000	$ (5,000)	
Second quarter	35,000	(10,000)	
Third quarter	50,000	(10,000)	$ (55,000)
Fourth quarter	50,000*	—	—
Fiscal year	$160,000	$ (25,000)	$ (55,000)

*Estimated

No changes have occurred in continuing operations that would affect the estimated annual effective tax rate. Anticipated annual tax credits of $10,000 included $2,000 of credits related to the operations of Division X. The revised estimated annual effective tax rate applicable to "ordinary" income from continuing operations is 45 percent, computed as follows:

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Estimated "ordinary" income from continuing operations	$160,000
Tax at 50% statutory rate	$ 80,000
Less anticipated tax credits applicable to continuing operations	(8,000)
Net tax to be provided	$ 72,000
Estimated annual effective tax rate	45%

Quarterly computations of tax applicable to "ordinary" income from continuing operations are as follows:

	"Ordinary" income		Estimated	Tax		
Reporting period	Reporting period	Year-to-date	annual effective tax rate	Year-to-date	Less previously provided	Reporting period
First quarter	$ 25,000	$ 25,000	45%	$11,250	$ —	$11,250
Second quarter	35,000	60,000	45%	27,000	11,250	15,750
Third quarter	50,000	110,000	45%	49,500	27,000	22,500
Fourth quarter	50,000	160,000	45%	72,000	49,500	22,500
Fiscal year	$160,000					$72,000

Tax benefit applicable to Division X for the first two quarters is computed as follows:

Reporting period	Tax applicable to "ordinary" income: Previously reported (A)	Tax applicable to "ordinary" income: Recomputed (above) (B)	Tax benefit applicable to Division X (A-B)
First quarter	$ 8,000	$11,250	$(3,250)
Second quarter	10,000	15,750	(5,750)
			$(9,000)

The third quarter tax benefits applicable to both the loss from operations and the provision for loss on disposal of Division X are computed based on estimated annual income with and without the effects of the Division X losses. Current year tax credits related to the operations of Division X have not been recognized. It is assumed that the tax benefit of those credits will not be realized because of the discontinuance of Division X operations. Any reduction in tax benefits resulting from recapture of previously recognized tax credits resulting from discontinuance or current year tax credits applicable to the discontinued operations would be reflected in the tax benefit recognized for the loss on disposal or loss from operations as appropriate. If, because of capital gains and losses, etc., the individually computed tax effects of the items do not equal the aggregate tax effects of the items, the aggregate tax effects are allocated to the individual items in the same manner that they will be allocated in the annual financial statements. The computations are as follows:

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	Loss from operations of Division X	Provision for loss on disposal
Estimated annual income from continuing operations	$160,000	$160,000
Loss from Division X operations	(25,000)	
Provision for loss on disposal of Division X		(55,000)
Total	$135,000	$105,000
Tax at 50% statutory rate	$ 67,500	$ 52,500
Anticipated credits from continuing operations	(8,000)	(8,000)
Tax credits of Division X and recapture of previously recognized tax credits resulting from discontinuance	—	—
Taxes on income after effect of Division X losses	59,500	44,500
Taxes on income before effect of Division X losses — see computation above	72,000	72,000
Tax benefit applicable to the losses of Division X	(12,500)	(27,500)
Amounts previously recognized — see computation above	(9,000)	—
Tax benefit recognized in third quarter	$ (3,500)	$ (27,500)

The resulting revised quarterly tax provisions are summarized as follows:

	Pretax income (loss)			Tax (or benefit) applicable to		
Reporting period	Continuing operations	Operations of Division X	Provision for loss on disposal	Continuing operations	Operations of Division X	Provision for loss on disposal
First quarter	$ 25,000	$ (5,000)		$11,250	$ (3,250)	
Second quarter	35,000	(10,000)		15,750	(5,750)	
Third quarter	50,000	(10,000)	$(55,000)	22,500	(3,500)	$(27,500)
Fourth quarter	50,000			22,500		
Fiscal year	$160,000	$(25,000)	$(55,000)	$72,000	$(12,500)	$(27,500)

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Accounting for Income Taxes Applicable to the Cumulative Effect of a Change in Accounting Principle

.63 The tax (or benefit) applicable to the cumulative effect of the change on retained earnings at the beginning of the fiscal year shall be computed the same as for the annual financial statements.

.64 When an enterprise makes a cumulative effect type accounting change in other than the first interim period of the enterprise's fiscal year, paragraph 10 of *FASB Statement No. 3* [section 2072.10], "Reporting Accounting Changes in Interim Financial Statements," requires that financial information for the pre-change interim periods of the fiscal year shall be restated by applying the newly adopted accounting principle to those pre-change interim periods. The tax (or benefit) applicable to those pre-change interim periods shall be recomputed. The restated tax (or benefit) shall reflect the year-to-date amounts and annual estimates originally used for the pre-change interim periods, modified only for the effect of the change in accounting principle on those year-to-date and estimated annual amounts.

Accounting for Income Taxes Applicable to "Ordinary" Income If an Enterprise Is Subject to Tax in Multiple Jurisdictions

.65 An enterprise operates through separate corporate entities in two countries. Applicable tax rates are 50 percent in the United States and 20 percent in Country A. The enterprise has no unusual or extraordinary items during the fiscal year and anticipates no tax credits or permanent differences. (The effect of foreign tax credits and the necessity of providing tax on undistributed earnings are ignored because of the wide range of tax planning alternatives available.) For the full fiscal year the enterprise anticipates "ordinary" income of $60,000 in the United States and $40,000 in Country A. The enterprise is able to make a reliable estimate of its Country A "ordinary" income and tax for the fiscal year in dollars. Computation of the overall estimated annual effective tax rate is as follows:

Anticipated "ordinary" income for the fiscal year:	
In the U.S.	$ 60,000
In Country A	40,000
Total	$100,000
Anticipated tax for the fiscal year:	
In the U.S. ($60,000 at 50% statutory rate)	$ 30,000
In Country A ($40,000 at 20% statutory rate)	8,000
Total	$ 38,000
Overall estimated annual effective tax rate ($38,000 ÷ $100,000)	38%

Quarterly tax computations are as follows:

	"Ordinary" income				Overall estimated annual effective tax rate	Tax		
Reporting period	U.S.	Country A	Total	Year-to-date		Year-to-date	Less previously reported	Reporting period
First quarter	$ 5,000	$15,000	$ 20,000	$ 20,000	38%	$ 7,600	$ —	$ 7,600
Second quarter	10,000	10,000	20,000	40,000	38%	15,200	7,600	7,600
Third quarter	10,000	10,000	20,000	60,000	38%	22,800	15,200	7,600
Fourth quarter	35,000	5,000	40,000	100,000	38%	38,000	22,800	15,200
Fiscal year	$60,000	$40,000	$100,000					$38,000

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.66 Assume the facts stated in paragraph .65. In addition the enterprise operates through a separate corporate entity in Country B. Applicable tax rates in Country B are 40 percent. Operations in Country B have resulted in losses in recent years and an "ordinary" loss is anticipated for the current fiscal year in Country B. Realization of the tax benefit of those losses is not assured beyond any reasonable doubt; accordingly, no tax benefit is recognized for losses in Country B, and interim period tax (or benefit) is separately computed for the "ordinary" loss in Country B and for the overall "ordinary" income in the United States and Country A. The tax applicable to the overall "ordinary" income in the United States and Country A is computed as in paragraph .65. Quarterly tax provisions are as follows:

	"Ordinary" income (or loss)					Tax (or benefit)		
Reporting period	U.S.	Country A	Combined excluding Country B	Country B	Total	Overall excluding Country B	Country B	Total
First quarter	$ 5,000	$15,000	$ 20,000	$ (5,000)	$15,000	$ 7,600	$ —	$ 7,600
Second quarter	10,000	10,000	20,000	(25,000)	(5,000)	7,600	—	7,600
Third quarter	10,000	10,000	20,000	(5,000)	15,000	7,600	—	7,600
Fourth quarter	35,000	5,000	40,000	(5,000)	35,000	15,200	—	15,200
Fiscal year	$60,000	$40,000	$100,000	$(40,000)	$60,000	$38,000	$ —	$38,000

.67 Assume the facts stated in paragraph .65. In addition the enterprise operates through a separate corporate entity in Country C. Applicable tax rates in Country C are 40 percent in foreign currency. Depreciation in that country is large and exchange rates have changed in prior years. The enterprise is unable to make a reasonable estimate of its "ordinary" income for the year in Country C and thus is unable to reasonably estimate its annual effective tax rate in Country C in dollars. Accordingly, tax (or benefit) in Country C is separately computed as "ordinary" income (or loss) occurs in Country C. The tax applicable to the overall "ordinary" income in the United States and Country A is computed as in paragraph .65. Quarterly computations of tax applicable to Country C are as follows:

	Foreign currency amounts		Translated amounts in dollars	
Reporting period	"Ordinary" income in reporting period	Tax (at 40% rate)	"Ordinary" income in reporting period	Tax
First quarter	FC 10,000	FC 4,000	$12,500	$ 3,000
Second quarter	5,000	2,000	8,750	1,500
Third quarter	30,000	12,000	27,500	9,000
Fourth quarter	15,000	6,000	16,250	4,500
Fiscal year	FC 60,000	FC 24,000	$65,000	$18,000

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Quarterly tax provisions are as follows:

	"Ordinary" income					Tax		
Reporting period	U.S.	Country A	Combined excluding Country C	Country C	Total	Overall excluding Country C	Country C	Total
First quarter	$ 5,000	$15,000	$ 20,000	$12,500	$ 32,500	$ 7,600	$ 3,000	$10,600
Second quarter	10,000	10,000	20,000	8,750	28,750	7,600	1,500	9,100
Third quarter	10,000	10,000	20,000	27,500	47,500	7,600	9,000	16,600
Fourth quarter	35,000	5,000	40,000	16,250	56,250	15,200	4,500	19,700
Fiscal year	$60,000	$40,000	$100,000	$65,000	$165,000	$38,000	$18,000	$56,000

Effect of New Tax Legislation

.68 The following assumed facts are applicable to the examples of application of this Interpretation in paragraphs .69 and .70.

For the full fiscal year, an enterprise anticipates "ordinary" income of $100,000. All income is taxable in one jurisdiction at a 50 percent rate. Anticipated tax credits for the fiscal year total $10,000. No permanent differences are anticipated.

Computation of the estimated annual effective tax rate applicable to "ordinary" income is as follows:

Tax at statutory rate ($100,000 at 50%)	$ 50,000
Less anticipated tax credits	(10,000)
Net tax to be provided	$ 40,000
Estimated annual effective tax rate ($40,000 ÷ $100,000)	40%

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.69 Assume the facts stated in paragraph .68. In addition, assume that new legislation creating additional tax credits is enacted during the second quarter of the enterprise's fiscal year. The new legislation is effective on the first day of the third quarter. As a result of the estimated effect of the new legislation, the enterprise revises its estimate of its annual effective tax rate to the following:

Tax at statutory rate ($100,000 at 50%)	$ 50,000
Less anticipated tax credits	(12,000)
Net tax to be provided	$ 38,000
Estimated annual effective tax rate ($38,000 ÷ $100,000)	38%

The effect of the new legislation shall not be reflected until it is effective or administratively effective. Accordingly, quarterly tax computations are:

	"Ordinary" income		Estimated	Tax		
Reporting period	Reporting period	Year-to-date	annual effective tax rate	Year-to-date	Less previously provided	Reporting period
First quarter	$ 20,000	$ 20,000	40%	$ 8,000	$ —	$ 8,000
Second quarter	20,000	40,000	40%	16,000	8,000	8,000
Third quarter	20,000	60,000	38%	22,800	16,000	6,800
Fourth quarter	40,000	100,000	38%	38,000	22,800	15,200
Fiscal year	$100,000					$38,000

.70 Assume the facts stated in paragraph .68. In addition, assume that new legislation creating additional tax credits is enacted after the end of the third quarter of the enterprise's fiscal year but before the enterprise has reported the results of its operations for the third quarter. The new legislation is effective retroactive to the first day of the third quarter. The new legislation results in the following revised estimated annual effective tax rate:

Tax at statutory rate ($100,000 at 50%)	$ 50,000
Less anticipated tax credits	(12,000)
Net tax to be provided	$ 38,000
Estimated annual effective tax rate ($38,000 ÷ $100,000)	38%

Quarterly tax computations are:

	"Ordinary" income		Estimated annual effective tax rate	Tax		
Reporting period	Reporting period	Year-to-date		Year-to-date	Less previously provided	Reporting period
First quarter	$ 20,000	$ 20,000	40%	$ 8,000	$ —	$ 8,000
Second quarter	20,000	40,000	40%	16,000	8,000	8,000
Third quarter	20,000	60,000	38%	22,800	16,000	6,800
Fourth quarter	40,000	100,000	38%	38,000	22,800	15,200
Fiscal year	$100,000					$38,000

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Appendix D

ILLUSTRATION OF INCOME TAXES IN INCOME STATEMENT DISPLAY

.71 The following illustrates the location in an income statement display of the various tax amounts computed under this Interpretation:

*Net sales		$XXXX
*Other income		XXX
		XXXX
Costs and expenses:		
*Cost of sales	$XXXX	
*Selling, general, and administrative expenses	XXXX	
*Interest expense	XXX	
*Other deductions	XX	
Unusual items	XXX	
Infrequently occurring items	XXX	XXXX
Income (loss) from continuing operations before income taxes and other items listed below		XXXX
†Provision for income taxes (benefit)		XXXX
Income (loss) from continuing operations before other items listed below		XXXX
Discontinued operations:		
Income (loss) from operations of discontinued Division X (less applicable income taxes of $XXXX)	XXXX	
Income (loss) on disposal of Division X, including provision of $XXXX for operating losses during phase-out period (less applicable income taxes of $XXXX)	XXXX	XXXX
Income (loss) before extraordinary items and cumulative effect of a change in accounting principle		XXXX
Extraordinary items (less applicable income taxes of $XXXX)		XXXX
‡Cumulative effect on prior years of a change in accounting principle (less applicable income taxes of $XXXX)		XXXX
Net income (loss)		$XXXX

*Components of "ordinary" income (loss).

†Consists of the total of income taxes (or benefit) applicable to (a) "ordinary" income, (b) unusual items, and (c) infrequently occurring items.

‡This amount is net of applicable income taxes. The amount of the applicable income taxes is usually separately disclosed but that is not required.

Appendix E

SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT

.72 The "Notice of Exposure and Request for Comments" accompanying the Exposure Draft issued October 7, 1976 for this Interpretation stated:

> The Interpretation set forth in this EXPOSURE DRAFT explains, clarifies, and elaborates on the requirements of *APB Opinion No. 28*, "Interim Financial Reporting," which relies in part on *APB Opinion No. 11*, "Accounting for Income Taxes," and on other APB Opinions with respect to accounting for income taxes in interim periods.
>
> The FASB currently has on its technical agenda a project entitled Interim Financial Reporting. As part of that project, the Board will examine possible methods of accounting for income taxes in interim periods. At the completion of that project, the Board expects to issue a comprehensive Statement specifying the financial accounting and reporting standards to be applied in interim financial reporting. The Board recognizes that some might prefer methods of accounting for income taxes in interim periods other than those required by the concepts of *APB Opinion No. 28*. However, the Board is of the view that any other methods should be considered as part of the FASB's technical agenda project on Interim Financial Reporting.
>
> The FASB Rules of Procedure permit the issuance of a final Interpretation without exposure for public comment but allow public exposure prior to final issuance when the Board deems such procedure to be advisable. The Board has reached that conclusion here and has also concluded that a public comment period extending to November 15, 1976 is appropriate.

.73 In response to the request for comments on the Exposure Draft, the FASB received and considered 99 letters of comment. Certain of the comments and the FASB's consideration of them are summarized in paragraphs .74-.85.

Issuance of the Interpretation

.74 Many respondents recommended that the FASB not issue a final Interpretation on "Accounting for Income Taxes in Interim Periods" at this time. Some of those respondents recommended that the project be deferred until the FASB issues its comprehensive Statement on Interim Financial

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Reporting. Others questioned if the number of existing differences in accounting for similar situations was great enough to require an Interpretation at this time.

.75 It is not likely that a final Statement for the Board's current agenda project on Interim Financial Reporting will be issued and effective before 1979. Comments received in respect of the Exposure Draft indicate that there is, currently, diversity of practice. The Board concluded that the provisions of *APB Opinion No. 28* [section 2071] are sufficiently clear to provide a basis for an Interpretation and that a final Interpretation should be issued.

Applicability to Annual Financial Statements

.76 Some respondents stated that the proposed Interpretation and the examples in Appendix B implicitly included a number of interpretations of the application of *APB Opinion No. 11* [section 4091] to annual financial statements. They recommended that, if the Board intends to interpret Opinion No. 11 [section 4091], the intent should be stated. The Board does not intend to modify annual accounting practices in this Interpretation. Accordingly, specific guidance on those matters that appeared to imply interpretations of the application of *APB Opinion No. 11* [section 4091] to annual financial statements was deleted.

.77 Some respondents asked if the example in paragraph .49 of Appendix C of this Interpretation was intended to change the annual accounting for investment tax credits. Paragraph .49 includes "tax credits" in the computed tax benefit of an "ordinary" loss, but does not identify those "tax credits" as "investment tax credits." Various tax credits other than investment tax credits may be available to an enterprise. This Interpretation is not intended to change annual accounting for unrealized investment tax credits.

Applicability to Regulated Industries

.78 A number of respondents stated that the proposed Interpretation should not apply to regulated industries. Some respondents noted that the Addendum to *APB Opinion No. 2* [section 6011] may provide an exemption from the Interpretation for certain enterprises in regulated industries. The Board is aware that differing applications of the Addendum exist in practice and has not addressed that issue.

Amortization of Deferred Investment Tax Credits

.79 Several respondents recommended that the amortization of deferred investment tax credits be excluded from the estimated annual effective tax rate. Some stated that the rationale of *APB Opinion No. 2* [section 4094] requires those items to be allocated among interim periods on the same basis as depreciation expense for the property giving rise to the credit. Paragraph 13 of Opinion No. 2 [section 4094.11] states that "the . . . investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service."[27] Footnote 6 to paragraph .08 of this Interpretation was revised to indicate that amortization of deferred investment tax credits need not be taken into account in estimating the annual effective tax rate. However, if an enterprise elects to consider investment tax credits in estimating the annual effective tax rate, the amount to be taken into account shall be the estimated amount of the current year's amortization and not the amount that reduces income tax payable on the enterprise's tax return.

Tax Exempt Interest

.80 A number of respondents recommended that tax-exempt interest income be excluded from "ordinary" income in estimating the annual effective tax rate and in computing the year-to-date tax (or benefit). A number of them stated that the tax effect of tax-exempt interest income must be reported on a discrete period basis to reflect the economic effects of tax-exempt investments. A few respondents noted that the practice of excluding tax-exempt interest income from "ordinary" income in estimating the annual effective tax rate and in computing interim period tax (or benefit) is followed by virtually all financial institutions. The Board noted that the accounting practice described above for tax-exempt interest income in interim periods appears to be uniform and concluded that it should not address the issue in this Interpretation.

Exchange Gains and Losses

.81 Several respondents requested that the Board provide guidance on accounting for the tax effects of exchange gains

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[27] That conclusion was amended by *APB Opinion No. 4* [section 4094], "Accounting for the 'Investment Credit'." Paragraph 10 of Opinion No. 4 [section 4094.17] permits "the alternative method of treating the credit as a reduction of Federal income taxes of the year in which the credit arises. . . ."

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and losses in interim periods. Paragraphs 166 and 192 of *FASB Statement No. 8* [sections 1083.166 and 1083.192], "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," indicate that it would be rare that the timing, direction, and magnitude of future exchange rate changes and the enterprise's financial position at the time of an expected future exchange rate change could each be reasonably estimated. Footnote 7 to paragraph .08 has been expanded to explain that the tax (or benefit) applicable to an item that cannot be estimated shall be reported in the interim period in which the item is reported.

Estimated Annual Effective Tax Rate

.82 Several respondents recommended that an estimated annual effective tax rate not be applied in various specific circumstances. Circumstances mentioned included (a) if the rate is extremely high or low, (b) if an "ordinary" loss is expected for the year, and (c) if an enterprise has a year-to-date "ordinary" income and anticipates an "ordinary" loss for the year. An example cited was an enterprise that experienced "ordinary" income in an early part of the year and anticipated offsetting "ordinary" losses in the balance of the year, resulting in zero estimated "ordinary" income and no tax (or benefit). Such unusual circumstances may result in significant variations in the customary relationship between income tax expense and pretax accounting income in interim periods and footnote 2 to paragraph 19 of Opinion No. 28 [section 2071.19] requires disclosure of the reasons for those variations. Footnote 7 to paragraph .08 of this Interpretation states that if a reliable estimate cannot be made the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. What is and what is not a "reliable estimate" is a matter of judgment. In the break-even situation cited above, a small change in the enterprise's estimated "ordinary" income could produce a large change in the estimated annual effective tax rate. In those circumstances, a break-even estimate would not be reliable if a small change in the estimated "ordinary" income were considered likely to occur.

Operations Taxable in Multiple Jurisdictions

.83 Many respondents stated that the intent of Opinion No. 28 [section 2071] was to apply one overall estimated annual effective tax rate to "ordinary" income for the consolidated reporting entity. Several respondents stated that interrelationships between jurisdictions would make the use of separate rates impractical. Paragraph .22 was modified to indicate that one overall estimated annual effective tax rate shall be used with the two exceptions described in that paragraph and discussed further in paragraphs .84 and .85 below.

.84 If an enterprise that operates in multiple jurisdictions has losses in one or more of the jurisdictions and realization of the tax benefit of the losses is not assured beyond any reasonable doubt, use of one overall estimated annual effective tax rate can result in the recognition of tax benefits for the year-to-date for those losses. Paragraph 20 of Opinion No. 28 [section 2071.20] states that "the tax effects of losses that arise in the early portion of a fiscal year (in the event carryback of such losses is not possible) should be recognized only when realization is assured beyond any reasonable doubt. . . ." Accordingly, a separate computation is necessary for the tax (or benefit) applicable to "ordinary" income (or loss) in those jurisdictions.

.85 The effect of translating foreign currency financial statements may make it difficult to estimate an annual effective foreign currency tax rate in dollars. For example, depreciation is translated at historical exchange rates, whereas many transactions included in income are translated at current period average exchange rates. If depreciation is large in relation to earnings, a change in the estimated "ordinary" income that does not change the effective foreign currency tax rate can change the effective tax rate in the dollar financial statements. This result can occur with no change in exchange rates during the current year if there have been exchange rate changes in past years. If the enterprise is unable to estimate its annual effective tax rate in dollars or is otherwise unable to make a reliable estimate of its "ordinary" income (or loss) or of the related tax (or benefit) for the fiscal year in a jurisdiction, the tax (or benefit) applicable to "ordinary" income (or loss) in that jurisdiction shall be recognized in the interim period in which the "ordinary" income (or loss) is reported, as described in footnote 7 to paragraph .08.

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AC Section 2072

Reporting Accounting Changes in Interim Financial Statements

an amendment of Section 2071
[Source: FASB Statement No. 3.]

December 1974

INTRODUCTION AND BACKGROUND INFORMATION

.01 As a result of numerous inquiries concerning the appropriate procedures for reporting a change to the LIFO method of inventory pricing in interim financial reports, the FASB has examined certain conclusions of *APB Opinion No. 28* [section 2071], "Interim Financial Reporting," with respect to two aspects of reporting accounting changes in interim financial reports:

a) Reporting a cumulative effect type accounting change (as described in *APB Opinion No. 20* [section 1051], "Accounting Changes") including a change to the LIFO method of inventory pricing for which a cumulative effect cannot be determined.

b) Reporting an accounting change made during the fourth quarter of a fiscal year by a company whose securities are publicly traded.

.02 *APB Opinion No. 28* [section 2071] became effective for interim periods relating to fiscal years beginning on or after January 1, 1974, and paragraphs 23-29 of that Opinion set forth standards for reporting accounting changes in interim financial reports. Those paragraphs provide that, in general, an accounting change made in an interim period should be reported in accordance with the provisions of *APB Opinion No. 20* [section 1051].

.03 Paragraphs 9-14 of this Statement establish standards of financial accounting and reporting that address the matters identified in paragraph 1. The Appendices to this Statement contain examples of application of *APB Opinion No. 28* [section 2071] (as amended by this Statement) and the requirements of *APB Opinion No. 20* [section 1051] as they are incorporated by reference in *APB Opinion No. 28* [section 2071].

.04 An Exposure Draft of a proposed Statement on "Reporting Accounting Changes in Interim Financial Statements" was issued on November 11, 1974. Fifty-five letters were received in response to the request for comments. This Statement incorporates a number of changes suggested by those respondents. The principal change is to require that, if an accounting change is made in other than the first interim period of an enterprise's fiscal year, the cumulative effect of the change on retained earnings at the beginning of that year shall be included in the determination of net income of the first interim period of the year of change (by restatement of that period's financial information).

.05 The Board has concluded that it can make an informed decision on the matters identified in paragraph 1 of this Statement without a public hearing. It has also concluded that the effective date in paragraph 16 of this Statement is advisable to permit application of the provisions of this Statement before divergent interpretations of *APB Opinion No. 28* [section 2071] develop in practice.

Cumulative Effect Type Accounting Changes

.06 Paragraph 27 of *APB Opinion No. 28* [section 2071.27] provides that "a change in accounting principle or practice adopted in an interim period that requires an adjustment for the cumulative effect of the change to the beginning of the current fiscal year should be reported in the interim period in a manner similar to that to be followed in the annual report. . . . The effect of the change from the beginning of the annual period to the period of change should be reported as a determinant of net income in the interim period in which the change is made." That paragraph goes on to require, however, that when information is subsequently presented for the period in which the change is made or for pre-change interim periods of that year, that information should be restated to give effect to the accounting change.

.07 As a result of those requirements, if a cumulative effect type accounting change is made, the cumulative effect of the change on retained earnings at the beginning of that fiscal year is a component of net income of the interim period in which the change is adopted. If a change is made in other than the first interim period, since the cumulative effect remains a component of that interim period's income when financial information for that period is subsequently reported, reissued pre-change interim period balance sheets would not reflect the

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cumulative effect of the change on retained earnings at the beginning of the fiscal year on a retroactive basis, whereas reissued pre-change interim period income statements would be restated. In addition, an enterprise may issue interim financial information knowing that the information will subsequently have to be revised. For example, during the second quarter of its fiscal year an enterprise may make an accounting change as of the beginning of that quarter. If, subsequently during that second quarter, the enterprise issues first quarter financial information (perhaps in a report to its securityholders, in a report to a bank, or in a filing with the SEC), that first quarter information would be prepared on the basis of the old accounting principle — not the newly adopted one. When that enterprise later issues second quarter information, both the cumulative effect of the change up to the beginning of the fiscal year and the effect from the beginning of the year to the beginning of the second quarter would be included in the determination of second quarter net income. However, in any subsequent report that separately presents information either for that first quarter or that second quarter, the first quarter information would be retroactively restated on the basis of the newly adopted accounting principle, and the effect of the change from the beginning of the year to the beginning of the second quarter would no longer be included in second quarter net income. Thus the enterprise issued both first and second quarter information that had to be restated in subsequent periods. A similar situation arises if the accounting change were made during the third or fourth quarters.

Fourth Quarter Accounting Changes Made by Publicly Traded Companies

.08 Paragraphs 30-33 of *APB Opinion No. 28* [section 2071.30—.33] set forth special requirements for disclosure of summarized financial data by publicly traded companies (as defined in footnote 1 to that Opinion). Some publicly traded companies are required by paragraph 31 of the Opinion to disclose certain fourth quarter information in a note to the annual financial statements. Information about the effects of an accounting change made during the fourth quarter is not explicitly identified as one of the items for which disclosure is required.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Cumulative Effect Type Accounting Changes Other Than Changes to LIFO

.09 If a cumulative effect type accounting change is made during the *first* interim period of an enterprise's fiscal year, the

cumulative effect of the change on retained earnings at the *beginning of that fiscal year* shall be included in net income of the first interim period (and in last-twelve-months-to-date financial reports that include that first interim period).

.10 If a cumulative effect type accounting change is made in *other than the first* interim period of an enterprise's fiscal year, *no* cumulative effect of the change shall be included in net income of the period of change. Instead, financial information for the pre-change interim periods of the fiscal year in which the change is made shall be restated by applying the newly adopted accounting principle to those pre-change interim periods. The cumulative effect of the change on retained earnings at the *beginning of that fiscal year* shall be included in restated net income of the first interim period of the fiscal year in which the change is made (and in any year-to-date or last-twelve-months-to-date financial reports that include the first interim period). Whenever financial information that includes those pre-change interim periods is presented, it shall be presented on the restated basis.

.11 The following disclosures about a cumulative effect type accounting change shall be made in interim financial reports:

a) In financial reports for the interim period in which the new accounting principle is adopted, disclosure shall be made of the nature of and justification for the change.

b) In financial reports for the interim period in which the new accounting principle is adopted, disclosure shall be made of the effect of the change on income from continuing operations, net income, and related per share amounts for the interim period in which the change is made. In addition, when the change is made in other than the first interim period of a fiscal year, financial reports for the period of change shall also disclose (i) the effect of the change on income from continuing operations, net income, and related per share amounts for each pre-change interim period of that fiscal year and (ii) income from continuing operations, net income, and related per share amounts for each pre-change interim period restated in accordance with paragraph 10 of this Statement.

c) In financial reports for the interim period in which the new accounting principle is adopted, disclosure shall be made of income from continuing operations, net income, and related

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per share amounts computed on a pro forma basis for (i) the interim period in which the change is made and (ii) any interim periods of prior fiscal years for which financial information is being presented. If no financial information for interim periods of prior fiscal years is being presented, disclosure shall be made, in the period of change, of the actual and pro forma amounts of income from continuing operations, net income, and related per share amounts for the interim period of the immediately preceding fiscal year that corresponds to the interim period in which the change is made. In all cases, the pro forma amounts shall be computed and presented in conformity with paragraphs 19, 21, 22, and 25 of *APB Opinion No. 20* [sections 1051.19, 1051.21, 1051.22, and 1051.25].

d) In year-to-date and last-twelve-months-to-date financial reports that include the interim period in which the new accounting principle is adopted, the disclosures specified in the first sentence of subparagraph (b) above and in subparagraph (c) above shall be made.

e) In financial reports for a subsequent (post-change) interim period of the fiscal year in which the new accounting principle is adopted, disclosure shall be made of the effect of the change on income from continuing operations, net income, and related per share amounts for that post-change interim period.

Changes to the LIFO Method of Inventory Pricing and Similar Situations

.12 Paragraph 26 of *APB Opinion No. 20* [section 1051.26] indicates that in rare situations—principally a change to the LIFO method of inventory pricing[1]—neither the cumulative effect of the change on retained earnings at the beginning of the fiscal year in which the change is made nor the pro forma amounts can be computed. In those situations, that paragraph requires an explanation of the reasons for omitting (a) accounting for a cumulative effect and (b) disclosure of pro forma amounts for prior years. If a change of that type is made in the *first* interim period of an enterprise's fiscal year, the disclosures specified in paragraph 11 of this Statement shall be made (except the pro forma amounts for interim periods of prior fiscal years called for by paragraph 11(c) will not be disclosed).

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[1]In making disclosures about changes to the LIFO method, enterprises should be aware of the limitations the Internal Revenue Service has placed on such disclosures.

.13 If the change is made in *other than* the first interim period of an enterprise's fiscal year, the disclosure specified in paragraph 11 of this Statement shall be made (except the pro forma amounts for interim periods of prior fiscal years called for by paragraph 11(c) will not be disclosed) and in addition, financial information for the pre-change interim periods of that fiscal year shall be restated by applying the newly adopted accounting principle to those pre-change interim periods. Whenever financial information that includes those pre-change interim periods is presented, it shall be presented on the restated basis.

Fourth Quarter Accounting Changes Made by Publicly Traded Companies

.14 When a publicly traded company that regularly reports interim information to its securityholders makes an accounting change during the fourth quarter of its fiscal year and does not report the data specified by paragraph 30 of *APB Opinion No. 28* [section 2071.30] in a separate fourth quarter report or in its annual report[2] to its securityholders, the disclosures about the effect of the accounting change on interim periods that are required by paragraphs 23-26 of *APB Opinion No. 28* [section 2071.23—.26] or by paragraphs 9-13 of this Statement, as appropriate, shall be made in a note to the annual financial statements for the fiscal year in which the change is made.

Amendments to Existing Pronouncement

.15 Paragraph 27 of *APB Opinion No. 28* [section 2071.27] is superseded by paragraphs 9-13 of this Statement. Paragraph 31 of that Opinion is amended by this Statement to require the additional disclosures set forth in paragraph 14.

Effective Date

.16 The provisions of this Statement shall apply to accounting changes made in interim periods ending on or after December 31, 1974.

The provisions of this Statement need not be applied to immaterial items.

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[2] See footnote 1.

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Appendix A

REPORTING A CUMULATIVE EFFECT TYPE ACCOUNTING CHANGE (OTHER THAN A CHANGE TO LIFO)

.17 The following are examples of application of *APB Opinion No. 28* [section 2071] (as amended by this Statement) and the requirements of *APB Opinion No. 20* [section 1051] as they are incorporated by reference in *APB Opinion No. 28* [section 2071]. The examples do not encompass all possible circumstances and are not intended to indicate the Board's preference for a particular format.

FACTS

.18 In the year 19x5, ABC Company decides 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.

.19 These examples assume that the effects of the change are limited to the effect on depreciation, incentive compensation, and related income tax provisions and that the effect on inventories is not material. The pro forma amounts have been adjusted for an assumed 10% pre-tax effect of the change on the provisions for incentive compensation and an assumed 50% income tax rate. The per share amounts are computed assuming that throughout the two years 19x4 and 19x5, 1,000,000 shares of common stock were issued and outstanding with no potential dilution. Other data assumed for these examples are:

Period	Net Income on the Basis of Old Accounting Principle (Accelerated Depreciation)	Gross Effect of Change to Straight-Line Depreciation	Gross Effect Less Income Taxes	Net Effect After Incentive Compensation and Related Income Taxes
Prior to first quarter 19x4		$ 20,000	$ 10,000	$ 9,000
First quarter 19x4	$1,000,000	30,000	15,000	13,500
Second quarter 19x4	1,200,000	70,000	35,000	31,500
Third quarter 19x4	1,100,000	50,000	25,000	22,500
Fourth quarter 19x4	1,100,000	80,000	40,000	36,000
Total at beginning of 19x5	$4,400,000	$250,000	$125,000	$112,500
First quarter 19x5	$1,059,500	$ 90,000	$ 45,000	$ 40,500
Second quarter 19x5	1,255,000	100,000	50,000	45,000
Third quarter 19x5	1,150,500	110,000	55,000	49,500
Fourth quarter 19x5	1,146,000	120,000	60,000	54,000
	$4,611,000	$420,000	$210,000	$189,000

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EXAMPLE 1

.20 The change in depreciation method is made in the first quarter of 19x5. The manner of reporting the change in the first quarter of 19x5, with comparative information for the first quarter of 19x4, is as follows:

	Three Months Ended March 31,	
	19x5	19x4
Income before cumulative effect of a change in accounting principle	$1,100,000	$1,000,000
Cumulative effect on prior years (to December 31, 19x4) of changing to a different depreciation method (Note A)	125,000	
Net income	$1,225,000	$1,000,000
Amounts per common share:		
Income before cumulative effect of a change in accounting principle	$1.10	$1.00
Cumulative effect on prior years (to December 31, 19x4) of changing to a different depreciation method (Note A)	.13	
Net income	$1.23	$1.00
Pro forma amounts assuming the new depreciation method is applied retroactively (Note A):		
Net income	$1,100,000	$1,013,500
Net income per common share	$1.10	$1.01

NOTE A: Change in Depreciation Method for Plant Equipment

In the first quarter of 19x5, the method of computing depreciation of plant equipment was changed from the . . . (state previous method) . . . used in prior years, to the straight-line method . . . (state justification for the change in method) . . . and the new method has been applied to equipment acquisitions of prior years. The $125,000 cumulative effect of the change on prior years (after reduction for income taxes of $125,000) is included in income of the first quarter of 19x5. The effect of the change on the first quarter of 19x5 was to increase income before cumulative effect of a change in accounting principle $40,500 ($.04 per share) and net income $165,500 ($.17 per share). The pro forma amounts reflect the effect of retroactive application on depreciation, the change in provisions for incentive compensation that would have been made in 19x4 had the new method been in effect, and related income taxes.

EXAMPLE 2

.21 Assume the same facts as in Example 1, except that the change is made in the third quarter of 19x5.

The manner of reporting the change in the third quarter of 19x5, with year-to-date information and comparative information for similar periods of 19x4, is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	19x5	19x4	19x5	19x4
Income before cumulative effect of a change in accounting principle	$1,200,000	$1,100,000	$3,600,000	$3,300,000
Cumulative effect on prior years (to December 31, 19x4) of changing to a different depreciation method (Note A)			125,000	
Net income	$1,200,000	$1,100,000	$3,725,000	$3,300,000
Amounts per common share:				
Income before cumulative effect of a change in accounting principle	$1.20	$1.10	$3.60	$3.30
Cumulative effect on prior years (to December 31, 19x4) of changing to a different depreciation method (Note A)			.13	
Net income	$1.20	$1.10	$3.73	$3.30
Pro forma amounts assuming the new depreciation method is applied retroactively (Note A):				
Net income	$1,200,000	$1,122,500	$3,600,000	$3,367,500
Net income per common share	$1.20	$1.12	$3.60	$3.37

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NOTE A: Change in Depreciation Method for Plant Equipment

In the third quarter of 19x5, the method of computing depreciation of plant equipment was changed from the . . . (state previous method) . . . used in prior years, to the straight-line method . . . (state justification for the change in method) . . . and the new method has been applied to equipment acquisitions of prior years. The $125,000 cumulative effect of the change on prior years (after reduction for income taxes of $125,000) is included in income of the nine months ended September 30, 19x5. The effect of the change on the three months ended September 30, 19x5 was to increase net income $49,500 ($.05 per share); the effect of the change on the nine months ended September 30, 19x5 was to increase income before cumulative effect of a change in accounting principle $135,000 ($.14 per share) and net income $260,000 ($.26 per share). The pro forma amounts reflect the effect of retroactive application on depreciation, the change in provisions for incentive compensation that would have been made in 19x4 had the new method been in effect, and related income taxes. The effect of the change on the first quarter of 19x5 was to increase income before cumulative effect of a change in accounting principle $40,500 ($.04 per share) to $1,100,000 ($1.10 per share) and net income $165,500 ($.17 per share) to $1,225,000 ($1.23 per share); the effect of the change on the second quarter was to increase net income $45,000 ($.04 per share) to $1,300,000 ($1.30 per share).

Alternatively, the last sentence of Note A could be replaced with the following tabular disclosure:

The effect of the change on the first and second quarters of 19x5 is as follows:

	Three Months Ended	
	March 31, 19x5	June 30, 19x5
Net income as originally reported*	$1,059,500	$1,255,000
Effect of change in depreciation method	40,500	45,000
Income before cumulative effect of a change in accounting principle	1,100,000	1,300,000
Cumulative effect on prior years (to December 31, 19x4) of changing to a different depreciation method	125,000	
Net income as restated	$1,225,000	$1,300,000
Per share amounts:		
Net income as originally reported*	$1.06	$1.26
Effect of change in depreciation method	.04	.04
Income before cumulative effect of a change in accounting principle	1.10	1.30
Cumulative effect on prior years (to December 31, 19x4) of changing to a different depreciation method	.13	
Net income as restated	$1.23	$1.30

* Disclosure of net income as originally reported is not required.

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Appendix B

REPORTING A CHANGE TO THE LIFO METHOD OF INVENTORY PRICING

.22 The following are examples of application of *APB Opinion No. 28* [section 2071] (as amended by this Statement) and the requirements of *APB Opinion No. 20* [section 1051] as they are incorporated by reference in *APB Opinion No. 28* [section 2071]. The examples do not encompass all possible circumstances and are not intended to indicate the Board's preference for a particular format.

FACTS

.23 In the year 19x5, XYZ Company decides to change to the LIFO method of inventory pricing. These examples assume that the effects of the change are limited to the effect on inventory, incentive compensation, and related income tax provisions. A 10% pre-tax effect of the change on incentive compensation and a 50% income tax rate are assumed. The per share amounts are computed assuming that throughout 19x4 and 19x5, 1,000,000 shares of common stock were issued and outstanding with no potential dilution. Other data assumed for these examples are:

Period	Net Income on the Basis of Old Accounting Principle	Gross Effect of Change to LIFO	Net Effect After Incentive Compensation and Income Taxes
First quarter 19x5	$1,095,500	$(90,000)	$(40,500)
Second quarter 19x5	1,295,000	(100,000)	(45,000)
Third quarter 19x5	1,194,500	(110,000)	(49,500)
Fourth quarter 19x5	1,194,000	(120,000)	(54,000)
	$4,779,000	$(420,000)	$(189,000)

EXAMPLE 3

.24 The change to LIFO is made in the first quarter of 19x5. The manner of reporting the change in the first quarter of 19x5, with comparative information for the first quarter of 19x4, is as follows:

	Three Months Ended March 31,	
	19x5	19x4
Net income (Note A)	$1,055,000	$1,000,000
Net income per common share (Note A)	$1.06	$1.00

NOTE A: Change to LIFO Method of Inventory Pricing

In the first quarter of 19x5, the Company changed its method of inventory pricing from . . . (state previous method) . . . used previously to the LIFO method because . . . (state justification for change and reasons for not disclosing a cumulative effect on, and pro forma amounts for, prior periods). The effect of the change on the first quarter of 19x5 was to decrease net income $40,500 ($.04 per share).

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EXAMPLE 4

.25 Assume the same facts as in Example 3, except that the change is made in the third quarter of 19x5.

The manner of reporting the change in the third quarter of 19x5, with year-to-date information and comparative information for similar periods of 19x4, is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	19x5	19x4	19x5	19x4
Net income (Note A)	$1,145,000	$1,200,000	$3,450,000	$3,400,000
Net income per common share (Note A)	$1.15	$1.20	$3.45	$3.40

NOTE A: Change to LIFO Method of Inventory Pricing

In the third quarter of 19x5, the Company changed its method of inventory pricing from . . . (state previous method) . . . used previously to the LIFO method because . . . (state justification for change and reasons for not disclosing a cumulative effect on, and pro forma amounts for, prior periods). The effect of the change on the three months and nine months ended September 30, 19x5 was to decrease net income $49,500 ($.05 per share) and $135,000 ($.14 per share), respectively. The effect of the change on the first and second quarters of 19x5 was to decrease net income $40,500 ($.04 per share) to $1,055,000 ($1.06 per share) and $45,000 ($.05 per share) to $1,250,000 ($1.25 per share), respectively.

Alternatively, the last sentence of Note A could be replaced with the following tabular disclosure:

The effect of the change on the first and second quarters of 19x5 is as follows:

	Three Months Ended	
	March 31, 19x5	June 30, 19x5
Net income as originally reported*	$1,095,500	$1,295,000
Effect of change to LIFO method of inventory pricing	(40,500)	(45,000)
Net income as restated	$1,055,000	$1,250,000
Per share amounts:		
Net income as originally reported*	$1.10	$1.30
Effect of change to LIFO method of inventory pricing	(.04)	(.05)
Net income as restated	$1.06	$1.25

*Disclosure of net income as originally reported is not required.

The next page is 8283.

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AC Section 2081

*Financial Reporting for Segments of a Business Enterprise**

[Source: FASB Statement No. 14, as amended.]

December 1976

INTRODUCTION

.001 In recent years, many business enterprises have broadened the scope of their activities into different industries, foreign countries, and markets. This Statement requires that the financial statements of a business enterprise (hereinafter enterprise) include information about the enterprise's operations in different industries, its foreign operations and export sales, and its major customers. This Statement also requires that an enterprise operating predominantly or exclusively in a single industry identify that industry.

.002 Appendix A contains background information. Appendix B sets forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others. Appendix C describes two systems that have been developed for classifying business activities, and Appendix D describes a number of factors to be considered in grouping products and services by industry lines. An illustration of applying paragraph .015(b) is presented in Appendix E, and illustrations of the disclosures required by this Statement are presented in Appendix F.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Inclusion in Financial Statements

.003 When an enterprise issues a complete set of financial statements that present financial position at the end of the enterprise's fiscal year and results of operations and changes in financial posi-

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* See section 2083, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises.*

tion for that fiscal year in conformity with generally accepted accounting principles, those financial statements shall include certain information relating to:

a) The enterprise's operations in different industries—paragraphs .009-.030.

b) Its foreign operations and export sales—paragraphs .031-.038.

c) Its major customers—paragraph .039.

If such statements are presented for more than one fiscal year, the information required by this Statement shall be presented for each such year, except as provided in paragraph .041.

[.004] [Superseded, effective December 1, 1977, by FASB Statement No. 18.] (See section 2082.)

Purpose of Segment Information

.005 The purpose of the information required to be reported by this Statement is to assist financial statement users in analyzing and understanding the enterprise's financial statements by permitting better assessment of the enterprise's past performance and future prospects. As noted in paragraph .076, information prepared in conformity with this Statement may be of limited usefulness for comparing a segment of one enterprise with a similar segment of another enterprise.

Accounting Principles Used in Preparing Segment Information

.006 The information required to be reported by this Statement is a disaggregation of the consolidated financial information [1] included

[1] The term "consolidated financial information" is used herein to refer to aggregate information relating to an enterprise as a whole whether or not the enterprise has consolidated subsidiaries.

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in the enterprise's financial statements. The accounting principles underlying the disaggregated information should be the same accounting principles as those underlying the consolidated information, except that most intersegment transactions that are eliminated from consolidated financial information are included in segment information (see paragraph .008). For example, a segment for which information is required to be reported by this Statement may include a consolidated subsidiary that prepares separate financial statements. Amounts reported in the subsidiary's financial statements sometimes differ from amounts included in consolidation for reasons other than intersegment transactions, for instance, because the subsidiary was acquired in a business combination accounted for by the purchase method. In that event, the segment information required to be reported by this Statement with respect to the consolidated financial statements shall be based on the amounts included in consolidation, not on the amounts reported in the subsidiary's financial statements.

.007 Enterprises are not required by this Statement to disaggregate financial information pertaining to unconsolidated subsidiaries or other unconsolidated investees. Unconsolidated subsidiaries and investments in corporate joint ventures and 50 percent or less owned companies are normally accounted for by the equity method, and financial information about equity method investees is required to be disclosed in the investor's financial statements in accordance with paragraph 20 of *APB Opinion No. 18* [section 5131.20]. "The Equity Method of Accounting for Investments in Common Stock." In addition, *ARB No. 43,* Chapter 12 [section 1081], "Foreign Operations and Foreign Exchange," requires the disclosure of certain financial information about foreign subsidiaries of an enterprise. This Statement does not amend those disclosure requirements. However, in addition to those disclosures, identification shall be made of both the industries and the geographic areas in which the equity method investees operate. Also, paragraph .027(c) of this Statement requires special disclosures with respect to an equity method investee whose operations are vertically integrated with those of a reportable segment of the enterprise. Disaggregation of financial information pertaining to unconsolidated subsidiaries and other unconsolidated equity method investees is encouraged when that is considered to be desirable for an understanding of the enterprise's operations. When a complete set of financial statements that present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles is presented for a subsidiary, corporate joint venture,

or 50 percent or less owned investee, each such entity is considered to be an enterprise as that term is used in this Statement and thus is subject to its requirements whether those financial statements are issued separately or included in another enterprise's financial report.

.008 Transactions between a parent and its subsidiaries or between two subsidiaries are eliminated in preparing consolidated financial statements (see paragraph 6 of *ARB No. 51* [section 2051.07], "Consolidated Financial Statements"). In preparing the information required to be reported by this Statement, however, transactions between the segments of an enterprise shall be included in the segment information. Thus, for example, revenue reported for a segment includes both sales to unaffiliated customers (i.e., customers outside the enterprise) and intersegment sales or transfers. Similarly, expenses relating both to sales to unaffiliated customers and to intersegment sales or transfers are deducted in measuring a segment's profitability. Exceptions to the general rule that intersegment transactions are not eliminated from segment information are provided in paragraphs .010(c)-.010(e) for certain intersegment advances and loans and related interest revenue and expense. Paragraphs .030 and .038 require reconciliation of segment information with amounts reported in consolidated financial statements.

Information about an Enterprise's Operations in Different Industries

.009 The financial statements of an enterprise shall include certain information about the industry segments of the enterprise. Criteria for determining industry segments for which information shall be reported are in paragraphs .011-.021. The type of information to be presented for each reportable industry segment is specified in paragraphs .022-.027. Requirements for presenting that information in financial statements are in paragraphs .028-.030.

Definitions

.010 Certain terms are defined for purposes of this Statement as follows:

a) *Industry segment.*[2] A component of an enterprise engaged in providing a product or service or a group of related products

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[2] The meaning of the term "industry segment" as it is used in this Statement is different from the use of the term "segment" in pronouncements of the Cost Accounting Standards Board.

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and services primarily to unaffiliated customers (i.e., customers outside the enterprise) for a profit.[3] By defining an industry segment in terms of products and services that are sold primarily to unaffiliated customers, this Statement does not require the disaggregation of the vertically integrated operations of an enterprise.

b) *Reportable segment.* An industry segment (or, in certain cases, a group of two or more closely related industry segments—see paragraph .019) for which information is required to be reported by this Statement.

c) *Revenue.* The revenue of an industry segment includes revenue both from sales[4] to unaffiliated customers (i.e., revenue from customers outside the enterprise as reported in the enterprise's income statement) and from intersegment sales or transfers, if any, of products and services similar to those sold to unaffiliated customers.[5] Interest from sources outside the enterprise and interest earned on intersegment trade receivables is included in revenue if the asset on which the interest is earned is included among the industry segment's identifiable assets (see paragraph .010(e)), but interest earned on advances or loans to other industry segments is not included.[6] For purposes of this Statement, revenue from intersegment sales or transfers shall be accounted for on the basis used by the enterprise to price the intersegment sales or transfers.

d) *Operating profit or loss.* The operating profit or loss of an industry segment is its revenue as defined in paragraph .010(c)

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[3] In some industries, it is normal practice for an enterprise to purchase and sell substantially identical commodities to minimize transportation or other costs. In those situations, sales and purchases of substantially identical commodities shall be netted for the purpose of determining whether a product or service or a group of related products and services is sold primarily to unaffiliated customers. Although those sales and purchases are netted for the purpose of identifying an industry segment, it is not intended that this rule change an enterprise's accounting practice with respect to determining the revenue of the enterprise or any of its industry segments.

[4] For convenience, the term "sales" is used in this Statement to include the sale of a product, the rendering of a service, and other types of transactions by which revenue is earned.

[5] Intersegment billings for the cost of shared facilities or other jointly incurred costs do not represent intersegment sales or transfers as that term is used in this Statement.

[6] Interest earned on advances or loans to other industry segments is included in computing the operating profit or loss of an industry segment whose operations are principally of a financial nature (e.g., banking, insurance, leasing, or financing).

minus all operating expenses. As used herein, operating expenses include expenses that relate to both revenue from sales to unaffiliated customers and revenue from intersegment sales or transfers; those operating expenses incurred by an enterprise that are not directly traceable to an industry segment shall be allocated on a reasonable basis among those industry segments for whose benefit the expenses were incurred (see paragraph .024). For purposes of this Statement, intersegment purchases shall be accounted for on the same basis as intersegment sales or transfers (i.e., on the basis used by the enterprise to price the intersegment sales or transfers—see the last sentence of paragraph .010(c)). None of the following shall be added or deducted, as the case may be, in computing the operating profit or loss of an industry segment: revenue earned at the corporate level and not derived from the operations of any industry segment; general corporate expenses;[7] interest expense;[8] domestic and foreign income taxes; equity in income or loss from unconsolidated subsidiaries and other unconsolidated investees; gain or loss on discontinued operations (as defined in *APB Opinion No. 30* [section 2012], "Reporting the Results of Operations"); extraordinary items; minority interest; and the cumulative effect of a change in accounting principles (see *APB Opinion No. 20* [section 1051], "Accounting Changes").

e) *Identifiable assets.* The identifiable assets of an industry segment are those tangible and intangible enterprise assets that are used by the industry segment, including (i) assets that are used exclusively by that industry segment and (ii) an allocated portion of assets used jointly by two or more industry segments. Assets used jointly by two or more industry segments shall be allocated among the industry segments on a reasonable basis. Because the assets of an industry segment that transfers products or services to another industry segment are not used

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[7] Some of the expenses incurred at an enterprise's central administrative office may not be general corporate expenses, but rather may be operating expenses of industry segments that should therefore be allocated to those industry segments. The nature of an expense rather than the location of its incurrence shall determine whether it is an operating expense. Only those expenses identified by their nature as operating expenses shall be allocated as operating expenses in computing an industry segment's operating profit or loss.

[8] Interest expense is deducted in computing the operating profit or loss of an industry segment whose operations are principally of a financial nature (e.g., banking, insurance, leasing, or financing).

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in the operations of the receiving segment, no amount of those assets shall be allocated to the receiving segment. Assets that represent part of an enterprise's investment in an industry segment, such as goodwill, shall be included in the industry segment's identifiable assets.[9] Assets maintained for general corporate purposes (i.e., those not used in the operations of any industry segment) shall not be allocated to industry segments. The identifiable assets of an industry segment shall not include advances or loans to or investments in another industry segment, except that advances or loans to other industry segments shall be included in the identifiable assets of a financial segment because the income therefrom is included in computing the financial segment's operating profit or loss (see footnote 6). Asset valuation allowances such as the following shall be taken into account in computing the amount of an industry segment's identifiable assets: allowance for doubtful accounts, accumulated depreciation, and marketable securities valuation allowance.

Determining Reportable Segments

.011 The reportable segments of an enterprise shall be determined by (a) identifying the individual products and services from which the enterprise derives its revenue, (b) grouping those products and services by industry lines into industry segments (see paragraphs .012-.014), and (c) selecting those industry segments that are significant with respect to the enterprise as a whole (see paragraphs .015-.021).

Grouping Products and Services by Industry Lines

.012 Several systems have been developed for classifying business activities, such as the Standard Industrial Classification (SIC) and the Enterprise Standard Industrial Classification (ESIC). (The SIC and ESIC systems are described in Appendix C to this Statement.) The Board has examined those systems and has judged that none is, by itself, suitable to determine industry segments for purposes of this Statement. Moreover, although certain characteristics can be identified that assist in differentiating among industries (such as those discussed in Appendix D to this Statement), no single set of characteristics is universally applicable in determining the industry segments of all enterprises, nor is any single characteristic deter-

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[9] Any related depreciation or amortization expense is deducted in determining the operating profit of the industry segment.

minative in all cases. Consequently, determination of an enterprise's industry segments must depend to a considerable extent on the judgment of the management of the enterprise.

.013 Many enterprises presently accumulate information about revenue and profitability on a less-than-total-enterprise basis for internal planning and control purposes. Frequently, that type of information is maintained by profit centers for individual products and services or for groups of related products and services, particularly with respect to an enterprise's domestic operations. The term "profit center" is used in this Statement to refer only to those components of an enterprise *that sell primarily to outside markets* and *for which information about revenue and profitability is accumulated.* An enterprise's existing profit centers—the smallest units of activity for which revenue and expense information is accumulated for internal planning and control purposes—represent a logical starting point for determining the enterprise's industry segments. If an enterprise's existing profit centers cross industry lines, it will be necessary to disaggregate its existing profit centers into smaller groups of related products and services (except as provided in paragraph .014). If an enterprise operates in more than one industry but does not presently accumulate any information on a less-than-total-enterprise basis (i.e., its only profit center is the enterprise as a whole), it shall disaggregate its operations along industry lines (except as provided in paragraph .014).

.014 Industry segmentation on a worldwide basis is a desirable objective but it may be impracticable for some enterprises. To the extent that revenue and profitability information is accumulated along industry lines for an enterprise's foreign operations, as defined in paragraph .031, or that it would be practicable to do so, industry segments shall be determined on a worldwide basis. To the extent that it is impracticable to disaggregate part or all of its foreign operations along industry lines, the enterprise shall disaggregate along industry lines its domestic operations and its foreign operations for which disaggregation is practicable and shall treat the aggregate of its foreign operations for which disaggregation is not practicable as a single industry segment. When that segment qualifies as a reportable industry segment (see paragraphs .015-.021), disclosure shall be made of the types of industry operations included in the foreign operations that have not been disaggregated.

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Selecting Reportable Segments

.015 Each industry segment that is significant to an enterprise as a whole shall be identified as a reportable segment. For purposes of this Statement, an industry segment shall be regarded as significant—and therefore identified as a reportable segment (see paragraph .016)—if it satisfies one or more of the following tests. The tests shall be applied separately for each fiscal year for which financial statements are presented, except as provided in paragraph .041.

a) Its revenue (including both sales to unaffiliated customers and intersegment sales or transfers) is 10 percent or more of the combined revenue (sales to unaffiliated customers and intersegment sales or transfers) of all of the enterprise's industry segments.

b) The absolute amount of its operating profit or operating loss is 10 percent or more of the greater, in absolute amount, of:

   (i) The combined operating profit of all industry segments that did not incur an operating loss, or

   (ii) The combined operating loss of all industry segments that did incur an operating loss. (Appendix E illustrates the application of paragraph .015(b).)

c) Its identifiable assets are 10 percent or more of the combined identifiable assets of all industry segments.

Revenue, operating profit or loss, and identifiable assets relating to those foreign operations that have not been disaggregated along industry lines on grounds of impracticability (see paragraph .014) shall be included in computing the combined revenue, combined operating profit or operating loss, and combined identifiable assets of the enterprise's industry segments.

.016 The results of applying the percentage tests in paragraph .015 shall be evaluated from the standpoint of interperiod comparability before final determination of an enterprise's reportable segments is made. For instance, interperiod comparability would most likely require that an industry segment that has been significant in the past and is expected to be significant in the future be regarded as a reportable segment even though it fails to satisfy the tests in paragraph .015 in the current year. Conversely, a relatively insignificant industry segment may happen to satisfy the tests in paragraph .015 in the current fiscal year because its revenue

or operating profit or loss is abnormally high or the combined revenue or operating profit or loss of all industry segments is abnormally low. In that case, it may be inappropriate to regard it as a reportable segment. Appropriate explanation of such circumstances shall be included as a part of the enterprise's segment information.

.017 The reportable segments of an enterprise shall represent a substantial portion of the enterprise's total operations. The following test shall be applied to determine whether a substantial portion of an enterprise's operations is explained by its segment information: The combined revenue from sales to unaffiliated customers of all reportable segments (that is, revenue not including intersegment sales or transfers) shall constitute at least 75 percent of the combined revenue from sales to unaffiliated customers of all industry segments. The test shall be applied separately for each fiscal year for which financial statements are presented, except as provided in paragraph .041. Revenue relating to those foreign operations that have not been disaggregated along industry lines on grounds of impracticability shall be included in the denominator of the computation required by this paragraph and will be included in the numerator if those operations have been identified (in accordance with paragraphs .014 and .015) as a reportable segment.

.018 If the industry segments identified as reportable in accordance with paragraphs .015 and .016 do not satisfy the 75-percent test in paragraph .017, additional industry segments shall be identified as reportable segments (subject to the provisions of paragraph .019) until the 75-percent test is met.

.019 The Board recognizes the need for a practical limit to the number of industry segments for which an enterprise reports information; beyond that limit, segment information may become overly detailed. Without attempting to define that limit precisely, the Board suggests that as the number of industry segments that would be identified as reportable segments in accordance with paragraphs .015-.018 increases above 10, the question of whether a practical limit has been reached comes increasingly into consideration, and combining the most closely related industry segments into broader reportable segments may be appropriate. Combinations shall be made, however, only to the extent necessary to contain the number of reportable segments within practical limits while still meeting the 75-percent test.

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.020 An enterprise may operate exclusively in a single industry or a dominant portion of an enterprise's operations may be in a single industry segment with the remaining portion in one or more other industry segments. The Board has concluded that the disclosures required by paragraphs .022-.030 of this Statement need not be applied to a dominant industry segment, except that the financial statements of an enterprise that operates predominantly or exclusively in a single industry shall identify that industry. An industry segment may be regarded as dominant if its revenue, operating profit or loss, and identifiable assets (as defined in paragraphs .010(c)-(e)) each constitute more than 90 percent of related combined totals for all industry segments, and no other industry segment meets any of the 10-percent tests in paragraph .015.

.021 Paragraphs .011-.020 and the guidelines for grouping products and services into industry segments set forth in Appendix D are not intended to prohibit a more detailed disaggregation if that is considered to be desirable for an understanding of the enterprise's operations.

Information to Be Presented

.022 The following shall be presented for each of an enterprise's reportable segments determined in accordance with paragraphs .011-.021 (including those foreign operations that have not been disaggregated along industry lines on grounds of impracticability —see paragraph .014) and in the aggregate for the remainder of the enterprise's industry segments not deemed reportable segments:

a) Revenue information as set forth in paragraph .023.
b) Profitability information as set forth in paragraphs .024 and .025.
c) Identifiable assets information as set forth in paragraph .026.
d) Other related disclosures as set forth in paragraph .027.

In addition, the types of products and services from which the revenue of each reportable segment is derived shall be identified, and the accounting policies relevant to the information reported for industry segments shall be described to the extent not adequately explained by the disclosures of the enterprise's accounting policies required by *APB Opinion No. 22* [section 2045], "Disclosure of Accounting Policies." Presentation of additional information for some or all of an enterprise's reportable segments beyond that specified in paragraphs .023-.027 may be considered to be desirable, and this Statement does not preclude those additional disclosures.

.023 *Revenue.* Sales to unaffiliated customers and sales or transfers to other industry segments of the enterprise shall be separately disclosed in presenting revenue of a reportable segment. As indicated in paragraph .010(c), for purposes of this Statement sales or transfers to other industry segments shall be accounted for on the basis used by the enterprise to price the intersegment sales or transfers. The basis of accounting for intersegment sales or transfers shall be disclosed. If the basis is changed, disclosure shall be made of the nature of the change and its effect on the reportable segments' operating profit or loss in the period of change.

.024 *Profitability.* Operating profit or loss as defined in paragraph .010(d) shall be presented for each reportable segment. As part of its segment information, an enterprise shall explain the nature and amount of any unusual or infrequently occurring items (see paragraph 26 of *APB Opinion No. 30* [section 2012.26]) reported in its consolidated income statement that have been added or deducted in computing the operating profit or loss of a reportable segment in accordance with paragraph .010(d). Methods used to allocate operating expenses among industry segments in computing operating profit or loss should be consistently applied from period to period (but, if changed, disclosure shall be made of the nature of the change and its effect on the reportable segments' operating profit or loss in the period of change).

.025 *Other profitability information.* In addition to presenting operating profit or loss as required by paragraph .024, an enterprise may choose to present some other measure of profitability for some or all of its segments. If the enterprise elects to present a measure of contribution to operating profit or loss, the enterprise shall describe the differences between contribution and operating profit or loss. If the enterprise elects to present net income or a measure of profitability between operating profit or loss and net income, the nature and amount of each category of revenue or expense that was added or deducted and the methods of allocation, if any, shall be disclosed. Those methods should be consistently applied from period to period (but, if changed, disclosure shall be made of the nature and effect of the change in the period of change).

.026 *Identifiable assets.* The aggregate carrying amount of identifiable assets as defined in paragraph .010(e) shall be presented for each reportable segment.

.027 *Other related disclosures.* Disclosures relating to the information for reportable segments shall be made as follows:

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a) Disclosure shall be made of the aggregate amount of depreciation, depletion, and amortization expense for each reportable segment.

b) Disclosure shall be made of the amount of each reportable segment's capital expenditures, i.e., additions to its property, plant, and equipment.

c) For each reportable segment disclosure shall be made of the enterprise's equity in the net income from and investment in the net assets of unconsolidated subsidiaries and other equity method investees whose operations are vertically integrated with the operations of that segment. Disclosure shall also be made of the geographic areas in which those vertically integrated equity method investees operate.

d) Paragraph 17 of *APB Opinion No. 20* [section 1051.17] requires that the effect on income of a change in accounting principle be disclosed in the financial statements of an enterprise in the period in which the change is made. Disclosure shall also be made of the effect of the change on the operating profit of reportable segments in the period in which the change is made.[10]

Methods of Presentation

.028 Information about the reportable segments of a business enterprise shall be included in the enterprise's financial statements in any of the following ways:

a) Within the body of the financial statements, with appropriate explanatory disclosures in the footnotes to the financial statements.

b) Entirely in the footnotes to the financial statements.

c) In a separate schedule that is included as an integral part of the financial statements. If, in a report to securityholders, that schedule is located on a page that is not clearly a part of the financial statements, the schedule shall be referenced in the financial statements as an integral part thereof.

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[10] The pro forma effects of retroactive application, which are required to be disclosed on a consolidated basis by paragraph 21 of *APB Opinion No. 20* [section 1051.21], need not be disclosed for individual reportable segments. Also, the pro forma supplemental information relating to a business combination accounted for by the purchase method required to be presented by paragraph 96 of *APB Opinion No. 16* [section 1091.96], "Business Combinations," need not be presented for individual reportable segments.

.029 Financial information such as revenue, operating profit or loss, and identifiable assets of reportable segments shall be presented as dollar amounts. Corresponding percentages may be shown in addition to dollar amounts.

.030 The information required to be presented by paragraphs .022-.027 for individual reportable segments and in the aggregate for industry segments not deemed reportable shall be reconciled to related amounts in the financial statements of the enterprise as a whole, as follows: revenue shall be reconciled to revenue reported in the consolidated income statement, and operating profit or loss shall be reconciled to pretax income from continuing operations (before gain or loss on discontinued operations, extraordinary items, and cumulative effect of a change in accounting principle) in the consolidated income statement. Also, identifiable assets shall be reconciled to consolidated total assets, with assets maintained for general corporate purposes separately identified in the reconciliation. An illustration is presented in Appendix F to this Statement.

Information about Foreign Operations and Export Sales

.031 The financial statements of an enterprise shall include information about its foreign operations. The features that identify an operation as foreign vary among enterprises. Thus, the identification of foreign operations will depend on the facts and circumstances of the particular enterprise. For purposes of this Statement, an enterprise's foreign operations include those revenue-producing operations (except for unconsolidated subsidiaries and other unconsolidated investees (see paragraph .007)) that (a) are located outside of the enterprise's home country (the United States for U. S. enterprises)[11] and (b) are generating revenue either from sales to unaffiliated customers or from intraenterprise sales or transfers between geographic areas.[12] Similarly, an enterprise's

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[11] An enterprise whose home country is other than the United States but that prepares financial statements in conformity with U.S. generally accepted accounting principles shall classify operations outside of its home country as foreign operations.

[12] Difficulties may arise in classifying the activities of certain types of enterprises. The following examples may provide useful guidelines: (1) Determination of whether the employment of an enterprise's mobile assets, such as off-shore drilling rigs or ocean-going vessels, constitutes foreign operations should depend on whether such assets are normally identified with operations located and generating revenue from outside the home country. If they are normally identified with the enterprise's foreign operations, revenue generated from abroad would be considered foreign revenue. If they are

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domestic operations include those revenue-producing operations of the enterprise located in the enterprise's home country that generate revenue either from sales to unaffiliated customers or from intraenterprise sales or transfers between geographic areas. Operations, either domestic or foreign (and regardless of whether part of a branch or a division of the enterprise or part of a consolidated subsidiary), should have identified with them the revenues generated by those operations, the assets employed in or associated with generating those revenues, and the costs and expenses incurred in generating those revenues or employing those assets.

.032 The information specified in paragraph .035 shall be presented for (1) an enterprise's foreign operations, either in the aggregate or, if appropriate under paragraph .033, by geographic area, and (2) its domestic operations,[13] if either of the following conditions is met:

a) Revenue generated by the enterprise's foreign operations from sales to unaffiliated customers is 10 percent or more of consolidated revenue as reported in the enterprise's income statement.

b) Identifiable assets of the enterprise's foreign operations are 10 percent or more of consolidated total assets as reported in the enterprise's balance sheet.

.033 If an enterprise's foreign operations are conducted in two or more geographic areas as defined in paragraph .034, the information specified in paragraph .035 shall be presented separately for each significant foreign geographic area, and in the aggregate for all other foreign geographic areas not deemed significant. A geographic area shall be regarded as *significant,* for the purpose of applying this paragraph, if its revenue from sales to unaffiliated customers or its identifiable assets are 10 percent or more of related consolidated amounts.

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normally identified with the enterprise's domestic operations, revenue generated from abroad would be considered export sales; (2) Services rendered by the foreign offices of a service enterprise, such as a consulting firm, having offices or facilities located both in the home country and in foreign countries would be considered foreign operations, and the revenue should be considered foreign revenue. Revenue generated abroad from services provided by domestic offices should be considered export sales.

[13] Separate information about domestic operations need not be presented if domestic operations' revenue from sales to unaffiliated customers and domestic operations' identifiable assets are less than 10 percent of related consolidated amounts.

.034 For purposes of this Statement, foreign *geographic areas* are individual countries or groups of countries as may be determined to be appropriate in an enterprise's particular circumstances. No single method of grouping the countries in which an enterprise operates into the geographic areas can reflect all of the differences among international business environments. Each enterprise shall group its foreign operations on the basis of the differences that are most important in its particular circumstances. Factors to be considered include proximity, economic affinity, similarities in business environments, and the nature, scale, and degree of interrelationship of the enterprise's operations in the various countries.

.035 The following information shall be presented for an enterprise's foreign operations and for its domestic operations as appropriate in accordance with paragraphs .032-.034:

a) Revenue as defined in paragraph .010(c), with sales to unaffiliated customers and sales or transfers between geographic areas shown separately. For purposes of this Statement, intraenterprise sales or transfers between geographic areas shall be accounted for on the basis used by the enterprise to price the intraenterprise sales or transfers. The basis of accounting for intraenterprise sales or transfers shall be disclosed. If the basis is changed, disclosure shall be made of the nature of the change and its effect in the period of change.

b) Operating profit or loss as defined in paragraph .010(d) *or* net income *or* some other measure of profitability between operating profit or loss and net income. A common level of profitability shall be reported for all geographic areas, although an enterprise may choose to report additional profitability information for some or all of its geographic areas of operations.

c) Identifiable assets as defined in paragraph .010(e).

.036 With respect to an enterprise's *domestic* operations, sales to unaffiliated customers include both (a) sales to customers within the enterprise's home country and (b) sales to customers in foreign countries, i.e., export sales. If the amount of export sales from an enterprise's home country to unaffiliated customers in foreign countries is 10 percent or more of total revenue from sales to unaffiliated customers as reported in the enterprise's consolidated income statement, that amount shall be separately reported, in the aggregate and by such geographic areas as are considered appropriate in the circumstances. The disclosure required by this

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paragraph shall be made even if the enterprise is not required by this Statement to report information about its operations in different industries or foreign operations.

.037 Information about the foreign operations and export sales of a business enterprise may be included in the enterprise's financial statements in any of the ways identified in paragraph .028 of this Statement. Financial information shall be presented as U.S. dollar amounts; corresponding percentages may be shown in addition to dollar amounts. The geographic areas into which an enterprise's foreign operations have been disaggregated shall be identified.

.038 The information about revenue, profitability, and identifiable assets required to be presented for foreign operations shall be reconciled to related amounts in the financial statements of the enterprise as a whole, in a manner similar to that described in paragraph .030. An illustration is presented in Appendix F to this Statement.

Information about Major Customers

.039 If 10 percent or more of the revenue of an enterprise is derived from sales to any single customer, that fact and the amount of revenue from each such customer shall be disclosed. (For this purpose, a group of customers under common control shall be regarded as a single customer.) Similarly, if 10 percent or more of the revenue of an enterprise is derived from sales to domestic government agencies in the aggregate or to foreign governments in the aggregate, that fact and the amount of revenue shall be disclosed. The identity of the industry segment or segments making the sales shall be disclosed. The disclosures required by this paragraph shall be made even if the enterprise is not required by this Statement to report information about operations in different industries or foreign operations.

Restatement of Previously Reported Segment Information

.040 When prior period information about an enterprise's reportable industry segments, its foreign operations and export sales, and its major customers is being presented with corresponding information for the current period, the prior period information shall be retroactively restated (at least as far back as the effective date of this Statement—see paragraph .041) in the following circumstances, with appropriate disclosure of the nature and effect of the restatement:

a) When the financial statements of the enterprise as a whole have been retroactively restated, for example, for a change in accounting principle of the type described in paragraphs 27 and 29 of *APB Opinion No. 20* [sections 1051.27 and 1051.29] or for a business combination accounted for by the pooling of interests method.

b) When there has been a change in the way the enterprise's products and services are grouped into industry segments or a change in the way the enterprise's foreign operations are grouped[14] into geographic areas and such changes affect the segment or geographic area information being reported.

Effective Date and Transition

.041 The provisions of this Statement shall be effective for financial statements for fiscal years beginning after December 15, 1976.* Earlier application is encouraged in financial statements for periods beginning before December 16, 1976 that have not previously been issued. Information of the type required by this Statement need not be included in financial statements for periods beginning before the effective date of this Statement that are being presented for comparative purposes with financial statements for periods after the effective date, but if included, that information shall be prepared and presented in conformity with the provisions of this Statement to the extent practicable with appropriate explanation if the information for periods before the effective date is not comparable to that for periods after the effective date. [As amended, effective December 1, 1977, by FASB Statement No. 18.] (See section 2082.) [As amended, effective April 30, 1978, by FASB Statement No. 21.] (See section 2083.)

The provisions of this Statement need not be applied to immaterial items.

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[14] Restatement is not required when an enterprise's reportable segments change as a result of a change in the nature of an enterprise's operations or as a result of applying the tests in paragraphs .015-.020.

[15] Superseded for interim periods, effective December 1, 1977, by FASB Statement No. 18.

* The provisions of this Statement were suspended by *FASB Statement No. 21* [section 2083] and need not be applied by a nonpublic enterprise as defined in that Statement pending further action by the FASB.

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Appendix A

BACKGROUND INFORMATION

.042 Although the authoritative accounting literature has heretofore dealt principally with financial statements prepared on a consolidated or total-enterprise basis, several pronouncements of the Accounting Principles Board and its predecessor, the Committee on Accounting Procedure, have required business enterprises to report information on a less-than-total-enterprise basis in a limited number of areas. For example, Chapter 12 of *ARB No. 43* [section 1081] requires certain disclosures related to an enterprise's foreign operations; *APB Opinion No. 18* [section 5131] requires disclosure of information about companies accounted for by the equity method; and *APB Opinion No. 30* [section 2012] requires information about the discontinued operations of a segment of a business.

.043 Starting in the mid-1960s, a number of professional organizations, including the Financial Analysts Federation, the Financial Executives Research Foundation, and the National Association of Accountants, sponsored research studies to assess the desirability and feasibility of disclosing information for line-of-business segments in external financial reports. Several professional organizations have issued pronouncements that generally support segment reporting, including the APB (its Statement No. 2, "Disclosure of Supplemental Financial Information by Diversified Companies," issued in 1967, urged companies to report segment information voluntarily), the Financial Accounting Policy Committee of the Financial Analysts Federation, the Financial Executives Institute, the Committee on Management Accounting Practices of the National Association of Accountants, and the Accountants International Study Group.

.044 In 1969, the Securities and Exchange Commission issued requirements for reporting line-of-business information in registration statements. In 1970, those requirements were extended to annual reports filed with the SEC on Form 10-K, and in October 1974 they were extended to the annual reports to securityholders of companies filing with the SEC.

.045 In 1973, the New York Stock Exchange issued a "white paper" urging that line-of-business information at least as extensive as that required in SEC Form 10-K be included in annual reports to securityholders.

.046 In 1974, the Federal Trade Commission initiated an annual line-of-business reporting program to enable it to publish aggregate data on corporations engaged in commerce in the United States. Under the FTC program, large manufacturing companies are required to report detailed financial information for each line of business as defined by the FTC.[16]

.047 In recognition of the broadened scope of operations of many business enterprises, the need for disaggregation of enterprise-wide information expressed by many financial statement users, and the variety of present reporting practices in reports to security-holders, in April 1973 the FASB placed on its technical agenda a project on Financial Reporting for Segments of a Business Enterprise.

.048 A task force of 16 persons from industry, government, public accounting, the financial community, and academe was appointed in May 1973 to counsel the Board in preparing a Discussion Memorandum analyzing issues related to the project.

.049 A considerable number of research studies and articles on the subject were available to the Board, many of which were summarized or identified in the Discussion Memorandum. In addition, two research reports were prepared by the FASB staff. One was a survey of the existing reporting practices of 100 companies disclosing segment information in annual reports to shareholders. The other, involving field interviews of corporate executives of 30 companies, was directed primarily at identifying the decision criteria used by management for purposes of internal and external segmentation. Those research reports were included as appendixes to the Discussion Memorandum.

.050 The Board issued the Discussion Memorandum on May 22, 1974 and held a public hearing on the subject on August 1 and 2, 1974. The Board received 144 position papers, letters of comment, and outlines of oral presentations in response to the Discussion Memorandum. Twenty-one presentations were made at the public hearing.

.051 An Exposure Draft of a proposed Statement on "Financial Reporting for Segments of a Business Enterprise" was issued on

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[16] A number of companies are challenging the FTC's line-of-business reporting program through legal proceedings.

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September 30, 1975. The Board received 233 letters of comment on the Exposure Draft.

.052 In June 1976, the Organization for Economic Cooperation and Development (OECD) adopted a "Declaration on International Investment and Multinational Enterprises," recommending certain guidelines for a code of conduct for multinational corporations. Those guidelines include, but are not limited to, the following disclosures:

a) The geographical areas where operations are carried out and the principal activities carried on therein by the parent company and the main affiliates.

b) The operating results and sales by geographical area and the sales in the major lines of business for the enterprise as a whole.

c) Significant new capital investment by geographical area and, as far as practicable, by major lines of business for the enterprise as a whole.

d) The policies followed in respect of intergroup pricing.

e) The accounting policies, including those on consolidation, observed in compiling the published information.

The OECD is made up of representatives of the governments of 24 economically developed nations of Western Europe, North America, Asia, and the South Pacific.

Appendix B

BASIS FOR CONCLUSIONS

.053 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including alternatives considered and reasons for accepting some and rejecting others.

Inclusion in Financial Statements

.054 The Board concluded that information relating to an enterprise's industry segments, foreign operations, export sales, and major customers is useful to analyze and understand the financial statements of the enterprise. Reasons for that conclusion are discussed in paragraphs .055-.074.

.055 The financial statements of an enterprise are usually prepared on a consolidated or total-enterprise basis, aggregating the financial data of the various activities of the enterprise. The principal exception to the rule of consolidation is that financial subsidiaries (such as banks, insurance companies, and finance companies) of a manufacturing company usually are not consolidated (see *ARB No. 51* [section 2051], "Consolidated Financial Statements," especially paragraphs 1-5 [sections 2051.02-.06]). Another exception to the rule of consolidation is that foreign subsidiaries sometimes are not consolidated (see *ARB No. 43*, Chapter 12 [section 1081], "Foreign Operations and Foreign Exchange," especially paragraphs 8 and 9 [sections 1081.08-.09]).

.056 Investors and lenders who acquire equity interests in or extend credit to an enterprise as a whole recognize the importance of consolidated financial statements for reporting the overall performance of the enterprise. At the same time, however, investors, credit grantors, and other financial statement users have indicated that disaggregation of total-enterprise financial data to provide information about the various segments of an enterprise, in addition to aggregate data for the enterprise, is useful to them.

.057 Those financial statement users point out that the evaluation of risk and return is the central element of investment and lending decisions—the greater the perceived degree of risk associated with an investment or lending alternative, the greater is the required rate of return to the investor or lender. If return is defined as expected cash flows to the investor or creditor, the evaluation of risk

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involves assessment of the uncertainty surrounding both the timing and the amount of the expected cash flows to the enterprise, which in turn are indicative of potential cash flows to the investor or creditor. Users of financial statements indicate that uncertainty results, in part, from factors unique to the particular enterprise in which an investment may be made or to which credit may be extended. Uncertainty also results, in part, from factors related to the industries and geographic areas in which the enterprise operates and, in part, from national and international economic and political factors. Investors and lenders analyze factors at all of those levels to evaluate the risk and return associated with an investment or lending alternative.

.058 Information contained in an enterprise's financial statements constitutes an important input to that analysis. Financial statements provide information about conditions, trends, and ratios that assist in predicting cash flows. In analyzing an enterprise, a financial statement user often compares information about the enterprise with information about other enterprises, with industry-wide information, and with national or international economic information in general. Those comparisons are helpful in determining whether a given enterprise's operations may be expected to move with, against, or independently of developments in its industry and in the economy within which it operates.

.059 The broadening of an enterprise's activities into different industries or geographic areas complicates the analysis of conditions, trends, and ratios and, therefore, the ability to predict. The various industry segments or geographic areas of operations of an enterprise may have different rates of profitability, degrees and types of risk, and opportunities for growth. There may be differences in the rates of return on the investment commitment in the various industry segments or geographic areas and in their future capital demands.

.060 Consequently, many financial statement users have said that consolidated financial information, while important, would be more useful if supplemented with disaggregated information to assist them in analyzing the uncertainties surrounding the timing and amount of expected cash flows—and, therefore, the risks—related to an investment in or a loan to an enterprise that operates in different industries or areas of the world. Since the progress and prospects of a diversified enterprise are composites of the progress and prospects of its several parts, financial statement

users regard financial information on a less-than-total-enterprise basis as also important.

.061 Although many business enterprises presently include disaggregated financial information in reports to securityholders, in filings with the Securities and Exchange Commission and in other types of reports, the nature and extent of the information disclosed and the methods of presentation vary, and that information generally is not included in the financial statements.

.062 A few respondents to the Discussion Memorandum and the Exposure Draft contended that information on a less-than-total-enterprise basis is not useful to investors and creditors. They generally argued that investors and lenders who acquire equity interests in or extend credit to an enterprise as a whole should be concerned only with overall enterprise results as reported in its consolidated financial statements. For the reasons expressed in paragraphs .055-.061, however, the Board concluded that investors and creditors find segment information to be useful in analyzing and understanding consolidated statements and therefore in analyzing overall enterprise results.

.063 Although most respondents agreed that information on a less-than-total-enterprise basis is useful for investment and credit decisions, some said that the information should not be included in the financial statements of an enterprise, principally on two grounds:

a) Some said that while segment information may indeed be useful to investors and credit grantors, it is too analytical or interpretive to be classified as accounting information and, thus, does not belong in financial statements.

b) Others said that disaggregated information is not susceptible to the same degree of verifiability as consolidated information.

.064 The Board has given careful consideration to those points of view because inclusion of segment information in financial statements is an important question to be resolved in this project. The Board does not agree that segment information of the type required to be reported by this Statement is too analytical or interpretive to be properly classified as accounting information. The information called for by this Statement is a rearrangement

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(that is, a disaggregation) of information included in an enterprise's consolidated financial statements, as is the information required in the statement of changes in financial position a rearrangement of information reported in or underlying the balance sheet and income statement. Thus, in the Board's judgment, this Statement does not go beyond or enlarge the boundaries of accounting, as some have contended.

.065 As to the question of verifiability, the Board recognizes that disaggregated information is subject to certain limitations and that some of it may not be susceptible to the *same degree* of verifiability as some of the consolidated information. The Board believes, however, that the more critical question to be addressed is whether the disaggregated information is *sufficiently* verifiable to warrant its inclusion in an enterprise's financial statements.

.066 Verifiability is identified in *APB Statement No. 4* [sections 1021-1029], "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," as one of the qualitative objectives of financial accounting. Paragraph 90 [section 1024.18] of that Statement says:

> Verifiable financial accounting information provides results that would be substantially duplicated by independent measurers using the same measurement methods.

That paragraph further states:

> Measurements cannot be completely free from subjective opinions and judgments. The process of measuring and presenting information must use human agents and human reasoning and therefore is not founded solely on an "objective reality." Nevertheless, the usefulness of information is enhanced if it is verifiable, that is, if the attribute or attributes selected for measurement and the measurement methods used provide results that can be corroborated by independent measurers.

.067 Other qualitative objectives set forth in paragraphs 87-93 of *APB Statement No. 4* [section 1024.15-.21] are relevance (described as "the primary qualitative objective"), understandability, neutrality, timeliness, and comparability. Paragraph 94 [section 1024.22] sets forth a final qualitative objective, completeness: "Complete financial accounting information includes all financial accounting data that reasonably fulfill the requirements of the other qualitative objectives." Paragraph 94 [section 1024.22] goes on to say that the qualitative objectives are

not absolute but, rather, must be met "in reasonable degree." That is, an appropriate balance must be maintained among the objectives. For example, some degree of verifiability might have to be sacrificed to improve the relevance of information included in financial statements. In the Board's judgment, the information required to be reported by this Statement meets the objective of verifiability in reasonable degree and is useful for analyzing and understanding an enterprise's financial statements. Moreover, consistency from period to period in the methods by which an enterprise's segment information is prepared and presented is as important as consistency in the application of the accounting principles used in preparing the enterprise's consolidated financial statements. Consistency is a quality that is comprehended by the objective of comparability and is an important aspect of segment reporting that does lend itself to objective verification. For those reasons, the Board concluded that the information required to be reported by this Statement shall be included as an integral part of an enterprise's financial statements.

.068 Some respondents contended that the costs of compiling and processing the type of information called for by this Statement would be overly burdensome to many enterprises, particularly those that are relatively small or whose securities are not publicly traded. Many enterprises, however, already accumulate information similar to the type required to be reported by this Statement for various purposes, such as inclusion in filings with the SEC or internal planning and control. Those enterprises will be able to provide the information required to be reported by this Statement by using existing records.

.069 To lessen the information processing costs to enterprises, the Board has modified the proposal in the Exposure Draft that an enterprise's industry segments be determined by grouping its products and services by industry lines on a *worldwide* basis. Some respondents to the Exposure Draft felt that disaggregation of *foreign* operations was an especially burdensome requirement. Accordingly, this Statement does not require an enterprise to disaggregate its foreign operations to the extent that it is impracticable to do so (see paragraph .014).

.070 In the Exposure Draft, the Board proposed that any requirement to include segment information in financial statements be applicable to all enterprises regardless of their size or whether their securities are publicly traded. The Board continues to believe that there are no fundamental differences in the types of

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decisions and the decision-making processes of those who use the financial statements of smaller or privately held enterprises. Many small or privately held enterprises operate in more than one industry or country or rely significantly on a single or a few major customers or export sales. Information of the type required to be disclosed by this Statement is as important to users of the financial statements of those enterprises as it is to users of the financial statements of larger or publicly held enterprises. Accordingly, this Statement applies to all enterprises, regardless of their size or whether their securities are publicly traded. In reaching that conclusion, the Board neither rejects nor accepts the recommendations of the AICPA Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses, in its August 1976 report.*

.071 Several respondents cited harm to an enterprise's competitive position as a basis for opposing disclosures about industry segments such as this Statement requires. However, the required disclosures about an industry segment are no more detailed or specific than the disclosures typically provided by an enterprise that operates in a single industry. The information required to be reported is intended primarily to permit users to make a better assessment of the past performance and future prospects of an enterprise operating in more than one industry. In the Board's judgment, the information specified by this Statement is useful in making that assessment and, therefore, the information should be required.

.072 Some respondents recommended that the disclosure requirement of this Statement should apply only to annual financial statements and not to any interim financial statements. They said that an interim reporting requirement would be unnecessarily burdensome for many enterprises, particularly those enterprises not heretofore reporting any information of the type required by this Statement. Also, some said that for many enterprises, seasonal fluctuations could cause significant changes from quarter to quarter in the composition of an enterprise's significant industry segments, diminishing the interperiod comparability of segment information. On the other hand, some respondents took the position that segment information should be included in all interim reports,

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* See section 2083, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises.*

including those that present only condensed financial statements or selected financial data and that do not purport to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Those respondents contended that segment information is needed on a more timely basis than annually and that the difficulties of preparing it on an interim basis can be overcome.

[.073] [Superseded, effective December 1, 1977, by FASB Statement No. 18.] (See section 2082.)

.074 A number of respondents to both the Discussion Memorandum and the Exposure Draft said that differences among enterprises in the nature of their operations and in the extent to which components of the enterprise share common facilities, equipment, materials and supplies, or labor force make unworkable the prescription of highly detailed rules and procedures that must be followed by all enterprises. Moreover, they pointed out that differences in the accounting systems of business enterprises are a practical constraint on the degree of specificity with which standards of financial accounting and reporting for disaggregated information can be established. The Board agrees, in general, with those views. In the Board's judgment, the standards set forth in this Statement are sufficiently broad that when they are applied in the context of the objective stated in paragraph .005 they will result in reporting information that is useful in analyzing and understanding the financial statements of an enterprise that operates in different industries or geographic areas or that derives significant revenue from export sales or from a single or a few major customers.

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Purpose of Segment Information

.075 As stated in paragraph .005, the purpose of the information required to be disclosed by this Statement about an enterprise's operations in different industries and different areas of the world and about the extent of its reliance on export sales or major customers is to assist financial statement users in analyzing and understanding the enterprise's financial statements by permitting better assessment of the enterprise's past performance and future prospects. The standards of financial accounting and reporting set forth in paragraphs .003-.040 derive from that purpose.

.076 Information prepared in conformity with those standards may be of limited usefulness for comparing an industry segment of one enterprise with a similar industry segment of another enterprise (i.e., for interenterprise comparison). Interenterprise comparison of industry segments would require a fairly detailed prescription of the basis or bases of disaggregation to be followed by all enterprises, as well as specification of the basis of accounting for intersegment transfers and methods of allocating costs common to two or more segments. As explained in paragraph .074, the Board concluded that it is not appropriate to specify rules and procedures in that degree of detail. Moreover, differences in the bases of accounting for intersegment sales or transfers may also militate against comparison of a segment of an enterprise with extensive intersegment transactions with a similar but autonomous segment of another enterprise or with a unitary enterprise in the same industry.

Information Required to Be Presented

.077 This Statement requires that sales to outsiders be reported separately from sales or transfers to other segments because different types of uncertainties and measurement bases affect those two sources of a reportable segment's revenue. The Exposure Draft proposed that intersegment sales or transfers be accounted for at amounts that are consistent with the objective of determining segment profitability "as realistically as practicable." A number of respondents to the Exposure Draft asked the Board whether, under the draft, intersegment sales or transfers could be accounted for at other than market price, for example, at cost. The Board has concluded that for purposes of this Statement revenue from intersegment sales or transfers shall be accounted

for on whatever basis is used by the enterprise to price the intersegment sales or transfers. No single basis is prescribed or proscribed, but disclosure of the basis of accounting for intersegment sales or transfers is required.

.078 The Exposure Draft proposed that two specified levels of profitability—profit or loss contribution and operating profit or loss—be presented for each reportable segment. The former was defined as revenue less only those operating expenses that were directly traceable to the segment, and the latter was defined (as it is in paragraph .010(d) of this Statement) as revenue less all operating expenses including those allocated to segments on a reasonable basis as well as those that are directly traceable. This Statement, however, requires presentation of only operating profit or loss for reportable segments. In the Exposure Draft, the Board stated that "presenting profitability both before and after allocation of common costs and expenses highlights the extent to which the computation of operating profit or loss is affected by allocations." Although most respondents to the Exposure Draft did not disagree with the requirement that operating profit or loss be disclosed for individual reportable segments, many made the point that it is not practicable to distinguish between those operating expenses that may be said to be *directly traceable* to a segment and those that may be said only to be *allocable.* Some respondents pointed out that traceability often depends on the sophistication of an enterprise's internal recordkeeping system. They noted that traceability depends on the degree to which management of an enterprise's operations is decentralized. Some said that location of incurrence should not govern the attribution of a cost to a particular segment. In view of the problems cited by those who responded to the Exposure Draft, the Board has judged that disclosure of profit or loss contribution should not be required, although this Statement does not proscribe that disclosure if an enterprise wishes to include it.

.079 The Board continues to believe that certain items of revenue and expense either do not relate to segments or cannot *always* be allocated to segments on the basis of objective evidence, and for that reason this Statement does not require that net income be disclosed for reportable segments. Those items are revenue earned at the corporate level and not derived from operations of any industry segment, general corporate expenses, interest expense, domestic and foreign income taxes, and equity in income or loss from unconsolidated subsidiaries and other unconsolidated in-

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vestees. The Board also has not required that the following (which are normally reported net of income taxes) be allocated: extraordinary items, gain or loss on discontinued operations, minority interest, and the cumulative effect of a change in accounting principle. However, paragraph .025 permits additional disclosure of some other measure of profitability for some or all of an enterprise's reportable segments in addition to operating profit or loss, with appropriate disclosure of the nature and amount of each type of item allocated to segments and the method of allocation.

.080 Disclosure of identifiable assets is required, as proposed in the Exposure Draft, to allow financial statement users to assess the relative investment commitment in an enterprise's various segments and to assess the results obtained by the various segments in relation to the investment committed. Some respondents to the Exposure Draft stated that the definition of a segment's identifiable assets as proposed in the Exposure Draft was inconsistent with the proposed definition of a segment's operating profit or loss. They indicated that although allocation of all operating expenses common to two or more segments was required to compute operating profit or loss, allocation of all assets used jointly by two or more segments was not required. In response to that view, the definition of identifiable assets in paragraph .010(e) of this Statement requires that a portion of assets used jointly by two or more industry segments be allocated among the industry segments on a reasonable basis.

.081 To provide information useful in understanding the operating profit or loss and the identifiable assets of an industry segment, paragraph .027 requires disclosure of the aggregate amount of each reportable segment's depreciation, depletion, and amortization and of each reportable segment's capital expenditures. The Exposure Draft had identified certain additional disclosures that "may be important" in certain circumstances, including property, plant, and equipment and related accumulated depreciation, receivables and inventories, loans, deposits, or other monetary amounts, and research and development costs. A number of respondents to the Exposure Draft recommended that the final Statement not identify those disclosures as possibly "important" unless the circumstances were clearly specified. Some said the disclosures were overly detailed and would be of questionable benefit in many cases. The Board found those arguments persuasive and decided to delete them in the final Statement. As stated in paragraph .022, presentation of additional information beyond that required to be reported

by this Statement may be considered to be desirable, and this Statement does not preclude those additional disclosures.

.082 The Exposure Draft proposed that operating profit or loss and identifiable assets of an industry segment or geographic area of consolidated operations include, respectively, the income from and the investment in unconsolidated investees operating in the same industry or the same geographic area. Some respondents stated that, due to the complexity of many enterprises' unconsolidated operations, information called for by the Exposure Draft (i.e., operating profit or loss and identifiable assets) may not be available for some of those investees, especially for those investees in which the enterprise has less than a 50 percent ownership. Other respondents considered it inappropriate to combine the after-tax net income from the unconsolidated investees with operating profit of the consolidated operations. They also considered it inappropriate to combine the investment in the net assets of unconsolidated investees with identifiable assets of the consolidated operations. Such combinations, in their view, would distort the operating results and financial ratios for the industry segments and geographic areas and thereby make the reported information less useful in some cases and misleading in others. The Board found merit in those arguments and accordingly eliminated the requirement. The Board continues to believe, however, that if the operations of an unconsolidated investee are closely related with those of a reportable segment, information about the segment would be incomplete and therefore subject to possible misinterpretation without information about the relationship. For that reason, the Board concluded that disclosure should be made for each reportable segment of the enterprise's equity in the net income from and investment in the net assets of unconsolidated subsidiaries and other equity method investees whose operations are vertically integrated with the operations of that segment.[17] The Board further concluded that disclosure should also be made of the geographic areas in which those vertically integrated equity method investees operate.

Information about Foreign Operations and Export Sales

.083 Several respondents to the Exposure Draft indicated that for their particular industries the distinction between domestic and

[17] If the operations of two or more equity method investees are vertically integrated with a reportable segment, the amounts required to be disclosed may be combined respectively.

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foreign operations was very difficult to make and requested that the Board develop guidelines and allow judgment in determining the *distinction* between the two. The Board's intention had been to allow judgment and that intention is made explicit and guidelines are furnished in paragraph .031 and footnote 12 of this Statement.

.084 With respect to reporting information about an enterprise's operations in different geographic areas, some respondents to the Exposure Draft requested that the Board clarify or elaborate on a number of matters, including (a) whether the Statement would require disclosure of information on an individual country-by-country basis and (b) how should significance be determined for an enterprise's foreign operations in the aggregate or in any geographic area. The Board's conclusion on each of those matters is clarified or elaborated on in paragraphs .032 and .033 of this Statement.

.085 The Board recognized in the Exposure Draft and in this Statement that the variety of ways in which foreign operations are conducted made it impossible to define appropriate geographic areas for all enterprises. Therefore, only general guidelines for that determination are set forth in paragraph .034 of this Statement. For those enterprises conducting foreign operations in two or more geographic areas, the Board considered several methods of associating foreign revenue, a measure of profitability, and identifiable assets with a particular geographic area. Those methods include associating this information with geographic areas in terms of the location of the accounting records, the location of the assets, the location of the risks associated with the assets and liabilities, and the location of the customers. However, the Board concluded that none of those methods would necessarily correlate the profitability and identifiable assets of a geographic area in a manner consistent with the objective expressed in paragraph .031. The Board believes that the description of geographic areas of foreign operations in paragraph .034 is sufficiently broad to permit management to accomplish that objective by determining the scope of its operations in each area and then identifying (i) the revenue generated from those operations, (ii) the assets employed in or associated with generating those revenues, and (iii) the costs and expenses related to those revenues and assets. The Board believes that disclosing a measure of assets or assets and liabilities that can be related to a measure of profitability for each significant geographic area will provide users of financial statements with useful financial information about an enterprise's foreign operations consistent with the purpose set forth in paragraph .005.

.086 Some respondents to the Exposure Draft recommended that the Statement not require disclosure of operating profit or loss for each geographic area of an enterprise's operations if it is determined instead to present a level of profitability below operating profit or loss. They said that in many cases an after-tax profitability measure is more informative than a pretax measure and that because of significant differences in income tax rates among different geographic areas a pretax measure could at times be misinterpreted. They also said that many enterprises can more easily determine net income or another measure of profitability below operating profit or loss by geographic area than by industry segment. The Board found those arguments convincing, and paragraph .035(b) requires presentation of operating profit or loss, or net income, or some other measure of profitability between operating profit or loss and net income.

.087 The Board considered whether this Statement should supersede any part of *ARB No. 43,* Chapter 12 [section 1081], "Foreign Operations and Foreign Exchange," especially paragraph 9 [section 1081.09] thereof. Since paragraph 9 of Chapter 12 [section 1081.09] deals with consolidation of foreign subsidiaries which is a subject beyond the scope of this Statement, the Board concluded that it should not be superseded. However, this Statement provides definitions and guidelines that may also be useful in applying that Bulletin.

.088 The Board has determined that disclosure of working capital and property, plant, and equipment and related accumulated depreciation should not be required by geographic area. Those disclosures had been proposed in the Exposure Draft, but a number of respondents said, and the Board agreed, that the volume of detail that would be required would be excessive. However, as noted in paragraph .087, this Statement does not supersede the requirements of paragraph 9, Chapter 12, *ARB No. 43* [section 1081.09], for certain disclosures with respect to the assets and liabilities of foreign subsidiaries.

.089 A number of respondents to the Exposure Draft requested that the Board provide guidance as to when export sales should be considered significant, and paragraph .036 of this Statement provides a test of significance. The Board also was asked to clarify certain matters with respect to the disclosures about major customers, including a guideline as to significance and an elaboration on the type of information required to be presented. Paragraph .039 of this Statement reflects the appropriate revisions. Because many respondents argued that identification of the major

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customer could be competitively harmful to either the enterprise or the customer, the proposal for disclosure of the name of the customer has been dropped.

Effective Date and Transition

.090 On considering all circumstances, the Board determined that prospective application of the standards set forth in this Statement effective for periods beginning after December 15, 1976 as stated in paragraph .041, is appropriate because enterprises may not have accumulated in prior years all of the information required to be disclosed by this Statement; the Board also determined that the effective date is advisable in the circumstances.

Appendix C

STANDARD INDUSTRIAL CLASSIFICATIONS

.091 As indicated in paragraph .012, the Board has examined several systems that have been developed for classifying business activities, such as the Standard Industrial Classification and the Enterprise Standard Industrial Classification systems and has judged that none is, by itself, suitable to determine industry segments as that term is used in this Statement. Nonetheless, those systems may provide guidance for the exercise of the judgment required to group an enterprise's products and services by industry lines.

.092 As set forth in the *Standard Industrial Classification Manual* prepared by the Statistical Policy Division of the U.S. Office of Management and Budget, SIC is a system for classifying business establishments (generally, individual plants, stores, banks, etc.) by the type of economic activity in which they are engaged. An establishment is not necessarily identical with a business enterprise, which may consist of one or more establishments.

.093 The 649-page manual contains one-digit, two-digit, three-digit, and four-digit SIC industry codes, each of which is described in detail. At the one-digit level, the SIC classifies business activities into 11 divisions:

A Agriculture, forestry, and fishing.
B Mining.
C Construction.
D Manufacturing.
E Transportation, communications, electric, gas, and sanitary services.
F Wholesale trade.
G Retail trade.
H Finance, insurance, and real estate.
I Services.
J Public administration.
K Nonclassifiable establishments.

.094 Each of those divisions is subdivided into two-digit major groups. There is a total of 84 two-digit groups. For example, the 20 major groups in manufacturing are:

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1. Food and kindred products.
2. Tobacco manufacturers.
3. Textile mill products.
4. Apparel and other finished products made from fabrics and similar materials.
5. Lumber and wood products, except furniture.
6. Furniture and fixtures.
7. Paper and allied products.
8. Printing, publishing, and allied products.
9. Chemicals and allied products.
10. Petroleum refining and related industries.
11. Rubber and miscellaneous plastics products.
12. Leather and leather products.
13. Stone, clay, glass, and concrete products.
14. Primary metal industries.
15. Fabricated metal products, except machinery and transportation equipment.
16. Machinery, except electrical.
17. Electrical and electronic machinery, equipment, and supplies.
18. Transportation equipment.
19. Measuring, analyzing, and controlling instruments; photographic, medical, and optical goods; watches and clocks.
20. Miscellaneous manufacturing industries.

.095 Each of the two-digit SIC major groups, in turn, is further subdivided into three-digit industry groups. There are 421 three-digit industry groups. For example, the "machinery, except electrical" group includes the following industry groups:

1. Engines and turbines.
2. Farm and garden machinery and equipment.
3. Construction, mining, and materials handling machinery and equipment.
4. Metalworking machinery and equipment.
5. Special industry machinery, except metalworking machinery.
6. General industry machinery and equipment.
7. Office, computing, and accounting machines.
8. Refrigeration and service industry machinery.
9. Miscellaneous machinery, except electrical.

.096 The three-digit SIC industry groups are still further subdivided by product lines into over 1,000 narrower four-digit industry

groups. Metalworking machinery and equipment (a three-digit industry group), for example, is divided into metal cutting machine tools, metal forming machine tools, power driven hand tools, rolling mill machinery and equipment, and so on.

.097 The *Standard Industrial Classification Manual* is revised periodically, most recently in 1972. It is available for sale by the Superintendent of Documents, U.S. Government Printing Office.

.098 The *Enterprise Standard Industrial Classification Manual,* like the *SIC Manual,* is prepared by the Statistical Policy Division of the U. S. Office of Management and Budget. It classifies enterprises (companies, firms, partnerships, etc.) rather than establishments (plants, stores, banks, etc.). The structure of ESIC follows closely the structure of the SIC codes. It includes eight classes of enterprises at the one-digit level, 67 at the two-digit level, 216 at the three-digit level, and 252 at the four-digit level.

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Appendix D

FACTORS TO BE CONSIDERED IN DETERMINING INDUSTRY SEGMENTS

.099 This Appendix identifies a number of factors to be considered in grouping products and services by industry lines into industry segments. As indicated in paragraph .012, although certain characteristics can be identified that assist in differentiating among industries, no single set of characteristics is universally applicable to determine the industry segments of all business enterprises. Nor is any single characteristic determinative in all cases.

.100 Among the factors that should be considered in determining whether products and services are related (and, therefore, should be grouped into a single industry segment) or unrelated (and, therefore, should be separated into two or more industry segments) are the following:

a) *The nature of the product.* Related products or services have similar purposes or end uses. Thus, they may be expected to have similar rates of profitability, similar degrees of risk, and similar opportunities for growth.

b) *The nature of the production process.* Sharing of common or interchangeable production or sales facilities, equipment, labor force, or service group or use of the same or similar basic raw materials may suggest that products or services are related. Likewise, similar degrees of labor intensiveness or similar degrees of capital intensiveness may indicate a relationship among products or services.

c) *Markets and marketing methods.* Similarity of geographic marketing areas, types of customers, or marketing methods may indicate a relationship among products or services. For instance, the use of a common or interchangeable sales force may suggest a relationship among products or services. The sensitivity of the market to price changes and to changes in general economic conditions may also indicate whether products or services are related or unrelated.

.101 Broad categories such as *manufacturing, wholesaling, retailing,* and *consumer products* are not per se indicative of the industries in which an enterprise operates, and those terms should not be used without identification of a product or service to describe an enterprise's industry segments.

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Appendix E

ILLUSTRATION OF APPLYING PARAGRAPH .015(b)

.102 Under paragraph .015(b), an industry segment is to be regarded as significant if the absolute amount of its operating profit or operating loss is 10 percent or more of the greater, in absolute amount, of:

(i) The combined operating profit of all industry segments that did not incur an operating loss, or

(ii) The combined operating loss of all industry segments that did incur an operating loss.

.103 To illustrate how that paragraph is applied, assume that an enterprise has seven industry segments some of which incurred operating losses, as follows:

Industry Segment	Operating Profit or (Operating Loss)	
A	$ 100	
B	500	$1,000
C	400	
D	(295)	
E	(600)	
F	(100)	(1,100)
G	(105)	
	$(100)	

.104 The combined operating profit of all industry segments that did not incur a loss (A, B, and C) is $1,000. The absolute amount of the combined operating loss of those segments that did incur a loss (D, E, F, and G) is $1,100. Under paragraph .015(b), therefore, Industry Segments B, C, D, and E are significant because the absolute amount of their individual operating profit or operating loss equals or exceeds $110 (10 percent of $1,100). Additional industry segments might, of course, also be deemed significant under the revenue and identifiable assets tests in paragraphs .015(a) and .015(c).

Appendix F

ILLUSTRATIONS OF FINANCIAL STATEMENT DISCLOSURES

.105 This Appendix contains examples of disclosures of the type that this Statement requires to be included in the financial statements of an enterprise. The illustrations do not encompass all possible circumstances, nor do the formats used indicate a particular preference of the Board.

.106 Exhibit A presents the consolidated income statement of a hypothetical company for the year ended December 31, 1977. Exhibit B illustrates how the company might present information about its operations in different industries and its reliance on major customers. Exhibit C illustrates how the company might present information about its foreign operations in different geographic areas and its export sales.

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EXHIBIT A

X Company
Consolidated Income Statement
Year ended December 31, 1977

Sales		$4,700
Cost of sales	$3,000	
Selling, general, and administrative expense	700	
Interest expense	200	3,900
		800
Equity in net income of Z Co. (25% owned)		100
Income from continuing operations before income taxes		900
Income taxes		400
Income from continuing operations		500
Discontinued operations:		
Loss from operations of discontinued West Coast division (net of income tax effect of $50)	70	
Loss on disposal of West Coast division (net of income tax effect of $100)	130	200
Income before extraordinary gain and before cumulative effect of change in accounting principle		300
Extraordinary gain (net of income tax effect of $80)		90
Cumulative effect on prior years of change from straight-line to accelerated depreciation (net of income tax effect of $60)		(60)
Net income		$ 330

EXHIBIT B

X Company
Information about the Company's Operations in Different Industries
Year ended December 31, 1977

	Industry A	Industry B	Industry C	Other Industries	Adjustments and Eliminations	Consolidated
Sales to unaffiliated customers	$1,000	$2,000	$1,500	$ 200		$ 4,700
Intersegment sales	200		500		$(700)	
Total revenue	$1,200	$2,000	$2,000	$ 200	$(700)	$ 4,700
Operating profit	$ 200	$ 290	$ 600	$ 50	$ (40)	$ 1,100
Equity in net income of Z Co.						100
General corporate expenses						(100)
Interest expense						(200)
Income from continuing operations before income taxes						$ 900
Identifiable assets at December 31, 1977	$2,000	$4,050	$6,000	$1,000	$ (50)	$13,000
Investment in net assets of Z Co.						400
Corporate assets						1,600
Total assets at December 31, 1977						$15,000

See accompanying note.

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EXHIBIT B (continued)

Note

The Company operates principally in three industries, A, B, and C. Operations in Industry A involve production and sale of (describe types of products and services). Operations in Industry B involve production and sale of (describe types of products and services). Operations in Industry C involve production and sale of (describe types of products and services). Total revenue by industry includes both sales to unaffiliated customers, as reported in the Company's consolidated income statement, and intersegment sales, which are accounted for by (describe the basis of accounting for intersegment sales).

Operating profit is total revenue less operating expenses. In computing operating profit, none of the following items has been added or deducted: general corporate expenses, interest expense, income taxes, equity in income from unconsolidated investee, loss from discontinued operations of the West Coast division (which was a part of the Company's operations in Industry B), extraordinary gain (which relates to the Company's operations in Industry A), and the cumulative effect of the change from straight-line to accelerated depreciation (of which $30 relates to the Company's operations in Industry A, $10 to Industry B, and $20 to Industry C). Depreciation for Industries A, B, and C, respectively, was $80, $100, and $150. Capital expenditures for the three industries were $100, $200, and $400, respectively.

The effect of the change from straight-line to accelerated depreciation was to reduce the 1977 operating profit of Industries A, B, and C, respectively, by $40, $30, and $20.

Identifiable assets by industry are those assets that are used in the Company's operations in each industry. Corporate assets are principally cash and marketable securities.

The Company has a 25 percent interest in Z Co., whose operations are in the United States and are vertically integrated with the Company's operations in Industry A. Equity in net income of Z Co. was $100; investment in net assets of Z Co. was $400.

To reconcile industry information with consolidated amounts, the following eliminations have been made: $700 of intersegment

sales; $40 relating to the net change in intersegment operating profit in beginning and ending inventories; and $50 intersegment operating profit in inventory at December 31, 1977.

Contracts with a U.S. government agency account for $1,100 of the sales to unaffiliated customers of Industry B.

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EXHIBIT C

X Company
Information about the Company's Operations in Different Geographic Areas
Year ended December 31, 1977

	United States	Geographic Area A	Geographic Area B	Adjustments and Eliminations	Consolidated
Sales to unaffiliated customers	$3,000	$1,000	$ 700		$ 4,700
Transfers between geographic areas	1,000			$(1,000)	
Total revenue	$4,000	$1,000	$ 700	$(1,000)	$ 4,700
Operating profit	$ 800	$ 400	$ 100	$ (200)	$ 1,100
Equity in net income of Z Co.					100
General corporate expenses					(100)
Interest expense					(200)
Income from continuing operations before income taxes					$ 900
Identifiable assets at December 31, 1977	$7,300	$3,400	$2,450	$ (150)	$13,000
Investment in net assets of Z Co.					400
Corporate assets					1,600
Total assets at December 31, 1977					$15,000

See accompanying note.

EXHIBIT C (continued)

Note

Transfers between geographic areas are accounted for by (describe the basis of accounting for such transfers). Operating profit is total revenue less operating expenses. In computing operating profit, none of the following items has been added or deducted: general corporate expenses, interest expense, income taxes, equity in income from unconsolidated investee, loss from discontinued operations of West Coast division (which was part of the Company's U.S. operations), extraordinary gain (which relates to the Company's operations in Geographic Area B), and the cumulative effect of the change from straight-line to accelerated depreciation (which relates entirely to the Company's operations in the United States).

Identifiable assets are those assets of the Company that are identified with the operations in each geographic area. Corporate assets are principally cash and marketable securities.

Of the $3,000 U.S. sales to unaffiliated customers, $1,200 were export sales, principally to Geographic Area C.

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AC Section 2082

Financial Reporting for Segments of a Business Enterprise—Interim Financial Statements

an amendment of section 2081

[Source: FASB Statement No. 18.]

November 1977

INTRODUCTION AND BACKGROUND INFORMATION

.01 Paragraph 4 of *FASB Statement No. 14* [section 2081.004], "Financial Reporting for Segments of a Business Enterprise," issued by the Board in December 1976, provides for the inclusion of segment information in interim financial statements as follows:

> If an enterprise issues for an interim period a complete set of financial statements that are expressly described as presenting financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles, this Statement requires that the information referred to in paragraph 3 be included in those interim financial statements. If an enterprise issues for an interim period financial statements that are not a complete set or are otherwise complete but not expressly described as presenting financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles, this Statement does not require that the information referred to in paragraph 3 be included in those interim financial statements.

The alternatives considered by the Board and the basis for its conclusions are set forth in paragraphs 72 and 73 of the Statement [section 2081.072-.073].

.02 Since the issuance of *FASB Statement No. 14* [section 2081], the Board has received a number of questions about when the information specified in the Statement is required in financial statements for interim periods. On March 2, 1977, the Board submitted a proposed interpretation of paragraph 4 of the Statement [section 2081.004] to the members of the Financial Accounting Standards Advisory Council for comment. That proposed Interpretation included examples of situations in which the "expressly described" test of paragraph 4 [section

2081.004] was met and segment information was required and other situations in which the "expressly described" test was not met and segment information was not required. A number of the comment letters received from Council members indicated that the proposed Interpretation did not provide adequate clarification and that an amendment of Statement No. 14 [section 2081] was necessary.

.03 The Board has the subject of interim financial reporting on its technical agenda. The issues addressed in that project include consideration of the type of financial information that should be reported for interim periods.

.04 The Board has reconsidered the question of whether segment information shall be included in interim financial statements and has decided to eliminate any requirement to report the information specified by *FASB Statement No. 14* [section 2081] in interim period financial statements pending completion of the interim financial reporting project.

.05 An Exposure Draft of a proposed Statement on "Financial Reporting for Segments of a Business Enterprise—Interim Financial Statements" was issued on September 20, 1977. Sixty-five letters were received in response to that Exposure Draft, virtually all of which expressed agreement.

.06 The Board concluded that on the basis of existing data it can reach an informed decision without a public hearing and that the effective date and transition specified in paragraph .09 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to Section 2081

.07 The information specified in paragraph 3 of *FASB Statement No. 14* [section 2081.003] is not required in financial statements for interim periods. Accordingly, Statement No. 14 [section 2081] is amended as follows:

a. Paragraphs 4 and 73 and footnote 15 to paragraph 41 [sections 2081.004 and 2081.073 and footnote 15 to section 2081.041] are deleted.

b. The words "and for interim periods [15] within those fiscal years" are deleted from the first sentence of paragraph 41 [section 2081.041] and that sentence is modified to read as follows:

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The provisions of this Statement shall be effective for financial statements for fiscal years beginning after December 15, 1976.

.08 Although segment information is not required in financial statements for interim periods, any segment information that is presented in interim period financial statements shall be consistent with the requirements of *FASB Statement No. 14* [section 2081].

Effective Date and Transition

.09 This amendment to *FASB Statement No. 14* [section 2081] shall be effective December 1, 1977, retroactive to the effective date of that Statement. Segment information presented in interim period financial statements issued prior to December 1, 1977 need not be included if those interim period financial statements are subsequently presented for comparative purposes after the effective date of this Statement.

The provisions of this Statement need not be applied to immaterial items.

The next page is 8295.

AC Section 2083

Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises

an amendment of sections 2011 and 2081

[Source: FASB Statement No. 21.]

April 1978

INTRODUCTION AND BACKGROUND INFORMATION

.01 The Accounting Standards Division of the AICPA began a study of the application of generally accepted accounting principles (GAAP) to smaller or closely held enterprises in 1974 and issued its report on that study in August 1976. One of the major recommendations in that report states:

> The Financial Accounting Standards Board should develop criteria to distinguish disclosures that should be required by GAAP, which is applicable to the financial statements of all entities, from disclosures that merely provide additional or analytical data. (Some of these latter disclosures may, however, still be required in certain circumstances for certain types of entities.) The criteria should then be used in a formal review of disclosures presently considered to be required by GAAP and should also be considered by the Board in any new pronouncements.

The report also recommends that the FASB amend *APB Opinion No. 15* [section 2011], "Earnings per Share," to require disclosure of earnings per share information only by enterprises whose securities are publicly traded. In addition to the recommendation contained in the AICPA report, a number of respondents to the FASB agenda project, "Conceptual Framework for Financial Accounting and Reporting: Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises," have expressed the view that the Board should distinguish between the information that should be included in financial statements and the so-called predictive, interpretive, or "soft" data that should be provided by financial reporting other than financial statements. Further, since the issuance in December 1976 of *FASB Statement No. 14* [section 2081], "Financial Reporting for Segments of a Business Enterprise," the Board has received a number of suggestions that nonpublic enterprises be exempted from the requirements of

that Statement. Others have suggested that segment information is an example of the type of interpretive or analytical information that should be presented outside the financial statements.

.02 *APB Opinion No. 15* [section 2011] requires that earnings per share data be presented on the face of an enterprise's income statement and requires certain other disclosures in specified situations. *FASB Statement No. 14* [section 2081] requires disclosure of certain information relating to (a) the operations of an enterprise in different industries, (b) its foreign operations and export sales, and (c) its major customers. In its deliberations leading to the issuance of Statement No. 14 [section 2081], the Board considered whether certain enterprises should be exempted from disclosing segment information based on the size of the enterprise or whether its securities are publicly traded and concluded, for the reasons set forth in paragraph 70 of the Statement [section 2081.070], that segment information should be included in the financial statements of all business enterprises.

.03 The members of the Financial Accounting Standards Advisory Council and the FASB Screening Committee on Emerging Problems were consulted in January 1978 about the possibility of different applications of generally accepted accounting principles to small or closely held enterprises and large or public enterprises. Many of the members of the Advisory Council and the Screening Committee who advised the Board on this matter indicated that there should be a differentiation between disclosures required of small or closely held enterprises and disclosures required of large publicly traded enterprises and recommended that the Board add a project to its agenda to develop criteria for such a differentiation. Further, many of the members of the Advisory Council and the Screening Committee who advised the Board on this matter cited earnings per share and segment information as examples of disclosures that they believe should be optional for certain enterprises.

.04 On February 23, 1978, the Board added to its agenda a major project to consider whether guidelines should be established for (a) distinguishing between information that should be disclosed in financial statements and information that should be disclosed in financial reporting otherwise and (b) distinguishing between information that all enterprises should be required to disclose and information that only designated types of enterprises should be required to disclose. Special attention will be

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given in that project to the financial statements and financial reporting of small or closely held enterprises.

.05 In recognition of (a) the apparent pervasive public concern about the burden on small or closely held enterprises of compliance with certain financial statement disclosure requirements, (b) the recommendations of the AICPA report on "Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses," and (c) the recommendations of the members of the Board's Screening Committee on Emerging Problems and the Board's Advisory Council, the Board has concluded that application of *APB Opinion No. 15* [section 2011] and *FASB Statement No. 14* [section 2081] to nonpublic enterprises should be suspended, pending completion of the project referred to in paragraph .04. The Board will consider whether the disclosure requirements in pronouncements issued while that project is underway should be applicable to all enterprises.

.06 An Exposure Draft of a proposed Statement of Financial Accounting Standards, "Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises," was issued on February 27, 1978. The Board received 126 letters of comment in response to the Exposure Draft, most of which expressed agreement.

.07 Some respondents recommended that the Board clarify whether the definition of "nonpublic" applies to a subsidiary, corporate joint venture, or other investee. The Board has a project on its agenda addressing the question of whether a complete set of financial statements of a parent company, a subsidiary, a corporate joint venture, or other investee accounted for by the equity method should include segment information when those financial statements are presented with consolidated financial statements. That project involves a reconsideration of the requirements of the last sentence of paragraph 7 of *FASB Statement No. 14* [section 2081.007].[1] The Board concluded that it should not delay issuance of this Statement pending completion of its deliberations on that project. This Statement applies to a complete set of separately issued

[1] The last sentence of paragraph 7 of *FASB Statement No. 14* [section 2081.007] states:

> When a complete set of financial statements that present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles is presented for a subsidiary, corporate joint venture, or 50 percent or less owned investee, each such entity is considered to be an enterprise as that term is used in this Statement and thus is subject to its requirements wheher those financial statements are issued separately or included in another enterprise's financial report.

financial statements of a subsidiary, corporate joint venture, or other investee that is nonpublic as that term is used in this Statement. This Statement does not extend to those financial statements when presented in the financial report of another enterprise, as that matter is included in the scope of the project involving reconsideration of the last sentence of paragraph 7 of Statement No. 14 [section 2081.007] referred to above. An Exposure Draft of a proposed Statement of Financial Accounting Standards addressing that matter will be issued in the near future.

.08 Some respondents noted that defining a nonpublic enterprise as an enterprise other than one whose debt or equity securities trade in a public market would exempt other kinds of enterprises with public participation from the requirements of *FASB Statement No. 14* [section 2081]. Those exempted enterprises include certain mutual associations, cooperatives, nonbusiness organizations, and partnerships that often make their financial statements available to a broad class, such as, insurance policyholders, depositors, members, contributors, or partners. The Board concluded that it should not delay the issuance of this Statement to refine the meaning of the term "nonpublic" at this time. Accordingly, the suspensions in paragraph .12 apply for the present to enterprises with a broad class of public participants that meet the "nonpublic" definition in paragraph .13. Those suspensions, however, should not be construed as an indication that the Board has decided that the information requirements for those enterprises are significantly different from those for an enterprise whose debt or equity securities are publicly traded.

.09 Some respondents stated that the requirement of paragraph 39 of *FASB Statement No. 14* [section 2081.039] to disclose information about major customers should not be suspended. Those respondents believe that disclosure is necessary if an enterprise sells much of its output to one or relatively few other enterprises. Although this Statement suspends the application of Statement No. 14 [section 2081] to the financial statements of nonpublic enterprises, the Board notes that it does not affect the disclosure of information about economic dependency when such disclosure may be necessary for a fair presentation.[2]

[2] Paragraph .05 of section 335 [AU section 335.05], "Related Party Transactions," of *Statements on Auditing Standards* states:

> An entity may be economically dependent on one or more parties with which it transacts a significant volume of business, such as a sole or major customer, supplier, franchisor, franchisee, distributor, general agent, borrower,

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.10 Some respondents stated that the effective date and transition set forth in the Exposure Draft of the proposed Statement were too restrictive. They noted that financial statements issued prior to the effective date of this Statement may be reissued subsequent to its effective date for other than comparative purposes and recommended that disclosure of earnings per share and segment information for fiscal years ended prior to the effective date of this Statement should not be required in financial statements of nonpublic enterprises that are reissued for any reason subsequent to the effective date of this Statement. The Board accepted those views, and the provisions of this Statement are retroactive to fiscal years beginning after December 15, 1976, the effective date of *FASB Statement No. 14* [section 2081].

.11 The Board has concluded that on the basis of existing information it can reach an informed decision without a public hearing and the effective date and transition specified in paragraph .16 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

.12 This Statement suspends the requirements of *APB Opinion No. 15* [section 2011][3] and *FASB Statement No. 14* [section 2081] in the financial statements of nonpublic enterprises as defined in paragraph .13. Therefore, this Statement suspends any requirement to disclose the information specified by Opinion No. 15 [section 2011] and Statement No. 14 [section 2081] in a complete set of separately issued financial statements of a subsidiary, corporate joint venture, or other investee that is a nonpublic enterprise.[4]

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or lender. Such parties should not be considered related parties solely by virtue of economic dependency unless one of them clearly exercises significant management or ownership influence over the other. Disclosure of economic dependency may, however, be necessary for a fair presentation of financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles.

[3] This Statement does not suspend or modify other generally accepted accounting principles or practices (such as those specified in paragraph 15 of Chapter 13B, "Compensation Involved in Stock Option and Stock Purchase Plans," of *ARB No. 43* [section 4061.15] and paragraphs 10 and 11, "Liquidation Preference of Preferred Stock," of *APB Opinion No. 10* [section 5515.01-.02]) that require disclosure of information concerning the capital structure of an enterprise.

[4] As mentioned in paragraph .07, the Board has a project on its agenda addressing the question of whether a complete set of financial statements of a parent company, a subsidiary, a corporate joint venture, or other investee accounted for by the equity method should include segment information when those financial statements are presented with consolidated financial statements.

.13 For purposes of this Statement, a nonpublic enterprise is an enterprise other than one (a) whose debt or equity securities trade in a public market on a foreign or domestic stock exchange or in the over-the-counter market (including securities quoted only locally or regionally) or (b) that is required to file financial statements with the Securities and Exchange Commission. An enterprise is no longer considered a nonpublic enterprise when its financial statements are issued in preparation for the sale of any class of securities in a public market.

.14 Although the presentation of earnings per share and segment information is not required in the financial statements of nonpublic enterprises, any such information that is presented in the financial statements shall be consistent with the requirements of *APB Opinion No. 15* [section 2011] and *FASB Statement No. 14* [section 2081].

Amendments to Existing Pronouncements

.15 The following footnote is added to the end of the first sentence of paragraph 45 of *APB Opinion No. 15* [section 2011.45] and to the end of the first sentence of paragraph 41 of *FASB Statement No. 14* [section 2081.041] (as amended by *FASB Statement No. 18* [section 2082], "Financial Reporting for Segments of a Business Enterprise—Interim Financial Statements: an amendment of FASB Statement No. 14"):

> The provisions of this [Opinion/Statement] were suspended by *FASB Statement No. 21* [section 2083] and need not be applied by a nonpublic enterprise as defined in that Statement pending further action by the FASB.

Effective Date and Transition

.16 This Statement shall be effective April 30, 1978 retroactive to fiscal years beginning after December 15, 1976.

The provisions of this Statement need not be applied to immaterial items.

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AC Section 4000

REVENUE AND EXPENSE

. . . unrealized profit . . . installment method . . . construction-type contracts . . . government contracts . . . leases . . . compensation . . . pension plan costs . . . deferred compensation . . . depreciation . . . real and personal property taxes . . . income taxes . . . interest . . . research and development . . . contingencies

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AC Section 4010

Unrealized Profit

[Source: ARB No. 43, Chap. 1A, Par. 1.]

Issue date, unless otherwise indicated: 1934[1]

.01 Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost. (See section 4020, *Installment Method of Accounting,* effective for fiscal periods beginning after December 31, 1966—APB Opinion No. 10.)

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[1] The above rule was adopted by the membership of the Institute in 1934. It had been recommended in 1932 to the New York Stock Exchange by the Institute's committee on cooperation with stock exchanges.

AC Section 4020

Installment Method of Accounting

[Source: APB Opinion No. 10, Par. 12.]

Effective for fiscal periods beginning after December 31, 1966

.01 Section 4010 states that "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured." The Board reaffirms this statement; it believes that revenues should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts. Accordingly, it concludes that, in the absence of the circumstances[1] referred to above, the installment method of recognizing revenue is not acceptable.

The next page is 8341.

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

AC Section 4031

Long-Term Construction-Type Contracts

[Source: ARB No. 45.]

Issue date, unless otherwise indicated: October, 1955

.01 This section is directed to the accounting problems in relation to construction-type contracts in the case of commercial organizations engaged wholly or partly in the contracting business. It does not deal with cost-plus-fixed-fee contracts, which are discussed in section 4041, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered. In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, the section would also be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant. The problems in accounting for construction-type contracts arise particularly in connection with long-term contracts as compared with those requiring relatively short periods for completion.

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

GENERALLY ACCEPTED METHODS

.03 Two accounting methods commonly followed by contractors are the percentage-of-completion method and the completed-contract method.

Percentage-of-Completion Method

.04 The percentage-of-completion method recognizes income as work on a contract progresses. The committee

recommends that the recognized income be that percentage of estimated total income, either:

(a) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or

(b) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income.

.05 Under this method current assets may include costs and recognized income not yet billed, with respect to certain contracts; and liabilities, in most cases current liabilities, may include billings in excess of costs and recognized income with respect to other contracts.

.06 When the current estimate of total contract costs indicates a loss, in most circumstances provision should be made for the loss on the entire contract. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for loss.

.07 The principal advantages of the percentage-of-completion method are periodic recognition of income currently rather than irregularly as contracts are completed, and the reflection of the status of the uncompleted contracts provided through the current estimates of costs to complete or of progress toward completion.

.08 The principal disadvantage of the percentage-of-completion method is that it is necessarily dependent upon estimates of ultimate costs and consequently of currently accruing income, which are subject to the uncertainties frequently inherent in long-term contracts.

Completed-Contract Method

.09 The completed-contract method recognizes income only when the contract is completed, or substantially so.

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Accordingly, costs of contracts in process and current billings are accumulated but there are no interim charges or credits to income other than provisions for losses. A contract may be regarded as substantially completed if remaining costs are not significant in amount.

.10 When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period costs, particularly in years when no contracts were completed. It is not so important, however, when the contractor is engaged in numerous projects and in such circumstances it may be preferable to charge those expenses as incurred to periodic income. In any case there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process.

.11 Although the completed-contract method does not permit the recording of any income prior to completion, provision should be made for expected losses in accordance with the well established practice of making provision for foreseeable losses. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for losses.

.12 When the completed-contract method is used, an excess of accumulated costs over related billings should be shown in the balance sheet as a current asset, and an excess of accumulated billings over related costs should be shown among the liabilities, in most cases as a current liability. If costs exceed billings on some contracts, and billings exceed costs on others, the contracts should ordinarily be segregated so that the figures on the asset side include only those contracts on which costs exceed billings, and those on the liability side include only those on which billings exceed costs. It is suggested that the asset item be described as "costs of uncompleted contracts in excess of related billings" rather than as "inventory" or "work in process," and that the item on the liability side be described as "billings on uncompleted contracts in excess of related costs."

.13 The principal advantage of the completed-contract method is that it is based on results as finally determined, rather than on estimates for unperformed work which may involve unforeseen costs and possible losses.

.14 The principal disadvantage of the completed-contract method is that it does not reflect current performance when the period of any contract extends into more than one accounting period and under such circumstances it may result in irregular recognition of income.

Selection of Method

.15 The committee believes that in general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable. Disclosure of the method followed should be made.

COMMITMENTS

.16 In special cases disclosures of extraordinary commitments may be required, but generally commitments to complete contracts in process are in the ordinary course of a contractor's business and are not required to be disclosed in a statement of financial position. They partake of the nature of a contractor's business, and generally do not represent a prospective drain on his cash resources since they will be financed by current billings.

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AC Section 4041

Cost-Plus-Fixed-Fee Contracts

[Source: ARB No. 43, Chap. 11A.]

Issue date, unless otherwise indicated: June, 1953

.01 This section deals with accounting problems arising under cost-plus-fixed-fee contracts, hereinafter referred to as CPFF contracts.

SUMMARY STATEMENT

.02 Fees under CPFF contracts may be credited to income on the basis of such measurement of partial performance as will reflect reasonably assured realization. One generally acceptable basis is delivery of completed articles. The fees may also be accrued as they are billable, under the terms of the agreements, unless such accrual is not reasonably related to the proportionate performance of the total work or services to be performed by the contractor from inception to completion.

.03 Where CPFF contracts involve the manufacture and delivery of products, the reimbursable costs and fees are ordinarily included in appropriate sales or other revenue accounts. Where such contracts involve only services, or services and the supplemental erection of facilities, only the fees should ordinarily be included in revenues.

.04 Unbilled costs and fees under such contracts are ordinarily receivables rather than advances or inventory, but should preferably be shown separately from billed accounts receivable.

.05 Offsetting of government advances on CPFF contracts by, or against, amounts due from the government on such contracts is acceptable only to the extent that the advances may under the terms of the agreement be offset in settlement, and only if that is the treatment anticipated in the normal course of business transactions under the contract. In case of offset, the amounts offset should be adequately disclosed.

DISCUSSION

.06 Contracts in the CPFF form are used (a) for the manufacture and delivery of various products, (b) for the construction of plants and other facilities, and (c) for management and other services. Under these agreements contractors are reimbursed at intervals for their expenditures and in addition are paid a specified fixed fee. Payments on account of the fees (less 10% or other amount which is withheld until completion) are made from time to time as specified in the agreements, usually subject to the approval of the contracting officer. In most cases the amount of each payment is, as a practical matter, determined by the ratio of expenditures made to the total estimated expenditures rather than on the basis of deliveries or on the percentage of completion otherwise determined.

.07 The agreements provide that title to all material applicable thereto vests in the government as soon as the contractor is reimbursed for his expenditures or, in some cases, immediately upon its receipt by the contractor at his plant even though not yet paid for. The contractor has a custodianship responsibility for these materials, but the government usually has property accountability officers at the plant to safeguard government interests.

.08 The contracts are subject to cancellation and termination by the government, in which event the contractor is entitled to reimbursement for all expenditures made and an equitable portion of the fixed fee.

.09 The government frequently makes advances of cash as a revolving fund or against the final payment due under the agreement.

Major Accounting Problems

.10 There are a number of basic accounting problems common to all CPFF contracts. This section deals with the four most important, which are:

(a) When should fees under such contracts be included in the contractor's income statement?

(b) What amounts are to be included in sales or revenue accounts?

(c) What is the proper balance-sheet classification of unbilled costs and fees?

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(d) What is the proper balance-sheet treatment of various items, debit and credit, identified with CPFF contracts?

(a) When should fees under such contracts be included in the contractor's income statement?

.11 It is recognized that income should be recorded and stated in accordance with certain accounting principles as to time and amount; that profit is deemed to be realized when a sale in the ordinary course of business is effected unless the circumstances are such that collection of the sales price is not reasonably assured; and that delivery of goods sold under contract is normally regarded as the test of realization of profit or loss.

.12 In the case of manufacturing, construction, or service contracts, profits are not ordinarily recognized until the right to full payment has become unconditional, i.e., when the product has been delivered and accepted, when the facilities are completed and accepted, or when the services have been fully and satisfactorily rendered. This accounting procedure has stood the test of experience and should not be departed from except for cogent reasons.

.13 It is, however, a generally accepted accounting procedure to accrue revenues under certain types of contracts and thereby recognize profits, on the basis of partial performance, where the circumstances are such that total profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. Particularly where the performance of a contract requires a substantial period of time from inception to completion, there is ample precedent for pro-rata recognition of profit as the work progresses, if the total profit and the ratio of the performance to date to the complete performance can be computed reasonably and collection is reasonably assured. Depending upon the circumstances, such partial performance may be established by deliveries, expenditures, or percentage of completion otherwise determined. This rule is frequently applied to long-term construction and other similar contracts; it is also applied in the case of contracts involving deliveries in instalments or the performance of services. However, the rule should be dealt with cautiously and not applied in the case of partial deliveries and uncompleted

contracts where the information available does not clearly indicate that a partial profit has been realized after making provision for possible losses and contingencies.

.14 CPFF contracts are much like the type of contracts upon which profit has heretofore been recognized on partial performance, and accordingly have at least as much justification for accrual of fee before final delivery as those cited. The risk of loss is practically negligible, the total profit is fairly definite, and even on cancellation, pro-rata profit is still reasonably assured.

.15 The basic problem in dealing with CPFF contracts is the measure of partial performance, i.e., whether fees thereunder should be accrued under the established rules as to partial deliveries or percentage of completion otherwise determined, or whether, in view of their peculiar terms with respect to part payments, the determination of amounts billable by continuous government audit, and the minimum of risk carried by the contractor, the fees should be accrued as they are billable.

.16 Ordinarily it is acceptable to accrue the fees as they become billable. The outstanding characteristic of CPFF contracts is reimbursement for all allowable costs, plus payment of a fixed fee for the contractor's efforts. Delivery of the finished product may not have its usual legal significance because title passes to the government prior thereto and the contractor's right to partial payment becomes unconditional in advance thereof; deliveries are not necessarily, under the terms of the agreement, evidence of the progress of the work or of the contractor's performance. Amounts billable indicate reasonably assured realization, possibly subject to renegotiation, because of the absence of a credit problem and minimum risk of loss involved. The fee appears to be earned when allowable costs are incurred or paid and the fee is billable. Finally, accrual on the basis of amounts billable is ordinarily not a departure from existing rules of accrual on the basis of partial performance, but rather a distinctive application of the rule for determining percentage of completion.

.17 Judgment must be exercised in each case as to whether accrual of the fee when billable is preferable to accrual on the usual basis of delivery or of percentage of

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completion otherwise determined. While the approval of the government as to amounts billable would ordinarily be regarded as objective evidence, factors may exist which suggest an earlier or later accrual. Such factors include indications of substantial difference between estimated and final cost, as where preparatory or tooling-up costs were much more than estimated, raw material needs were greatly and unduly anticipated by advance purchases, or delays in delivery schedules or other circumstances suggest that costs are exceeding estimates. While such factors are normally considered by the government and billings for fees may be temporarily adjusted to safeguard against too early proportionate payment, the contractor, in accruing income, should also consider them, particularly when any substantial lag exists between expenditures and billings and audit thereof. In such cases, the presumption may be that the fee will not be found to be billable when the charges are presented, and conservatism in accrual will be necessary. Excess costs may be indicated in some cases to such an extent that accrual of fee before actual production would be unwise. Where such a situation exists the usual rule of deliveries or percentage of completion may be a preferable method of accruing the fee.

.18 There are further questions as to whether the fee may be accrued as it is billed rather than as it becomes billable and whether accrual should be on the basis of the full fee or the full fee less the amount withheld. As to the first question, it seems obvious that when accrual in relation to expenditures is otherwise suitable it should be on the basis of amounts billable, since such matters as clerical delays in assembling data for billing should not affect the income statement. As to the second question, accrual on the basis of 100% of the fee is ordinarily preferable since, while payment of the balance depends on complete performance, such completion is to be expected under ordinary circumstances. Care must be exercised, of course, to provide for possible non-realization where there is doubt as to the collection of claimed costs or of the fee thereon.

(b) What amounts are to be included in sales or revenue accounts?

.19 This problem is whether sales or revenue as reported in the income statement should include reimburs-

able costs and the fee, or the fee alone. The answer to this question depends upon the terms of the contract and upon judgment as to which method gives the more useful information.

.20 Some CPFF contracts are service contracts under which the contractor acts solely in an agency capacity, whether in the erection of facilities or the management of operations. These appear to call for inclusion in the income statement of the fee alone. In the case of supply contracts, however, the contractor is more than an agent. For instance, he is responsible to creditors for materials and services purchased; he is responsible to employees for salaries and wages; he ordinarily uses his own facilities in carrying out his agreement; his position in many respects is that of an ordinary principal. In view of these facts, and the desirability of indicating the volume of his activities, it appears desirable to include reimbursable costs, as well as fees, in sales or revenues.

(c) What is the proper balance-sheet classification of unbilled costs and fee?

.21 The principal reason for the existence of unbilled costs at any date is the time usually required, after receipt of material or expenditures for labor, etc., to assemble data for billing. The right to bill usually exists upon expenditure or accrual, and that right unquestionably represents a receivable rather than an advance or inventory. There is nevertheless a difference in character between billed items and unbilled costs and distinction should be made between them on the balance sheet.

(d) What is the proper balance-sheet treatment of various items, debit and credit, identified with CPFF contracts?

.22 In statements of current assets and current liabilities, amounts due to and from the same person are ordinarily offset where, under the law, they may be offset in the process of collection or payment. An advance received on a contract is, however, usually not offset unless it is definitely regarded as a payment on account of contract work in progress, in which event it will be shown as a deduction from the related asset. An advance on a CPFF contract usually is made for the purpose of providing a revolving fund and is not ordinarily applied as a partial

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payment until the contract is completed or nears completion. It therefore appears to be preferable to offset advances on CPFF contracts against receivables in connection with the contracts only when it is expected that the advances will be applied in payment of those particular charges. In any case, amounts offset should be clearly disclosed.

The next page is 8361.

AC Section 4042

Renegotiation

[Source: ARB No. 43, Chap. 11B, as amended.]

Issue date, unless otherwise indicated: June, 1953 [1]

.01 This section [2] deals with certain aspects of the accounting for those government contracts and subcontracts which are subject to renegotiation.

.02 Where such contracts constitute a substantial part of the business done, the uncertainties resulting from the possibilities of renegotiation are usually such that appropriate indication of their existence should be given in the financial statements.

.03 It is impossible to lay down general rules which can be applied satisfactorily in all cases. Here, as elsewhere in accounting, there must be an exercise of judgment which should be based on experience and on a clear understanding of the objective to be attained. That objective is to present the fairest possible financial statements, and at the same time make clear any uncertainties that limit the significance of such statements.

.04 In keeping with the established accounting principle that provision should be made in financial statements for all liabilities, including reasonable estimates for liabilities not accurately determinable, provision should be made for probable renegotiation refunds wherever the amount of such refunds can be reasonably estimated. Thus, in cases where experience of the company or of comparable companies with renegotiation determinations is available and would make a reasonable estimate practicable, provision in the income account for an estimated refund affecting the current year's operations is called for. In cases in which a reasonable estimate cannot be made, as where the effect of a new or amended renegotiation act

[1] The material included in this section was drawn primarily from ARB 43, Chapter 11, Section B, *Renegotiation*. Paragraph 8 of that bulletin was superseded by APB Opinion No. 11, effective for fiscal periods beginning after December 31, 1967.

[2] The comments in this section are considered to be applicable also to price redetermination estimated to result in retroactive price reduction.

cannot be foretold within reasonable limits or where a company is facing renegotiation for the first time and no reliable precedent is available, disclosure of the inability, because of these circumstances, to determine renegotiation effects and of the consequent uncertainties in the financial statements is necessary.

.05 In addition to any provision made in the accounts, disclosure by footnote or otherwise may be required as to the uncertainties, their significance, and the basis used in determining the amount of the provision, such as the prior years' experience of the contractor or of similar contractors if their experience is available and is used, renegotiation discussions relating to the current year, etc. Such disclosure may be helpful in informing shareholders or other interested persons as to the company's status under the renegotiation law. It should also be recognized that, if conditions change, the results of a prior-year determination or settlement are not, in most cases, indicative of the amount probably refundable for the current year.

TREATMENT IN FINANCIAL STATEMENTS

.06 Provisions made for renegotiation refunds should be included in the balance sheet among the current liabilities.

.07 Accounting treatment in the income statement should conform to the concept that profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that collection of the sales price is not reasonably assured.[3] Renegotiation refunds are commonly referred to as involving a refund of "excessive profits"; realistically, however, renegotiation involves an adjustment of the original contract or selling price. Since a provision for renegotiation refund indicates that the collection, or retention, of the selling price is not reasonably assured, the provision should preferably be treated in the income statement as a deduction from sales. Because of the interrelationship of renegotiation and taxes on income, the provision for such taxes should then be computed accordingly.

[3] See section 4010.

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RENEGOTIATION REFUNDS FOR PRIOR YEARS

.08 A further question arises where a renegotiation refund applicable to a particular year is made in an amount materially different from the provision made in the financial statements originally issued for such year. The committee recommends that the difference between the renegotiation refund and the provision therefor be shown in the current income statement. (See section 2012.10-.12.) [As amended, effective for fiscal periods beginning after December 31, 1966, by APB Opinion No. 9.] [As amended, effective for events and transactions occurring after September 30, 1973, by APB Opinion No. 30.] [As amended, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.]

The next page is 8371.

AC Section 4043

Terminated War and Defense Contracts

[Source: ARB No. 43, Chap. 11C.]

Issue date, unless otherwise indicated: June, 1953

.01 This section deals with problems involved in accounting for fixed-price war and defense supply contracts terminated, in whole or in part, for the convenience of the government. It does not deal specifically with terminated cost-plus-fixed-fee contracts nor with contracts for facilities or services. However, the conclusions reached herein may serve as guides for the accounting applicable to such special contracts. Terminations for default of the contractor involve problems of a different nature and are not considered here.

.02 Except where the text clearly indicates otherwise, the term *contractor* is used to denote either a prime contractor or a subcontractor, and the term *contract* to denote either a prime contract or a subcontract.

SUMMARY STATEMENT

.03 The profit of a contractor on a fixed-price supply contract terminated for the convenience of the government accrues as of the effective date of termination.

.04 Those parts of the termination claim which are reasonably determinable should be included in financial statements after termination; when the total of the undeterminable elements is believed to be material, full disclosure of the essential facts should be made, by footnote or otherwise.

.05 Under ordinary circumstances the termination claim should be classified as a current asset and unless the amount is relatively small should be separately disclosed.

.06 Advances received on the contract before its termination may be shown in financial statements after termi-

nation as a deduction from the claim receivable and should be appropriately explained. Loans negotiated on the security of the termination claim, however, should be shown as current liabilities.

.07 All of the contractor's own cost and profit elements included in the termination claim are preferably accounted for as a sale and if material in amount should be separately disclosed. The costs and expenses chargeable to the claim may then be given their usual classification in the accounts.

.08 When inventory items whose costs are included in the termination claim are subsequently reacquired by the contractor the reacquisition value of those items should be recorded as a purchase and applied, together with other disposal credits, against the termination claim receivable.

.09 So called *no-cost* settlements—those in which the contractor waives the right to make a claim—result in no transaction which could be reflected in sales. The costs applicable to the contract may be given their usual classification in the accounts; the inventory retained should not be treated as a purchase but should be accounted for according to the usual methods and standards applicable to inventories.

DISCUSSION

.10 Termination of war and defense contracts for the convenience of the government is a means of adjusting the production of materials to the varying requirements of the military services. Since terminations transfer active contracts in process of execution into claims in process of liquidation, they, like contract renegotiations and cost-plus-fixed-fee contracts, may have important effects on the financial statements of defense contractors.

When Profit Accrues

.11 An important problem involved in accounting for the effect of terminations is that of determining the time at which profit earned on the contract should be recognized. This problem is similar to that described in other sections on renegotiation and cost-plus-fixed-fee contracts in that it involves accrual at a specific date of an element of profit whose original measurement may be difficult and

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will require informed judgment, and whose final amount may not be determined until some future period.

.12 Three dates have been mentioned as dates for the determination of profit from terminated contracts: (a) the effective date of termination; (b) the date of final settlement; and (c) some intermediate date, such as that on which the claim is finally prepared or filed. The effective date of termination is the date at which the contractor acquires the right to receive payment on the terminated portion of the contract. This date is also, of the three, the one most objectively determined.

.13 Under the accrual basis of accounting recognition is given to revenues and expenses, to the fullest extent possible, in the period to which they relate. Profit on a contract of sale is ordinarily taken into account upon delivery or performance. However, as stated in section 4041 it is a generally accepted accounting procedure to accrue revenues under certain types of contracts, and thereby recognize profits, on the basis of partial performance where the circumstances are such that total profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. Thus, the accrual of profit under a cost-plus-fixed-fee contract is recognized as the fee becomes billable rather than when it is actually billed. Upon termination of a contract the contractor acquires a claim for fair compensation; the government reserves the option of acquiring any of the inventories for which the contractor makes claim under the terminated contract. Except to effect settlements and to protect and dispose of property, the expenses of which are reimbursable, the contractor need perform no further service under a terminated contract in order to enforce his claim. It follows that any profit arising out of such a contract accrues at the effective date of termination and, if the amount can be reasonably ascertained, should be recorded at that time.

Determination of Claim

.14 Practical application of the accrual principle to the accounting for terminated war and defense contracts rests upon the possibility of making a reasonable estimate of the amount of the termination claim before its final determination by settlement. This involves two principal

considerations: (1) whether the costs of the contractor can be determined with reasonable accuracy and (2) whether the amount of profit to be realized can be estimated closely enough to justify inclusion in the accounts.

.15 The various acts and regulations, including a statement of principles for determining costs and certain termination cost memorandums, describe in general terms the costs and expenses which are to be taken into account in arriving at fair compensation, as well as certain costs which are not allowable, and establish uniform termination policies and procedures.

.16 While the total claim, and particularly the profit allowance, is subject to negotiation, the termination articles provide for a formula settlement allowing definite percentages of profit based on costs in the event of the failure of negotiations. This in effect fixes a minimum expectation of profit allowance since the formula percentages have also been recognized by regulation as a basis of negotiating settlement in the event of failure by the parties to agree on any other basis. The same regulations give other guides for estimating a fair profit allowance, which in some cases may be greater than the amount computed by the formula percentages. When the contractor, because of lack of prior negotiation experience or uncertainty as to the application of the principles of these regulations to a particular case, is unable to determine a more appropriate profit allowance, he may accrue the minimum amount determined by the formula percentages.

.17 The profit to be included in the accounts of the contractor upon termination is the difference between (a) the amount of his recorded claim and (b) the total of the inventory, deferred and capitalized items, and other costs applicable to the terminated contract as they are currently included in his accounts. This profit may exceed the amount specified as profit in the claim because costs applicable to the terminated portion of the contract may be allowable in the claim even though they may have been properly written off as incurred in prior periods.

.18 In some cases it will be impossible to make a reasonable estimate of a termination claim in time for inclu-

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sion in the financial statements of the period in which the termination occurs. Effect may then be given in the statements to those parts of the termination claim which are determinable with reasonable certainty and disclosure made, by footnote or otherwise, of the status of the remainder.

.19 When the contractor's claim includes items of known controversial nature it should be stated at the amount estimated to be collectible. When a particular termination claim or part thereof is so uncertain in amount that it cannot be reasonably estimated, it is preferable not to give effect to that part of the claim in the financial statements; but if the total of such undeterminable elements is material, the circumstances should be disclosed in statements issued before the removal of the uncertainty. In an extreme case involving undeterminable claims, consideration should be given to delaying the issuance of financial statements until necessary data are available.

Presentation in Financial Statements

.20 Termination has the effect of converting an active contract in process into a claim, or, from an accounting standpoint, from inventories and other charges into an account receivable. This receivable arises in the regular course of business; it is part of the working capital; and in view of the provisions made for financial assistance to the contractor during the period of termination, collection in large part may be expected within a relatively short time. The termination claim should therefore be classified as a current asset, unless there is an indication of extended delay, such as serious disagreement pointing to probable litigation, which would exclude it from this classification.

.21 Although a claim may be composed of several elements representing reimbursable items of special equipment, deferred charges, inventories, and other items, as well as claims for profit, it is preferable to record the claim in one account. When the total of termination claims is material it should be disclosed separately from other receivables. It is also desirable to segregate claims directly against the government from claims against other contractors where the amounts are significant.

.22 To assure adequate financial assistance to contractors, the acts provide in some cases for partial pay-

ments and in others for such payments or guaranteed loans from the effective date of termination until final settlement. Partial payments are, of course, to be recorded as reductions of the termination claim receivable. Termination loans, on the other hand, are definite liabilities to third parties, even though guaranteed in whole or in part by the government, and accordingly should be shown in the balance sheet as liabilities, with appropriate cross-reference to the related claim or claims. When a terminated contract is one on which advance payments had previously been received, the financial statements of the contractor issued before final collection of the claim ordinarily should reflect any balance of those advances disclosed as deductions from the claim receivable.[1] Financial statements issued before the termination claim is recorded should disclose, by footnote or otherwise, the relationship of such liabilities to a possible termination claim receivable.

.23 Ordinarily, a termination will result in the cessation of a contractor's activity through which materials or services have been supplied under the contract and of the related transactions which have been reflected in the contractor's income accounts as sales and cost elements. In effect, termination policies and procedures provide a basis upon which the contractor's costs in process may become the elements of a final sale under the terminated portion of the contract. Accordingly, the amount of the contractor's termination claim representing his cost and profit elements should be treated as a sale and the costs and expenses chargeable to the claim given their usual classification in the income statement. Because these termination sales are of a special type, their financial results should not be appraised in the same manner as are those of regular sales and they should, if material in amount, be separately disclosed in the income statement. Any items which the contractor chooses to retain without claim for cost or loss are, of course, not sold but remain as inventory or deferred charges in the contractor's accounts.

Claims of Subcontractors

.24 The term *subcontractor's claims* as used in connection with terminated contracts refers to those obliga-

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[1] See section 4041.22.

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tions of a contractor to a subcontractor which arise from the subcontractor's costs incurred through transactions which were related to the contract terminated but did not result in the transfer of billable materials or services to the contractor before termination. Other obligations of a contractor to a subcontractor, arising through transactions by which materials or services of the subcontractor are furnished or supplied to the contractor, are considered to be liabilities incurred in the ordinary course of business and are not included in the term *claims of subcontractors.*

.25 The termination articles provide that, following the termination of a contract, the contractor shall settle, with the approval or ratification of the contracting officer when necessary, all claims of subcontractors arising out of the termination; and that the contractor shall be paid, as part of his settlement, the cost of settling and paying claims arising out of the stoppage of work under subcontracts affected by the termination. While a contractor ordinarily is liable to his subcontractors or suppliers for such obligations, the amounts due them are an element in his termination claim and often are not paid to them until after his claim has been settled. He often has no control over the filing of subcontractors' claims and may not know their amount until some time after the termination date or even until some time after he has filed and received payment for his own claim.

.26 The possibility that a contractor may suffer loss through failure to recover the amount of his liability on subcontractors' claims arises principally from overcommitments, errors in ordering, and similar causes. Provision should be made in his accounts for losses of this character which are known or believed to be probable.

.27 Although the principle that liabilities may not be offset against assets in the financial statements is generally approved by accountants, there is no general agreement as to the accounting treatment to be accorded subcontractors' claims which are expected to be fully recoverable. To the extent that a subcontractor's claim is considered to be unrecoverable no difference of opinion exists; the liability should be recorded and provision made for any contemplated loss. The difference of opinion relates to

those subcontractors' claims which are deemed to be fully recoverable.

.28 Some accountants believe that the effect of the various acts and regulations is to establish a relationship between the claims of subcontractors and the resulting right of the contractor under his own termination claim which differs from an ordinary commercial relationship and justifies their omission from the accounts. Recoverable subcontractors' claims are thus said to be in the nature of contingent liabilities, which are customarily omitted from the accounts except where a loss is expected. Contingent liabilities may be disclosed in the financial statements without recording them as assets and liabilities, and even when they are recorded it is customary accounting practice to show them on the balance sheet as deductions from the related contingent assets so that no effect upon financial ratios and relationships results.

.29 Other accountants believe that the nature of an obligation to a subcontractor is that of an ordinary liability, even though it may arise through the termination of a war or defense contract, and that the contractor's termination claim receivable, although related to the subcontractor's claim, is to be accounted for independently as an asset. This group believes that all subcontractors' claims, to the extent that they are reasonably ascertainable, should be recorded in the accounts and displayed in the contractor's balance sheet as current liabilities, and that the amounts recoverable by the contractor should be included in his termination claim receivable. To the extent that the amounts of subcontractors' claims are not reasonably determinable, disclosure by footnote or otherwise in the financial statements is believed to be adequate.

.30 Because of the merits and prevalence of these alternative views, the committee expresses no preference for either treatment and considers either to be acceptable.

Disposal Credits

.31 Disposal credits are amounts deducted from the contractor's termination claim receivable by reason of his retention, or sale to outsiders, of some or all of the termination inventory for which claim was made. In the case

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of items retained, either as scrap or for use by the contractor, the amount of the credit is determined by agreement between the contractor and a representative of the government. The sale of inventory items by the contractor is likewise subject to approval by the government, except as permitted by regulation. Since the amount of the contractor's termination claim, as already indicated, is properly recorded as a sale, any elements included in that claim for items of inventory retained by the contractor are, in effect, reacquired by him and should be treated as purchases at the agreed value. Amounts received for items sold to others with the approval of the government are collections for the account of the government and should be applied in reduction of the claim receivable. Obviously inventories or other items that are retained by the contractor after termination without claim for loss should not be included as an element of the termination claim.

No-Cost Settlements

.32 A contractor whose contract is terminated may prefer to retain the termination inventory for use in other production or for disposal at his own risk. For these or other reasons the contractor may prefer to make no claim against the government or a higher-tier contractor. In the case of such no-cost settlements there is no sale of inventory or other items to the government and therefore no occasion to accrue any profit arising out of the termination. The costs otherwise applicable to the contract should be given their usual treatment in the accounts. Items of inventory or other property retained, having been previously recorded, will, of course, require no charge to purchases but should be treated in accordance with the usual procedures applicable to such assets.

The next page is 8421.

AC Section 4053

Accounting for Leases

[Source: FASB Statement No. 13.]

November 1976

INTRODUCTION

.001 This Statement establishes standards of financial accounting and reporting for leases by lessees and lessors. For purposes of this Statement, a lease is defined as an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. It includes agreements that, although not nominally identified as leases, meet the above definition, such as a "heat supply contract" for nuclear fuel.[1] This definition does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other. On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of this Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets. This Statement does not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor does it apply to licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights.

.002 This Statement supersedes *APB Opinion No. 5,* "Reporting of Leases in Financial Statements of Lessee"; *APB Opinion No. 7,* "Accounting for Leases in Financial Statements of Lessors"; paragraph 15 of *APB Opinion No. 18* [section 5131.15], "The Equity Method of Accounting for Investments in Common Stock"; *APB Opinion No. 27,* "Accounting for Lease Transactions by Manufacturer or Dealer Lessors"; and *APB Opinion No. 31,* "Disclosure of Lease Commitments by Lessees."

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

.003 This Statement applies to regulated enterprises in accordance with the provisions of the Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit'."

.004 Appendix A provides background information. Appendix B sets forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others. Illustrations of the accounting and disclosure requirements for lessees and lessors called for by this Statement are contained in Appendixes C and D. An example of the application of the accounting and disclosure provisions for leveraged leases is provided in Appendix E.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Definitions of Terms

.005 For purposes of this Statement, certain terms are defined as follows:

a. *Related parties in leasing transactions.* A parent company and its subsidiaries, an owner company and its joint ventures (corporate or otherwise) and partnerships, and an investor (including a natural person) and its investees, provided that the parent company, owner company, or investor has the ability to exercise significant influence over operating and financial policies of the related party, as significant influence is defined in *APB Opinion No. 18,* paragraph 17 [section 5131.17]. In addition to the examples of significant influence set forth in that paragraph, significant influence may be exercised through guarantees of indebtedness, extensions of credit, or through ownership of warrants, debt obligations, or other securities. If two or more entities are subject to the significant influence of a parent, owner company, investor (including a natural person), or common officers or directors, those entities shall be considered related parties with respect to each other.

b. *Inception of the lease.* With the exception noted below, the date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal terms of the transaction.

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However, if the property covered by the lease has yet to be constructed or has not been acquired by the lessor at the date of the lease agreement or commitment, the inception of the lease shall be the date that construction of the property is completed or the property is acquired by the lessor.

c. *Fair value of the leased property.* The price for which the property could be sold in an arm's-length transaction between unrelated parties. (See definition of related parties in leasing transactions in paragraph .005(a).) The following are examples of the determination of fair value:

   i. When the lessor is a manufacturer or dealer, the fair value of the property at the inception of the lease (as defined in paragraph .005(b)) will ordinarily be its normal selling price, reflecting any volume or trade discounts that may be applicable. However, the determination of fair value shall be made in light of market conditions prevailing at the time, which may indicate that the fair value of the property is less than the normal selling price and, in some instances, less than the cost of the property.

   ii. When the lessor is not a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its cost, reflecting any volume or trade discounts that may be applicable. However, when there has been a significant lapse of time between the acquisition of the property by the lessor and the inception of the lease, the determination of fair value shall be made in light of market conditions prevailing at the inception of the lease, which may indicate that the fair value of the property is greater or less than its cost or carrying amount, if different. (See paragraph .006(b).)

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

e. *Bargain renewal option.* A provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental[2] of the property at the date the option becomes

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[2] "Fair rental" in this context shall mean the expected rental for equivalent property under similar terms and conditions.

exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured.

f. *Lease term.* The fixed noncancelable term of the lease plus (i) all periods, if any, covered by bargain renewal options (as defined in paragraph .005(e)), (ii) all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured, (iii) all periods, if any, covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt related to the leased property is expected to be in effect, (iv) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option (as defined in paragraph .005(d)) is exercisable, and (v) all periods, if any, representing renewals or extensions of the lease at the lessor's option; however, in no case shall the lease term extend beyond the date a bargain purchase option becomes exercisable. A lease which is cancelable (i) only upon the occurrence of some remote contingency, (ii) only with the permission of the lessor, (iii) only if the lessee enters into a new lease with the same lessor, or (iv) only upon payment by the lessee of a penalty in an amount such that continuation of the lease appears, at inception, reasonably assured shall be considered "noncancelable" for purposes of this definition.

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

h. *Estimated residual value of leased property.* The estimated fair value of the leased property at the end of the lease term (as defined in paragraph .005 (f)).

i. *Unguaranteed residual value.* The estimated residual value of the leased property (as defined in paragraph .005(h)) exclusive of any portion guaranteed by the lessee[3] or by a third party unrelated to the lessor.[4]

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[3] A guarantee by a third party related to the lessee shall be considered a lessee guarantee.

[4] If the guarantor is related to the lessor, the residual value shall be considered as unguaranteed.

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j. *Minimum lease payments.*
   i. From the standpoint of the lessee: The payments that the lessee is obligated to make or can be required to make in connection with the leased property. However, a guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property shall be excluded. If the lease contains a bargain purchase option, only the minimum rental payments over the lease term (as defined in paragraph .005(f)) and the payment called for by the bargain purchase option shall be included in the minimum lease payments. Otherwise, minimum lease payments include the following:
      a. The minimum rental payments called for by the lease over the lease term.
      b. Any guarantee by the lessee[5] of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property. When the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount shall be considered a lessee guarantee. When the lessee agrees to make up any deficiency below a stated amount in the lessor's realization of the residual value, the guarantee to be included in the minimum lease payments shall be the stated amount, rather than an estimate of the deficiency to be made up.
      c. Any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the leased property. In this connection, it should be noted that the definition of lease term in paragraph .005(f) includes "all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured." If the lease term has been extended because of that provision, the related penalty shall not be included in minimum lease payments.
   ii. From the standpoint of the lessor: The payments described in (i) above plus any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee[6] or the lessor,[7] provided the

[5] See footnote 3.
[6] See footnote 3.
[7] See footnote 4.

third party is financially capable of discharging the obligations that may arise from the guarantee.

k. *Interest rate implicit in the lease.* The discount rate that, when applied to (i) the minimum lease payments (as defined in paragraph .005(j)), excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and (ii) the unguaranteed residual value (as defined in paragraph .005(i)) accruing to the benefit of the lessor,[8] causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property (as defined in paragraph .005(c)) to the lessor at the inception of the lease, minus any investment tax credit retained by the lessor and expected to be realized by him. (This definition does not necessarily purport to include all factors that a lessor might recognize in determining his rate of return, e. g., see paragraph .044.)

l. *Lessee's incremental borrowing rate.* The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset.

m. *Initial direct costs.* Those costs incurred by the lessor that are directly associated with negotiating and consummating completed leasing transactions. Those costs include, but are not necessarily limited to, commissions, legal fees, costs of credit investigations, and costs of preparing and processing documents for new leases acquired. In addition, that portion of salespersons' compensation, other than commissions, and the compensation of other employees that is applicable to the time spent in the activities described above with respect to completed leasing transactions shall also be included in initial direct costs. That portion of salespersons' compensation and the compensation of other employees that is applicable to the time spent in negotiating leases that are not consummated shall not be included in initial direct costs. No portion of supervisory and administrative expenses or other indirect expenses, such as rent and facilities costs, shall be included in initial direct costs. [As amended, effective for leasing transactions and lease agreement revisions entered into on or after January 1, 1978, by FASB Statement No. 17.] (See section 4054.)

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

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Classification of Leases for Purposes of this Statement

.006 For purposes of applying the accounting and reporting standards of this Statement, leases are classified as follows:

a. Classifications from the standpoint of the lessee:

   i. *Capital leases.* Leases that meet one or more of the criteria in paragraph .007.

   ii. *Operating leases.* All other leases.

b. Classifications from the standpoint of the lessor:

   i. *Sales-type leases.* Leases that give rise to manufacturer's or dealer's profit (or loss) to the lessor (i.e., the fair value of the leased property at the inception of the lease is greater or less than its cost or carrying amount, if different) and that meet one or more of the criteria in paragraph .007 and both of the criteria in paragraph .008. Normally, sales-type leases will arise when manufacturers or dealers use leasing as a means of marketing their products. Leases involving lessors that are primarily engaged in financing operations normally will not be sales-type leases if they qualify under paragraphs .007 and .008, but will most often be direct financing leases, described in paragraph .006(b)(ii) below. However, a lessor need not be a dealer to realize dealer's profit (or loss) on a transaction, e. g., if a lessor, not a dealer, leases an asset that at the inception of the lease has a fair value that is greater or less than its cost or carrying amount, if different, such a transaction is a sales-type lease, assuming the criteria referred to are met. A renewal or an extension [9] of an existing sales-type or direct financing lease shall not be classified as a sales-type lease; however, if it qualifies under paragraphs .007 and .008, it shall be classified as a direct financing lease. (See paragraph .017(f).)

   ii. *Direct financing leases.* Leases other than leveraged leases that do not give rise to manufacturer's or dealer's profit (or loss) to the lessor but that meet one or more of the criteria in paragraph .007 and both of the criteria in paragraph .008. In such leases, the cost or carrying amount, if different, and fair value of the leased property are the same at the inception of the lease. An exception arises when an existing lease is renewed or extended.[10] In such cases, the fact that the carrying amount of the property at the end of the original lease term is different from its fair value at that date shall

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

[10] See footnote 9.

not preclude the classification of the renewal or extension as a direct financing lease. (See paragraph .017(f).)

iii. *Leveraged leases.* Leases that meet the criteria of paragraph .042.

iv. *Operating leases.* All other leases.

Criteria for Classifying Leases (Other Than Leveraged Leases)

.007 The criteria for classifying leases set forth in this paragraph and in paragraph .008 derive from the concept set forth in paragraph .060. If at its inception (as defined in paragraph .005(b)) a lease meets one or more of the following four criteria, the lease shall be classified as a capital lease by the lessee. Otherwise, it shall be classified as an operating lease. (See Appendix C for an illustration of the application of these criteria.)

a. The lease transfers ownership of the property to the lessee by the end of the lease term (as defined in paragraph .005(f)).

b. The lease contains a bargain purchase option (as defined in paragraph .005(d)).

c. The lease term (as defined in paragraph .005(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph .005(g)). However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

d. The present value at the beginning of the lease term of the minimum lease payments (as defined in paragraph .005(j)), excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property (as defined in paragraph .005(c)) to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property,

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including earlier years of use, this criterion shall not be used for purposes of classifying the lease. A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease (as defined in paragraph .005(k)). A lessee shall compute the present value of the minimum lease payments using his incremental borrowing rate (as defined in paragraph .005(l)), unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate.

.008 From the standpoint of the lessor, if at inception a lease meets any one of the preceding four criteria and in addition meets both of the following criteria, it shall be classified as a sales-type lease or a direct financing lease, whichever is appropriate (see paragraphs .006(b)(i) and .006(b)(ii)). Otherwise, it shall be classified as an operating lease.

a. Collectibility of the minimum lease payments is reasonably predictable. A lessor shall not be precluded from classifying a lease as a sales-type lease or as a direct financing lease simply because the receivable is subject to an estimate of uncollectibility based on experience with groups of similar receivables.

b. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease. Important uncertainties might include commitments by the lessor to guarantee performance of the leased property in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the leased property. However, the necessity of estimating executory costs such as insurance, maintenance, and taxes to be paid by the lessor (see paragraphs .017(a) and .018(a)) shall not by itself constitute an important uncertainty as referred to herein.

.009 If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs .007 and .008 had the changed terms been in effect at the inception of the lease, the revised agreement shall be considered as a new agreement over its term, and the criteria in paragraphs .007 and

.008 shall be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered inoperative as described in paragraphs .012 and .017(e), any action that extends the lease beyond the expiration of the existing lease term (see paragraph .005(f)), such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the provisions of paragraphs .006-.008. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, shall not give rise to a new classification of a lease for accounting purposes.

Accounting and Reporting by Lessees

Capital Leases

.010 The lessee shall record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, together with any profit thereon. However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation shall be the fair value. If the portion of the minimum lease payments representing executory costs, including profit thereon, is not determinable from the provisions of the lease, an estimate of the amount shall be made. The discount rate to be used in determining present value of the minimum lease payments shall be that prescribed for the lessee in paragraph .007(d). (See Appendix C for illustrations.)

.011 Except as provided in paragraphs .025 and .026 with respect to leases involving land, the asset recorded under a capital lease shall be amortized as follows:

a. If the lease meets the criterion of either paragraph .007(a) or .007(b), the asset shall be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets.
b. If the lease does not meet either criterion .007(a) or .007(b), the asset shall be amortized in a manner consistent with the lessee's normal depreciation policy except that the period of

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amortization shall be the lease term. The asset shall be amortized to its expected value, if any, to the lessee at the end of the lease term. As an example, if the lessee guarantees a residual value at the end of the lease term and has no interest in any excess which might be realized, the expected value of the leased property to him is the amount that can be realized from it up to the amount of the guarantee.

.012 During the lease term, each minimum lease payment shall be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation.[11] (See Appendix C for illustrations.) In leases containing a residual guarantee by the lessee or a penalty for failure to renew the lease at the end of the lease term,[12] following the above method of amortization will result in a balance of the obligation at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension of the lease term or a new lease under which the lessee continues to lease the same property renders the guarantee or penalty inoperative, the asset and the obligation under the lease shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised agreement shall be computed using the rate of interest used to record the lease initially. In accordance with paragraph .009, other renewals and extensions of the lease term shall be considered new agreements, which shall be accounted for in accordance with the provisions of paragraph .014. Contingent rentals,[13] including rentals based on variables such as the prime interest rate, shall be charged to expense when actually incurred.

.013 Assets recorded under capital leases and the accumulated amortization thereon shall be separately identified in the lessee's balance sheet or in footnotes thereto. Likewise, the related obliga-

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[11] This is the "interest" method described in the first sentence of paragraph 15 of *APB Opinion No. 21* [section 4111.14], "Interest on Receivables and Payables," and in paragraphs 16 and 17 of *APB Opinion No. 12* [section 5361.01-.02], "Omnibus Opinion—1967."

[12] Residual guarantees and termination penalties that serve to extend the lease term (as defined in paragraph .005(f)) are excluded from minimum lease payments and are thus distinguished from those guarantees and penalties referred to in this paragraph.

[13] The term "contingent rentals" includes all or any portion of the stipulated rental that is contingent.

tions shall be separately identified in the balance sheet as obligations under capital leases and shall be subject to the same considerations as other obligations in classifying them with current and noncurrent liabilities in classified balance sheets. Unless the charge to income resulting from amortization of assets recorded under capital leases is included with depreciation expense and the fact that it is so included is disclosed, the amortization charge shall be separately disclosed in the financial statements or footnotes thereto.

.014 Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a capital lease (see *FASB Statement No. 22* [section 4055]), a change in the provisions of a lease, a renewal or extension [14] of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows:

a. If the provisions of the lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (i) does not give rise to a new agreement under the provisions of paragraph .009 or (ii) does give rise to a new agreement but such agreement is also classified as a capital lease, the present balances of the asset and the obligation shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised or new agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised or new agreement shall be computed using the rate of interest used to record the lease initially. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the asset and obligation under the lease shall be removed, gain or loss shall be recognized for the difference, and the new lease agreement shall thereafter be accounted for as any other operating lease.

b. Except when a guarantee or penalty is rendered inoperative as described in paragraph .012, a renewal or an extension [15] of an existing lease shall be accounted for as follows:

[14] See footnote 9.

[15] See footnote 9.

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i. If the renewal or extension is classified as a capital lease, it shall be accounted for as described in subparagraph (a) above.

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

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

[As amended, effective July 1, 1978, by FASB Statement No. 22.] (See section 4055.)

Operating Leases

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

Disclosures

.016 The following information with respect to leases shall be disclosed in the lessee's financial statements or the footnotes thereto (see Appendix D for illustrations).

a. For capital leases:

i. The gross amount of assets recorded under capital leases as of the date of each balance sheet presented by major classes according to nature or function. This information may be combined with the comparable information for owned assets.

ii. Future minimum lease payments as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years, with separate deductions from the total for the amount representing executory

costs, including any profit thereon, included in the minimum lease payments and for the amount of the imputed interest necessary to reduce the net minimum lease payments to present value (see paragraph .010).

iii. The total of minimum sublease rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

iv. Total contingent rentals (rentals on which the amounts are dependent on some factor other than the passage of time) actually incurred for each period for which an income statement is presented.

b. For operating leases having initial or remaining noncancelable lease terms in excess of one year:

i. Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.

ii. The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

c. For all operating leases, rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.

d. A general description of the lessee's leasing arrangements including, but not limited to, the following:

i. The basis on which contingent rental payments are determined.

ii. The existence and terms of renewal or purchase options and escalation clauses.

iii. Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.

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Accounting and Reporting by Lessors

Sales–Type Leases

.017 Sales-type leases shall be accounted for by the lessor as follows:

a. The minimum lease payments (net of amounts, if any, included therein with respect to executory costs such as maintenance, taxes, and insurance to be paid by the lessor, together with any profit thereon) plus the unguaranteed residual value (as defined in paragraph .005(i)) accruing to the benefit of the lessor shall be recorded as the gross investment in the lease.

b. The difference between the gross investment in the lease in (a) above and the sum of the present values of the two components of the gross investment shall be recorded as unearned income. The discount rate to be used in determining the present values shall be the interest rate implicit in the lease. The net investment in the lease shall consist of the gross investment less the unearned income. The unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.[16] However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. Contingent rentals, including rentals based on variables such as the prime interest rate, shall be credited to income when they become receivable.

c. The present value of the minimum lease payments (net of executory costs, including any profit thereon), computed at the interest rate implicit in the lease, shall be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any initial direct costs (as defined in paragraph .005(m)), less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, shall be charged against income in the same period.

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[16] See footnote 11.

d. The estimated residual value shall be reviewed at least annually. If the review results in a lower estimate than had been previously established, a determination must be made as to whether the decline in estimated residual value is other than temporary. If the decline in estimated residual value is judged to be other than temporary, the accounting for the transaction shall be revised using the changed estimate. The resulting reduction in the net investment shall be recognized as a loss in the period in which the estimate is changed. An upward adjustment of the estimated residual value shall not be made.

e. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,[17] following the method of amortization described in (b) above will result in a balance of minimum lease payments receivable at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension [18] of the lease term renders the guarantee or penalty inoperative, the existing balances of the minimum lease payments receivable and the estimated residual value shall be adjusted for the changes resulting from the revised agreement (subject to the limitation on the residual value imposed by subparagraph (d) above) and the net adjustment shall be charged or credited to unearned income.

f. Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a direct financing lease (see *FASB Statement No. 22* [section 4055]), a change in the provisions of a lease, a renewal or extension [19] of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows:

   i. If the provisions of a lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (a) does not give rise to a new agreement under the provisions of paragraph .009 or (b) does give rise to a new agreement but such agreement is classified as a direct financing lease, the balance of the

[17] See footnote 12.
[18] See footnote 9.
[19] See footnote 9.

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minimum lease payments receivable and the estimated residual value, if affected, shall be adjusted to reflect the change (subject to the limitation on the residual value imposed by subparagraph (d) above), and the net adjustment shall be charged or credited to unearned income. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the remaining net investment shall be removed from the accounts, the leased asset shall be recorded as an asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period. The new lease shall thereafter be accounted for as any other operating lease.

ii. Except when a guarantee or penalty is rendered inoperative as described in subparagraph (e) above, a renewal or an extension [20] of an existing lease shall be accounted for as follows:

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

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

iii. A termination of the lease shall be accounted for by removing the net investment from the accounts, recording the leased asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period.

[As amended, effective July 1, 1978, by FASB Statement No. 22.] (See section 4055.)

Direct Financing Leases

.018 Direct financing leases shall be accounted for by the lessor as follows (see Appendix C for illustrations):

a. The minimum lease payments (net of amounts, if any, included therein with respect to executory costs such as maintenance, taxes, and insurance to be paid by the lessor, together with any profit thereon) plus the unguaranteed residual value accruing

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[20] See footnote 9.

to the benefit of the lessor shall be recorded as the gross investment in the lease.

b. The difference between the gross investment in the lease in (a) above and the cost or carrying amount, if different, of the leased property shall be recorded as unearned income. The net investment in the lease shall consist of the gross investment less the unearned income. Initial direct costs (as defined in paragraph .005(m)) shall be charged against income as incurred, and a portion of the unearned income equal to the initial direct costs shall be recognized as income in the same period. The remaining unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.[21] However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method in the preceding sentence. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. Contingent rentals, including rentals based on variables such as the prime interest rate, shall be credited to income when they become receivable.

c. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,[22] the lessor shall follow the accounting procedure described in paragraph .017(e). The accounting provisions of paragraph .017(f) with respect to renewals and extensions not dealt with in paragraph .017(e), terminations, and other changes in lease provisions shall also be followed with respect to direct financing leases.

d. The estimated residual value shall be reviewed at least annually and, if necessary, adjusted in the manner prescribed in paragraph .017(d).

Operating Leases

.019 Operating leases shall be accounted for by the lessor as follows.

a. The leased property shall be included with or near property, plant, and equipment in the balance sheet. The property shall be depreciated following the lessor's normal depreciation

[21] See footnote 11.

[22] See footnote 12.

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policy, and in the balance sheet the accumulated depreciation shall be deducted from the investment in the leased property.

b. Rent shall be reported as income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the income shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used.

c. Initial direct costs shall be deferred and allocated over the lease term in proportion to the recognition of rental income. However, initial direct costs may be charged to expense as incurred if the effect is not materially different from that which would have resulted from the use of the method prescribed in the preceding sentence.

Participation by Third Parties

.020 The sale or assignment of a lease or of property subject to a lease that was accounted for as a sales-type lease or direct financing lease shall not negate the original accounting treatment accorded the lease. Any profit or loss on the sale or assignment shall be recognized at the time of the transaction except that (a) when the sale or assignment is between related parties, the provisions of paragraphs .029 and .030 shall be applied, or (b) when the sale or assignment is with recourse, the profit or loss shall be deferred and recognized over the lease term in a systematic manner (e.g., in proportion to the minimum lease payments).

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

property owned by the third-party purchaser over similar property owned or produced by the seller. (For example, a first-in, first-out remarketing arrangement is considered to be a priority.)

.022 If a sale to a third party of property subject to an operating lease or of property that is leased by or intended to be leased by the third-party purchaser to another party is not to be recorded as a sale because of the provisions of paragraph .021 above, the transaction shall be accounted for as a borrowing. (Transactions of these types are in effect collateralized borrowings.) The proceeds from the "sale" shall be recorded as an obligation on the books of the "seller." Until that obligation has been amortized under the procedure described herein, rental payments made by the lessee(s) under the operating lease or leases shall be recorded as revenue by the "seller," even if such rentals are paid directly to the third-party purchaser. A portion of each rental shall be recorded by the "seller" as interest expense, with the remainder to be recorded as a reduction of the obligation. The interest expense shall be calculated by application of a rate determined in accordance with the provisions of *APB Opinion No. 21,* "Interest on Receivables and Payables," paragraphs 13 and 14 [section 4111.12-.13]. The leased property shall be accounted for as prescribed in paragraph .019(a) for an operating lease, except that the term over which the asset is depreciated shall be limited to the estimated amortization period of the obligation. The sale or assignment by the lessor of lease payments due under an operating lease shall be accounted for as a borrowing as described above.

Disclosures

.023 When leasing, exclusive of leveraged leasing, is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the following information with respect to leases shall be disclosed in the financial statements or footnotes thereto (see Appendix D for illustrations):

a. For sales-type and direct financing leases:

   i. The components of the net investment in sales-type and direct financing leases as of the date of each balance sheet presented:

      a. Future minimum lease payments to be received, with separate deductions for (i) amounts representing executory costs, including any profit thereon, included in the minimum lease payments and (ii) the accumulated allowance for uncollectible minimum lease payments receivable.

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b. The unguaranteed residual values accruing to the benefit of the lessor.

c. Unearned income (see paragraphs .017(b) and .018(b)).

ii. Future minimum lease payments to be received for each of the five succeeding fiscal years as of the date of the latest balance sheet presented.

iii. The amount of unearned income included in income to offset initial direct costs charged against income for each period for which an income statement is presented. (For direct financing leases only.)

iv. Total contingent rentals included in income for each period for which an income statement is presented.

b. For operating leases:

i. The cost and carrying amount, if different, of property on lease or held for leasing by major classes of property according to nature or function, and the amount of accumulated depreciation in total as of the date of the latest balance sheet presented.

ii. Minimum future rentals on noncancelable leases as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.

iii. Total contingent rentals included in income for each period for which an income statement is presented.

c. A general description of the lessor's leasing arrangements.

Leases Involving Real Estate

.024 For purposes of this Statement, leases involving real estate can be divided into four categories: (a) leases involving land only, (b) leases involving land and building(s), (c) leases involving equipment as well as real estate, and (d) leases involving only part of a building.

Leases Involving Land Only

.025 If land is the sole item of property leased and the criterion in either paragraph .007(a) or .007(b) is met, the lessee shall account for the lease as a capital lease; otherwise, as an operating lease. If the criteria set forth in paragraph .008 are also met, the lessor shall account for the lease as a sales-type or direct financing lease, whichever is appropriate (see paragraphs

.006(b)(i) and .006(b)(ii)); otherwise, as an operating lease. Criteria .007(c) and .007(d) are not applicable to land leases. Because ownership of the land is expected to pass to the lessee if either criterion .007(a) or .007(b) is met, the asset recorded under the capital lease would not normally be amortized.

Leases Involving Land and Building(s)

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

a. Lease meets either criterion .007(a) or .007(b):

   i. Lessee's accounting: If either criterion (a) or (b) of paragraph .007 is met, the land and building shall be separately capitalized by the lessee. For this purpose, the present value of the minimum lease payments after deducting executory costs, including any profit thereon, shall be allocated between the two elements in proportion to their fair values at the inception of the lease. The building shall be amortized in accordance with the provisions of paragraph .011(a). As stated in paragraph .025, land capitalized under a lease that meets criterion (a) or (b) of paragraph .007 would not normally be amortized.

   ii. Lessor's accounting: If either criterion (a) or (b) of paragraph .007 is met and the criteria of paragraph .008 are also met, the lessor shall account for the lease as a single unit, either as a sales-type lease or as a direct financing lease as appropriate under paragraphs .006(b)(i) and .006(b)(ii). If the criteria of paragraph .008 are not met, the lessor shall account for the lease as an operating lease.

b. Lease meets neither criterion .007(a) nor .007(b):

   i. If the fair value of the land is less than 25 percent of the total fair value of the leased property at the inception of the lease: Both the lessee and the lessor shall consider the land and the building as a single unit for purposes of applying the criteria of paragraphs .007(c) and .007(d). For purposes of applying the criterion of paragraph .007(c), the estimated economic life of the building shall be considered as the estimated economic life of the unit.

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a. Lessee's accounting: If either criterion (c) or (d) of paragraph .007 is met, the lessee shall capitalize the land and building as a single unit and amortize it in accordance with the provisions of paragraph .011(b); otherwise, the lease shall be accounted for as an operating lease.

b. Lessor's accounting: If either criterion (c) or (d) of paragraph .007 and the criteria of paragraph .008 are met, the lessor shall account for the lease as a single unit, either as a sales-type lease or as a direct financing lease as appropriate under paragraphs .006(b)(i) and .006(b)(ii); otherwise, the lease shall be accounted for as an operating lease.

ii. If the fair value of the land is 25 percent or more of the total fair value of the leased property at the inception of the lease: Both the lessee and lessor shall consider the land and the building separately for purposes of applying the criteria of paragraphs .007(c) and .007(d). The minimum lease payments after deducting executory costs, including any profit thereon, applicable to the land and the building shall be separated both by the lessee and the lessor by determining the fair value of the land and applying the lessee's incremental borrowing rate to it to determine the annual minimum lease payments applicable to the land element; the remaining minimum lease payments shall be attributed to the building element.

a. Lessee's accounting: If the building element of the lease meets criterion (c) or (d) of paragraph .007, the building element shall be accounted for as a capital lease and amortized in accordance with the provisions of paragraph .011(b). The land element of the lease shall be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph .007, both the building element and the land element shall be accounted for as a single operating lease.

b. Lessor's accounting: If the building element of the lease meets criterion (c) or (d) of paragraph .007 and the criteria of paragraph .008, the building element shall be accounted for as a sales-type lease or a direct financing lease as appropriate under paragraphs

.006(b)(i) and .006(b)(ii). The land element of the lease shall be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph .007 or does not meet the criteria of paragraph .008, both the building element and the land element shall be accounted for as a single operating lease.

Leases Involving Equipment as Well as Real Estate

.027 If a lease involving real estate also includes equipment, the portion of the minimum lease payments applicable to the equipment element of the lease shall be estimated by whatever means are appropriate in the circumstances. The equipment shall be considered separately for purposes of applying the criteria in paragraphs .007 and .008 and shall be accounted for separately according to its classification by both lessees and lessors.

Leases Involving Only Part of a Building

.028 When the leased property is part of a larger whole, its cost (or carrying amount) and fair value may not be objectively determinable, as for example, when an office or floor of a building is leased. If the cost and fair value of the leased property are objectively determinable, both the lessee and the lessor shall classify and account for the lease according to the provisions of paragraph .026. Unless both the cost and the fair value are objectively determinable, the lease shall be classified and accounted for as follows:

a. Lessee:

   i. If the fair value of the leased property is objectively determinable, the lessee shall classify and account for the lease according to the provisions of paragraph .026.

   ii. If the fair value of the leased property is not objectively determinable, the lessee shall classify the lease according to the criterion of paragraph .007(c) only, using the estimated economic life of the building in which the leased premises are located. If that criterion is met, the leased property shall be capitalized as a unit and amortized in accordance with the provisions of paragraph .011(b).

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b. Lessor: If either the cost or the fair value of the property is not objectively determinable, the lessor shall account for the lease as an operating lease.

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

Leases Between Related Parties

.029 Except as noted below, leases between related parties (as defined in paragraph .005(a)) shall be classified in accordance with the criteria in paragraphs .007 and .008. Insofar as the separate financial statements of the related parties are concerned, the classification and accounting shall be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related. In such cases the classification and/or accounting shall be modified as necessary to recognize economic substance rather than legal form. The nature and extent of leasing transactions with related parties shall be disclosed.

.030 In consolidated financial statements or in financial statements for which an interest in an investee is accounted for on the equity basis, any profit or loss on a leasing transaction with the related party shall be accounted for in accordance with the principles set forth in *ARB No. 51* [section 2051], "Consolidated Financial Statements," or *APB Opinion No. 18* [section 5131], whichever is applicable.

.031 The accounts of subsidiaries (regardless of when organized or acquired) whose principal business activity is leasing property or facilities to the parent or other affiliated companies shall be consolidated. The equity method is not adequate for fair presentation of those subsidiaries because their assets and liabilities are significant to the consolidated financial position of the enterprise.

Sale–Leaseback Transactions

.032 Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller.

.033 If the lease meets one of the criteria for treatment as a capital lease (see paragraph .007), the seller-lessee shall account for the lease as a capital lease; otherwise, as an operating lease. Except as noted below, any profit or loss on the sale shall be deferred and amortized in proportion to the amortization of the leased asset,[23] if a capital lease, or in proportion to rental payments over the period of time the asset is expected to be used, if an operating lease. However, when the fair value of the property at the time of the transaction is less than its undepreciated cost, a loss shall be recognized immediately up to the amount of the difference between undepreciated cost and fair value.

.034 If the lease meets the criteria in paragraphs .007 and .008, the purchaser-lessor shall record the transaction as a purchase and a direct financing lease; otherwise, he shall record the transaction as a purchase and an operating lease.

Accounting and Reporting for Subleases and Similar Transactions

.035 This section deals with the following types of leasing transactions:

a. The leased property is re-leased by the original lessee to a third party, and the lease agreement between the two original parties remains in effect (a sublease).

b. A new lessee is substituted under the original lease agreement. The new lessee becomes the primary obligor under the agreement, and the original lessee may or may not be secondarily liable.

c. A new lessee is substituted through a new agreement, with cancellation of the original lease agreement.

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

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Accounting by the Original Lessor

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

.037 If the original lease agreement is replaced by a new agreement with a new lessee, the lessor shall account for the termination of the original lease as provided in paragraph .017(f) and shall classify and account for the new lease as a separate transaction.

Accounting by the Original Lessee

.038 If the nature of the transaction is such that the original lessee is relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraphs .035(b) and .035(c), the termination of the original lease agreement shall be accounted for as follows:

a. If the original lease was a capital lease, the asset and obligation representing the original lease shall be removed from the accounts, gain or loss shall be recognized for the difference, and, if the original lessee is secondarily liable, the loss contingency shall be treated as provided by *FASB Statement No. 5* [section 4311], "Accounting for Contingencies." Any consideration paid or received upon termination shall be included in the determination of gain or loss to be recognized.

b. If the original lease was an operating lease and the original lessee is secondarily liable, the loss contingency shall be treated as provided by *FASB Statement No. 5* [section 4311].

.039 If the nature of the transaction is such that the original lessee is not relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraph .035(a), the original lessee, as sublessor, shall account for the transaction as follows:

a. If the original lease met either criterion (a) or (b) of paragraph .007, the original lessee shall classify the new lease in accordance with the criteria of paragraphs .007 and .008. If the new lease meets one of the criteria of paragraph .007 and both of the criteria of paragraph .008, it shall be accounted

for as a sales-type or direct financing lease, as appropriate, and the unamortized balance of the asset under the original lease shall be treated as the cost of the leased property. If the new lease does not qualify as a sales-type or direct financing lease, it shall be accounted for as an operating lease. In either case, the original lessee shall continue to account for the obligation related to the original lease as before.

b. If the original lease met either criterion (c) or (d) but not criterion (a) or (b) of paragraph .007, the original lessee shall, with one exception, classify the new lease in accordance with the criteria of paragraphs .007(c) and .008 only. If it meets those criteria, it shall be accounted for as a direct financing lease, with the unamortized balance of the asset under the original lease treated as the cost of the leased property; otherwise, as an operating lease. In either case, the original lessee shall continue to account for the obligation related to the original lease as before. The one exception arises when the timing and other circumstances surrounding the sublease are such as to suggest that the sublease was intended as an integral part of an overall transaction in which the original lessee serves only as an intermediary. In that case, the sublease shall be classified according to the criteria of paragraphs .007(c) and .007(d), as well as the criteria of paragraph .008. In applying the criterion of paragraph .007(d), the fair value of the leased property shall be the fair value to the original lessor at the inception of the original lease.

c. If the original lease is an operating lease, the original lessee shall account for both it and the new lease as operating leases.

Accounting by the New Lessee

.040 The new lessee shall classify the lease in accordance with the criteria of paragraph .007 and account for it accordingly.

Accounting and Reporting for Leveraged Leases

.041 From the standpoint of the lessee, leveraged leases shall be classified and accounted for in the same manner as non-leveraged leases. The balance of this section deals with leveraged leases from the standpoint of the lessor.

.042 For purposes of this Statement, a leveraged lease is defined as one having all of the following characteristics:

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a. Except for the exclusion of leveraged leases from the definition of a direct financing lease as set forth in paragraph .006(b)(ii), it otherwise meets that definition. Leases that meet the definition of sales-type leases set forth in paragraph .006(b)(i) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph .017.

b. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).

c. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of the financing is sufficient to provide the lessor with substantial "leverage" in the transaction.

d. The lessor's net investment, as defined in paragraph .043, declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

A lease meeting the preceding definition shall be accounted for by the lessor using the method described in paragraphs .043-.047; an exception arises if the investment tax credit is accounted for other than as stated in paragraphs .043 and .044,[24] in which case the lease shall be classified as a direct financing lease and accounted for in accordance with paragraph .018. A lease not meeting the definition of a leveraged lease shall be accounted for in accordance with its classification under paragraph .006(b).

.043 The lessor shall record his investment in a leveraged lease net of the nonrecourse debt. The net of the balances of the following accounts shall represent the initial and continuing investment in leveraged leases:

a. Rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt.

b. A receivable for the amount of the investment tax credit to be realized on the transaction.

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[24] It is recognized that the investment tax credit may be accounted for other than as prescribed in this section, as provided by Congress in the Revenue Act of 1971.

c. The estimated residual value of the leased asset.

d. Unearned and deferred income consisting of (i) the estimated pretax lease income (or loss), after deducting initial direct costs, remaining to be allocated to income over the lease term and (ii) the investment tax credit remaining to be allocated to income over the lease term.

The investment in leveraged leases less deferred taxes arising from differences between pretax accounting income and taxable income shall represent the lessor's net investment in leveraged leases for purposes of computing periodic net income from the lease, as described in paragraph .044.

.044 Given the original investment and using the projected cash receipts and disbursements over the term of the lease, the rate of return on the net investment in the years[25] in which it is positive shall be computed. The rate is that rate which when applied to the net investment in the years in which the net investment is positive will distribute the net income to those years (see Appendix E, Schedule 3) and is distinct from the interest rate implicit in the lease as defined in paragraph .005(k). In each year, whether positive or not, the difference between the net cash flow and the amount of income recognized, if any, shall serve to increase or reduce the net investment balance. The net income recognized shall be composed of three elements: two, pretax lease income (or loss) and investment tax credit, shall be allocated in proportionate amounts from the unearned and deferred income included in net investment, as described in paragraph .043; the third element is the tax effect of the pretax lease income (or loss) recognized, which shall be reflected in tax expense for the year. The tax effect of the difference between pretax accounting income (or loss) and taxable income (or loss) for the year shall be charged or credited to deferred taxes. The accounting prescribed in paragraph .043 and in this paragraph is illustrated in Appendix E.

.045 If the projected net cash receipts [26] over the term of the lease are less than the lessor's initial investment, the deficiency shall be recognized as a loss at the inception of the lease. Likewise, if at

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

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

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any time during the lease term the application of the method prescribed in paragraphs .043 and .044 would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in cases where one of the important assumptions affecting net income is revised (see paragraph .046).

.046 Any estimated residual value and all other important assumptions affecting estimated total net income from the lease shall be reviewed at least annually. If during the lease term the estimate of the residual value is determined to be excessive and the decline in the residual value is judged to be other than temporary or if the revision of another important assumption changes the estimated total net income from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph .044 and using the revised assumption. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed. An upward adjustment of the estimated residual value shall not be made. The accounting prescribed in this paragraph is illustrated in Appendix E.

.047 For purposes of presenting the investment in a leveraged lease in the lessor's balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment), as prescribed in *APB Opinion No. 11,* "Accounting for Income Taxes," paragraphs 57, 59, and 64 [sections 4091.56, 4091.58, and 4091.63]. In the income statement or the notes thereto, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period. When leveraged leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases as set forth in paragraph .043 shall be disclosed in the footnotes to the financial statements. Appendix E contains an illustration of the balance sheet, income statement, and footnote presentation for a leveraged lease.

Effective Date and Transition

.048 The preceding paragraphs of this Statement shall be effective for leasing transactions and lease agreement revisions (see paragraph .009) entered into on or after January 1, 1977. However,

leasing transactions or revisions of agreements consummated on or after January 1, 1977 pursuant to the terms of a commitment made prior to that date and renewal options exercised under agreements existing or committed prior to that date shall not be considered as leasing transactions or lease agreement revisions entered into after January 1, 1977 if such commitment is in writing, signed by the parties in interest to the transaction, including the financing party,[27] if any, when specific financing is essential to the transaction, and specifically sets forth the principal terms of the transaction. The disclosures called for in the preceding paragraphs of this Statement shall be included in financial statements for calendar or fiscal years ending after December 31, 1976.[28] Earlier application of the preceding paragraphs of this Statement, including retroactive application to all leases regardless of when they were entered into or committed is encouraged but, until the effective date specified in paragraph .049, is not required. If applied retroactively, financial statements presented for prior periods shall be restated according to the provisions of paragraph .051.

.049 For purposes of financial statements for calendar or fiscal years beginning after December 31, 1980, paragraphs .001-.047 of this Statement shall be applied retroactively, and any accompanying financial statements presented for prior periods shall be restated as may be required by the provisions of paragraph .051.

.050 If paragraphs .001-.047 are not applied initially on a retroactive basis, as permitted by paragraph .048, those leases existing or committed at December 31, 1976 shall be subject to the following provisions until such time as paragraphs .001-.047 are applied retroactively to all leases.

a. For purposes of applying the presentation and disclosure requirements of this Statement applicable to lessees, those leases existing or committed at December 31, 1976 that are capitalized in accordance with the provisions of superseded *APB Opinion No. 5* shall be considered as capital leases, and those leases existing or committed at December 31, 1976 that are classified and accounted for as operating leases shall be con-

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[27] For purposes of this paragraph, the term "financing party" shall include an interim lender pending long-term financing.

[28] For an enterprise having a fiscal year of 52 or 53 weeks ending in the last seven days in December or the first seven days in January, references to December 31 in paragraphs .048-.051 shall mean the date in December or January on which the fiscal year ends.

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sidered as operating leases. For those leases that are classified and accounted for as operating leases but that meet the criteria of paragraph .007 for classification as capital leases, separate disclosure of the following information shall be made for purposes of financial statements for the year ending December 31, 1977 and for years ending thereafter:

i. The amounts of the asset and the liability that would have been included in the balance sheet had those leases been classified and accounted for in accordance with the provisions of paragraphs .001-.047. This information shall also be disclosed for balance sheets as of December 31, 1976 and thereafter when such balance sheets are included in the financial statements referred to in paragraph .050(a) above.

ii. The effect on net income that would have resulted if those leases had been classified and accounted for in accordance with the provisions of paragraphs .001-.047. This information shall also be disclosed for income statements for periods beginning after December 31, 1976 when such income statements are included in the aforementioned financial statements.

b. For purposes of applying the presentation and disclosure requirements of this Statement applicable to lessors, those leases existing or committed at December 31, 1976 that are accounted for as sales, financing leases, and as operating leases in accordance with superseded *APB Opinions No. 7* and *27* shall be considered as sales-type leases, as direct financing leases, and as operating leases, respectively. (Refer to (c) below for provisions applicable to leveraged leases.) For those leases existing or committed at December 31, 1976 that are classified and accounted for as operating leases but that meet the criteria of paragraphs .007 and .008 for classification as direct financing leases or sales-type leases, separate disclosure of the following information shall be made for purposes of financial statements for the year ending December 31, 1977 and for years ending thereafter:

i. The amount of the change in net worth that would have resulted had the leases been classified and accounted for in accordance with the provisions of paragraphs .001-.047. This information shall also be disclosed for balance sheets as of December 31, 1976 and thereafter when such balance

sheets are included in the foregoing financial statements referred to in paragraph .050(b) above.

ii. The effect on net income that would have resulted if the leases had been classified and accounted for in accordance with the provisions of paragraphs .001-.047. This information shall also be disclosed for income statements for periods beginning after December 31, 1976 when such income statements are included in the aforementioned financial statements.

c. For those leases that meet the criteria of paragraph .042 (leveraged leases) but that are accounted for other than as prescribed in paragraphs .001-.047, separate disclosure of the following information shall be made for purposes of lessors' financial statements for the year ending December 31, 1977 and for years ending thereafter:

i. The amounts of the net changes in total assets and in total liabilities that would have resulted had the leases been classified and accounted for in accordance with the provisions of paragraphs .001-.047. This information shall also be disclosed for balance sheets as of December 31, 1976 and thereafter when such balance sheets are included in the financial statements referred to in paragraph .050(c) above.

ii. The effect on net income that would have resulted if the leases had been classified and accounted for in accordance with the provisions of paragraphs .001-.047. This information shall also be disclosed for income statements for periods beginning after December 31, 1976 when such income statements are included in the aforementioned financial statements.

.051 Paragraph .049 requires retroactive application of paragraphs .001-.047 for purposes of financial statements for calendar or fiscal years beginning after December 31, 1980, and paragraph .048 encourages earlier retroactive application. If after retroactive application is adopted, financial statements for earlier periods and financial summaries or other data derived from them are presented, they shall be restated in accordance with the following requirements to conform to the provisions of paragraphs .001-.047:

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a. Such restatements shall include the effects of leases that were in existence during the periods covered by the financial statements even if those leases are no longer in existence.

b. Balance sheets presented as of December 31, 1976 and thereafter and income statements presented for periods beginning after December 31, 1976 and financial summaries and other data derived from those financial statements shall be restated to conform to the provisions of paragraphs .001-.047.

c. Balance sheets as of dates before December 31, 1976 and income statements for periods beginning before December 31, 1976 shall, when presented, be restated to conform to the provisions of paragraphs .001-.047 for as many consecutive periods immediately preceding December 31, 1976 as is practicable. Summaries or other data presented based on such balance sheets and income statements shall be treated in like manner.

d. The cumulative effect of applying paragraphs .001-.047 on the retained earnings at the beginning of the earliest period restated shall be included in determining net income of that period (see paragraph 20 of *APB Opinion No. 20* [section 1051.20], "Accounting Changes").[29] The effect on net income of applying paragraphs .001-.047 in the period in which the cumulative effect is included in determining net income shall be disclosed for that period, and the reason for not restating the prior periods presented shall be explained.

The provisions of this Statement need not be applied to immaterial items.

Appendix A begins on page 8429.

[29] Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* [sections 1051.19(d) and 1051.21] are not applicable.

Appendix A

BACKGROUND INFORMATION

.052 The growing importance of leasing as a financing device was recognized by the accounting profession as early as 1949, when the AI[CP]A issued *Accounting Research Bulletin No. 38,* "Disclosure of Long-Term Leases in Financial Statements of Lessees." In early 1960, the newly formed APB recognized the importance of the matter by including lease accounting as one of the first five topics to be studied by the AICPA's Accounting Research Division. That project culminated in 1962 with the publication of *Accounting Research Study No. 4*, "Reporting of Leases in Financial Statements," and shortly thereafter the APB took up the subject. In all, during the ten years ending June 30, 1973, the APB issued four Opinions (No. 5, 7, 27, and 31) dealing with leases. They were supplemented by three AICPA Accounting Interpretations. The last of the APB Opinions, *APB Opinion No. 31*, "Disclosure of Lease Commitments by Lessees," as its name implies, dealt only with disclosure. The APB had previously acknowledged that certain questions remained in connection with Opinions 5 and 7 and had publicly announced its intention to give those questions further consideration. The APB decided, however, to deal only with additional disclosure requirements. In paragraph 5 of *APB Opinion No. 31,* which was approved in June 1973, the APB noted that:

> . . . disclosure of lease commitments is part of the broad subject of accounting for leases by lessees, a subject which has now been placed on the agenda of the Financial Accounting Standards Board. The Board [APB] also recognizes that the forthcoming report of the Study Group on the Objectives of Financial Statements may contain recommendations which will bear on this subject and which the FASB may consider in its deliberations. Accordingly, the Board is refraining from establishing any disclosure requirements which may prejudge or imply any bias with respect to the outcome of the FASB's undertaking, particularly in relation to the questions of which leases, if any, should be capitalized and how such capitalization may influence the income statement. Nevertheless, in the meantime the Board recognizes the need to improve the disclosure of lease commitments in order that users of financial statements may be better informed.

.053 The SEC, too, has issued a number of pronouncements on accounting for leases, including three Accounting Series Releases:

No. 132, 141, and 147, adopted on October 5, 1973. The latter Release imposes essentially the same disclosure requirements with respect to total rental expense and minimum rental commitments as *APB Opinion No. 31*. However, it makes mandatory the disclosure of the present value of certain lease commitments (defined differently from the optional present value disclosure included in *APB Opinion No. 31*). In addition, it requires disclosure of the impact on net income had "financing" leases been capitalized, a disclosure not called for by *APB Opinion No. 31*.

.054 Despite the attention that the accounting profession has given to the matter of accounting for leases, inconsistencies remain in lease accounting practices, and differences of opinion as to what should be done about them remain. In recognition of that fact, the FASB placed on its initial agenda a project on Accounting for Leases. In October 1973, a task force of 11 persons from industry, government, public accounting, the financial community, and academe was appointed to provide counsel to the Board in preparing a Discussion Memorandum analyzing issues related to the project.

.055 As indicated above, accounting for leases is a subject which has been thoroughly studied over a long period of time and on which numerous pronouncements have been made. Extensive research has been carried out; several public hearings have been held for which position papers were filed by many interested parties and groups; especially appointed committees, not only of the Accounting Principles Board, but of a number of other organizations, have analyzed and debated the issues. A considerable number of the studies and articles on lease accounting were available to the Board, many of which are summarized or identified in the Discussion Memorandum. In addition, the FASB staff surveyed the accounting and reporting practices of a number of lessee and lessor companies, the results of which are set forth in Appendix C to the Discussion Memorandum. The staff also met on a number of occasions with representatives of various organizations interested in leasing for the purpose of obtaining specialized information helpful to the Board's consideration of the various issues involved in accounting for leases.

.056 The Board issued its Discussion Memorandum on July 2, 1974, and on November 18-21, 1974 held a public hearing on the subject. The Board received 306 position papers, letters of comment, and outlines of oral presentations in response to the

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Discussion Memorandum, and 32 presentations were made at the public hearing.

.057 On August 26, 1975, the Financial Accounting Standards Board issued an Exposure Draft of a Proposed Statement of Financial Accounting Standards on Accounting for Leases that, if adopted, would have been effective for leasing transactions entered into on or after January 1, 1976. Two hundred and fifty letters of comment were received in response to that Exposure Draft. The Board announced on November 25, 1975 that, because of the need to analyze the large number of responses and the complexity of the issues involved, it would be unable to issue a final Statement in 1975 but expected to do so early in 1976. A further announcement made by the Board on June 2, 1976 stated that a number of modifications were being made to the Exposure Draft and that a second Exposure Draft would be issued for public comment preparatory to the expected issuance of a final Statement in 1976.

.058 The Board issued the second Exposure Draft of a Proposed Statement of Financial Accounting Standards on Accounting for Leases on July 22, 1976. Two hundred and eighty-two letters of comment were received in response to that Exposure Draft.

Appendix B

BASIS FOR CONCLUSIONS

.059 This Appendix discusses factors deemed significant by the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others.

.060 The provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. In a lease that transfers substantially all of the benefits and risks of ownership, the economic effect on the parties is similar, in many respects, to that of an installment purchase. This is not to say, however, that such transactions are necessarily "in substance purchases" as that term is used in previous authoritative literature.

.061 The transfer of substantially all the benefits and risks of ownership is the concept embodied in previous practice in lessors' accounting, having been articulated in both *APB Opinion No. 7,* "Accounting for Leases in Financial Statements of Lessors," and *APB Opinion No. 27,* "Accounting for Lease Transactions by Manufacturer or Dealer Lessors," as a basis for determining whether a lease should be accounted for as a financing or sale or as an operating lease. However, a different concept has existed in the authoritative literature for lessees' accounting, as evidenced by *APB Opinion No. 5,* "Reporting of Leases in Financial Statements of Lessee." That Opinion required capitalization of those leases that are "clearly in substance installment purchases of property," which it essentially defined as those leases whose terms "result in the creation of a material equity in the property." Because of this divergence in both concept and criteria, a particular leasing transaction might be recorded as a sale or as a financing by the lessor and as an operating lease by the lessee. This difference in treatment has been the subject of criticism as being inconsistent conceptually, and some of the identifying criteria for classifying leases, particularly those applying to lessees' accounting, have been termed vague and subject to varied interpretation in practice.

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.062 The Board believes that this Statement removes most, if not all, of the conceptual differences in lease classification as between lessors and lessees and that it provides criteria for such classification that are more explicit and less susceptible to varied interpretation than those in previous literature.

.063 Some members of the Board who support this Statement hold the view that, regardless of whether substantially all the benefits and risks of ownership are transferred, a lease, in transferring for its term the right to use property, gives rise to the acquisition of an asset and the incurrence of an obligation by the lessee which should be reflected in his financial statements. Those members nonetheless support this Statement because, to them, (i) it clarifies and improves the guidelines for implementing the conceptual basis previously underlying accounting for leases and (ii) it represents an advance in extending the recognition of the essential nature of leases.

Definition of a Lease

.064 Some respondents took the position that nuclear fuel leases, sometimes called "heat supply" or "burn up" contracts, should be excluded from the definition of a lease on the grounds that such agreements are of the same nature as take-or-pay contracts to supply other types of fuel such as coal or oil which are excluded. The Board's conclusion that nuclear fuel leases meet the definition of a lease as expressed in paragraph .001 is based on the fact that under present generally accepted accounting principles a nuclear fuel installation constitutes a depreciable asset. Thus, a nuclear fuel lease conveys the right to use a depreciable asset whereas contracts to supply coal or oil do not. The fact that the latter contracts may be take-or-pay, in the Board's view, is irrelevant to this central point.

Classification of Leases

.065 The Board believes that the characteristics of a leasing transaction should determine its classification in terms of the appropriate accounting treatment by both the lessee and lessor; this is to say that the characteristics that identify a lease as a capital lease, as distinct from an operating lease, from the standpoint of the lessee should, with certain exceptions identified in this Statement, be the same attributes that identify a direct financing or sales-type lease, as distinct from an operat-

ing lease, from the standpoint of the lessor. The principal exceptions referred to are those stated in paragraph .008.

.066 The Board considered and rejected, for the reason set forth in paragraph .065, the argument that the difference in the nature of the lessor's and lessee's businesses is often sufficient to warrant different classification of a lease by the two parties.

.067 Some respondents to the Discussion Memorandum and Exposure Drafts, while agreeing generally with the premise that the nature of the transaction should govern its classification by both the lessee and lessor, pointed out that there is no assurance that the transaction will be discerned identically by both parties. However, the Board believes that by adopting essentially the same criteria for classification of leases by both parties (see paragraph .065), as contrasted with the difference in criteria previously existing between *APB Opinion No. 5,* concerning lessee accounting, and *APB Opinions No. 7* and *27,* concerning lessor accounting, and, by virtue of the fact that the criteria adopted are in some respects more explicit than those referred to in those Opinions, that a significant improvement in consistency of classification can be achieved.

.068 A large number of respondents favored capitalization by lessees of only those leases that they would classify as "in substance installment purchases." A wide range of preferences was expressed as to the criteria to be used to identify such leases. Most prominent among these was the "material equity" criterion that is the basic criterion of *APB Opinion No. 5* and that is discussed in paragraph .073. Most of those favoring this concept would apply it only to the lessee rather than to both parties.

.069 The Board considered the concept for capitalization by the lessee of those leases that are "in substance installment purchases." Such leases, if identifiable, would be encompassed within the concept described in paragraph .060, but, by itself, the installment purchase concept, in the Board's view, is too limiting as a basis for lease capitalization. Taken literally, the concept would apply only to those leases that automatically transfer ownership. All other leases contain characteristics not found in installment purchases, such as the reversion of the property to the lessor at the termination of the lease.

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.070 Some respondents advocated capitalization of leases that give rise to what they term "debt in a strict legal sense." A number of the respondents in this group were also represented in the group referred to in paragraph .068, indicating that they view the two concepts as not being mutually exclusive. The argument advanced is essentially that some leases contain clauses that make the lessee's obligation absolute and unconditional, and because the obligation is absolute, such clauses should be made the determinant for capitalization of leases containing them. Those advancing this view generally appeared to be focusing on the liability aspect of the transaction rather than on the nature of the corresponding asset to be recorded. Few had any comment to offer concerning cases in which the "legal debt" assumed by the lessee represents only a portion of the asset's cost; nor was it clear from the comments how, if at all, the concept of "legal debt" standing alone should affect accounting for the lease by the lessor.

.071 The Board noted that the determination of whether a lease obligation represents debt in the strict legal sense would of necessity rest primarily on court decisions, and that such decisions have arisen almost entirely from litigation involving bankruptcy, reorganization, or taxation. The Board concluded that legal distinctions of this nature were apt to be neither relevant nor practical in application to the accounting issue of lease capitalization. The Board believes further that, in most instances where the lessee has assumed an unconditional obligation that the courts might hold to be legal debt, it is reasonable to assume that he will have protected his interest through other features in the agreement that are likely to meet one or more of the criteria for capitalization stated in paragraph .007. The Board accordingly rejected the concept of "legal debt" as a determinant for lease capitalization.

Criteria for Classification

.072 The Discussion Memorandum listed 14 criteria as having some support for use in classifying leases by lessees. A number of criteria, including some of the 14, were also listed for possible use in classifying leases by lessors. Among the respondents, opinion was divided as to the criteria that identify leases that should be capitalized by the lessee as well as to those criteria that identify leases that should be recorded as sales or financing leases by lessors. The Board concluded that many of the listed criteria were overlapping, i.e., that the basic idea contained in one also was

embodied in others designed to identify the same attribute. The Board believes that the criteria stated in paragraphs .007 and .008 contain the essence of the listed criteria except those that the Board did not consider relevant or suitable. The basis for the Board's adoption or rejection of individual criteria is the concept discussed in paragraph .060, namely, the transfer of substantially all of the benefits and risks incident to the ownership of property. The following discusses the Board's conclusions with respect to each of the 14 criteria listed in the lessee section of the Discussion Memorandum together with 5 other criteria that were dealt with in the lessor section. These last 5 are discussed in paragraphs .087-.090.

.073 *Lessee builds up a material equity in the leased property.* Many of the respondents favored the material equity criterion as contained in *APB Opinion No. 5* as the principal basis for lease capitalization by the lessee. Of the criteria selected by the Board, the criterion stated in paragraph .007(b) wherein the lease contains a bargain purchase option is evidential that a material equity is being established. The criterion stated in paragraph .007(a) wherein ownership is transferred by the end of the lease term may in some circumstances be evidential that a material equity is being established. However, in relating material equity to the concept discussed in paragraph .060, the Board concluded that leases in which no material equity is established by the lessee may effectively transfer substantially all of the benefits and risks of ownership. For example, a lease whose term extends over the entire economic life of the asset and thus transfers all of the benefits and risks of ownership need not give rise to a material equity. Accordingly, the Board rejected material equity as a separate criterion and considered it too limiting to represent the central basis for lease capitalization by lessees.

.074 *Leased property is special purpose to the lessee.* The Board rejected this criterion for two reasons. First, "special purpose property" is a relative concept that is hard to define objectively. Second, the fact that the leased property is special purpose does not, of itself, evidence a transfer of substantially all of the benefits and risks of asset ownership. Although it is expected that most lessors would lease special purpose property only under terms that transfer substantially all of those benefits and risks to the lessee, nothing in the nature of special purpose property necessarily entails such lease terms. The Board concluded that, if the lease, in fact, contains such terms, it is likely that one or more of the adopted criteria in paragraph .007 would be met.

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.075 *Lease term is substantially equal to the estimated useful life of the property.* This criterion was modified as adopted in criterion (c) of paragraph .007 as follows:

> The lease term (as defined in paragraph .005(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph .005(g)).

In the Board's view, the fact that the lease term need be for only 75 percent of the economic life of the property is not inconsistent with the concept discussed in paragraph .060 for the following reasons:

> Although the lease term may represent only 75 percent of the economic life of the property in terms of years, the lessee can normally expect to receive significantly more than 75 percent of the total economic benefit to be derived from the use of the property over its life span. This is due to the fact that new equipment, reflecting later technology and in prime condition, can be assumed to be more efficient, and hence yield proportionately more use benefit, than old equipment which has been subject to obsolescence and the wearing-out process. Moreover, that portion of use benefit remaining in the equipment after the lease term, in terms of the dollar value that may be estimated for it, when discounted to present worth, would represent a still smaller percentage of the value of the property at inception.

As a result of comments received in response to the second Exposure Draft, the following qualification has been added to paragraph .007(c):

> However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

The Board found persuasive the argument that it would be inconsistent to require that a lease covering the last few years of an asset's life be recorded as a capital lease by the lessee and as a sales-type or direct financing lease by the lessor when a lease of the asset for a similar period earlier in its life would have been classified as an operating lease. Without the above qualification, in the case of a tank car having an estimated economic life of 25

years and placed under five successive 5-year leases, the first four leases would be classified as operating leases under this criterion and the last lease would be classified as a capital lease. The Board considered such a result illogical.

.076 *Lessee pays costs normally incident to ownership.* This criterion was rejected by the Board since it can be presumed that, one way or another, the lessee bears the costs of ownership in virtually all lease agreements.

.077 *Lessee guarantees the lessor's debt with respect to the leased property.* The Board concluded that this criterion does not necessarily evidence a lease that transfers substantially all of the benefits and risks of property ownership; the amount guaranteed may represent only a portion of the fair value of the property. When there is a guarantee, the Board believes it likely that the lessee will have protected his interest through other features in the agreement that may meet one or more of the adopted criteria stated in paragraph .007. In this regard, any periods covered by renewal options in which a lessee guarantee is expected to be outstanding are to be included in the lease term, as provided by paragraph .005(f), and the corresponding renewal rentals are to be included in minimum lease payments, as provided by paragraph .005(j). Thus, such periods would be recognized in applying criterion .007(c) to the property's economic life, and both the periods and the corresponding rentals would be recognized in applying the 90 percent recovery criterion (paragraph .007(d)).

.078. *Lessee treats the lease as a purchase for tax purposes.* The Board rejected this criterion. There are many instances in which tax and financial accounting treatments diverge, and the question of a possible need for conformity between them is beyond the scope of this Statement.

.079 *Lease is between related parties.* The Board did not consider this criterion as suitable, in itself, for determining lease classification. Leases between related parties are discussed in paragraphs .029-.031.

.080 *Lease passes usual risks and rewards to lessee.* The Board considered this to be a concept rather than a criterion. It is closely related to the basic concept underlying the conclusions of this Statement, described in paragraph .060.

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.081 *Lessee assumes an unconditional liability for lease rentals.* This criterion was rejected by the Board for the reasons given in paragraph .071.

.082 *Lessor lacks independent economic substance.* The Board considered the argument advanced by some that, if the lessor has no economic substance, the lessor serves merely as a conduit in that the lender looks to the lessee for payment and thus, it is asserted, the lessee is, in fact, the real debtor and purchaser. Whether the lessee is judged to be a debtor does not, in the Board's view, constitute a suitable criterion for determining lease classification for the reasons expressed in paragraph .071. The Board finds unpersuasive the argument that the lessee's accounting for a leasing transaction should be determined by the economic condition of an unrelated[30] lessor. If a lease qualifies as an operating lease because it does not meet the criteria in paragraph .007, the Board finds no justification for requiring that it be accounted for as a capital lease by the lessee simply because an unrelated lessor lacks independent economic substance. In such a case, it probably means that someone else, presumably the lender, is in substance the lessor, but this circumstance, per se, should not alter the lessee's accounting. Accordingly, the Board rejected this criterion.

.083 *Residual value at end of lease is expected to be nominal.* Some respondents recommended that such a criterion, if adopted, should be based on the present value of the residual, which, because of the long-term nature of many leases, would represent a much smaller percentage of asset value at inception than the undiscounted residual value. However, other respondents who favored the addition of a recovery criterion based on the relationship of the present value of the lease payments to the fair value of the leased property argued that a criterion based on residual value would be redundant in that it would essentially measure the complement of that relationship. Since, for the reasons set forth in paragraph .084 below, the Board favored the recovery criterion, it was adopted in lieu of a criterion based on residual values.

.084 *Lease agreement provides that the lessor will recover his investment plus a fair return (a) guaranteed by the lessee or (b) not so guaranteed.* A variation of this criterion was adopted as criterion (d) of paragraph .007. In the form adopted, the criterion is met when the present value of the minimum lease payments, de-

[30] If the lessee and the lessor are related parties, the provisions of paragraphs .029-.031 apply.

fined in paragraph .005(j), excluding executory costs, equals or exceeds 90 percent of the excess of the fair value of the leased property, defined in paragraph .005(c), to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him. The Board concluded that if the present value of the contractual receipts of the lessor provide for recovery of substantially all (defined as 90 percent or more) of his net investment in the fair value of the leased asset, the lessor has transferred substantially all of the benefits and risks of asset ownership. Likewise, if the present value of the lessee's lease obligations provide for that degree of recovery by the lessor, the conclusion was that the lessee has acquired those benefits and risks. Some respondents pointed out that a recovery criterion more clearly evidences the transfer of risks than of benefits since a substantial residual value may revert to the lessor at the end of the lease term. However, the Board concluded that, in leases meeting the recovery criterion, the residual amount, when discounted to its present value at the inception of the lease, is likely to represent only a small percentage of the fair value of the property. For the reasons cited above, the Board adopted a criterion based on recovery of substantially all (defined as 90 percent or more) of the fair value of the leased property. A lessee guarantee of recovery to the lessor is recognized through inclusion in the definition of minimum lease payments. Thus, such guarantees are taken into account in the application of the 90 percent recovery criterion. As a result of comments received in response to the second Exposure Draft, the following qualification has been added to paragraph .007(d):

> However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

The above qualification is the same as that added to criterion .007(c) and the reasons are the same as those discussed in paragraph .075.

.085 *Lessee has the option at any time to purchase the asset for the lessor's unrecovered investment.* The Board concluded that the existence of a purchase option is significant only if it is a bargain purchase option as defined in paragraph .005(d) and as adopted in paragraph .007(b); otherwise, there is no presumption that the lessee will exercise the option. Accordingly, the Board rejected this criterion.

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.086 *Lease agreement is noncancelable for a "long term."* This criterion was rejected by the Board in favor of criterion (c) of paragraph .007.

.087 *Lease transfers title (ownership) to the lessee by the end of the lease term.* This criterion was adopted by the Board as criterion (a) of paragraph .007. Such a provision effectively transfers all of the benefits and risks of ownership and, thus, the criterion is consistent with the concept discussed in paragraph .060.

.088 *Lease provides for a bargain purchase or a renewal option at bargain rates.* The existence of a bargain purchase option was adopted by the Board as criterion (b) of paragraph .007. Such a provision effectively transfers all of the benefits and risks of ownership and, thus, the criterion is consistent with the concept discussed in paragraph .060. The period covered by a bargain renewal option is included in the lease term, as defined in paragraph .005(f), and the option rentals are included in minimum lease payments, as defined in paragraph .005(j). Thus, a bargain renewal option enters into the determination of whether the lease meets either criterion (c) or criterion (d) of paragraph .007. Accordingly, the Board rejected the existence of a bargain renewal option as a separate criterion.

.089 *Collection of the rentals called for by the lease is reasonably assured.* This criterion relates only to lessors. It has been restated as follows and adopted by the Board as a necessary criterion (paragraph .008(a)): "Collectibility of the minimum lease payments is reasonably predictable." The wording change reflects the Board's view that lessors should not be precluded from classifying leases as direct financing or sales-type leases, when they meet one of the criteria for such classification in paragraph .007, if losses are reasonably predictable based on experience with groups of similar receivables. When other than normal credit risks are involved in a leasing transaction, it was the Board's conclusion that collectibility is not reasonably predictable and classification as a sales-type or direct financing lease, in such cases, is therefore not appropriate.

.090 *No important uncertainties surround costs yet to be incurred by lessor.* The matter of uncertainties surrounding future costs was dealt with in the Discussion Memorandum as one of the risks of ownership relevant to the classification of leases by lessors. This criterion is essentially equivalent to one of the criteria set forth in *APB Opinion No. 27*, paragraph 4, as a requirement for treating a

lease by a manufacturer or dealer lessor as a sale. In adopting this as a necessary criterion, the Board believes that if future unreimbursable costs to be incurred by the lessor under the lease are not reasonably predictable, the risks under the lease transaction may be so great that it should be accounted for as an operating lease instead of as a sales-type or direct financing lease.

Accounting by Lessees

.091 *APB Opinion No. 5,* paragraph 15, prescribed accounting for leases that were to be capitalized as "in substance installment purchases" as follows:

> Leases which are clearly in substance installment purchases of property . . . should be recorded as purchases. The property and the obligation should be stated in the balance sheet at an appropriate discounted amount of future payments under the lease agreement. . . . The method of amortizing the amount of the asset to income should be appropriate to the nature and use of the asset and should be chosen without reference to the period over which the related obligation is discharged.

As stated in paragraph .060, the concept underlying this Statement is that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee, and as a sale or financing by the lessor. The concept for capitalization by the lessee of only those leases that are "in substance installment purchases" was rejected by the Board as too limiting a basis for lease capitalization (see paragraph .069).

.092 Despite this difference in the concept for capitalization, the Board viewed the accounting prescribed by *APB Opinion No. 5* for capitalized leases as generally appropriate. While respondents expressed varying opinions as to the characteristics of leases that should be capitalized, there was little opposition to the method of accounting for such leases prescribed by *APB Opinion No. 5.* The accounting provisions of this Statement applicable to lessees, with the exceptions noted below, generally follow that Opinion; however, these provisions are more specific with respect to implementation.

.093 With respect to the rate of interest to be used in determining the present value of the minimum lease payments for recording the

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asset and obligation under a capital lease, the Board concluded the rate should generally be that which the lessee would have incurred to borrow for a similar term the funds necessary to purchase the leased asset (the lessee's incremental borrowing rate). An exception to that general rule occurs when (a) it is practicable for the lessee to ascertain the implicit rate computed by the lessor and (b) that rate is less than the lessee's incremental borrowing rate; if both of those conditions are met, the lessee shall use the implicit rate. However, if the present value of the minimum lease payments, using the appropriate rate, exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation shall be the fair value. A number of respondents pointed out that in many instances, the lessee does not know the implicit rate as computed by the lessor. Also, since the implicit rate is affected by the lessor's estimate of the residual value of the leased property in which the lessee will usually have no interest, and may also be affected by other factors extraneous to the lessee, it may, if higher than the lessee's incremental borrowing rate, produce a result that is less representative of the transfer of use benefit to the lessee than would be obtained from use of the lessee's incremental borrowing rate. For those reasons, the Board concluded that the lessee's use of the implicit rate for discounting purposes should be limited to circumstances in which he is able to ascertain that rate, as computed by the lessor, and it is less than his incremental borrowing rate. In the revised Exposure Draft, the Board had defined this rate as that which "the lessee would have incurred to borrow the funds necessary to buy the leased asset on a secured loan with repayment terms similar to the payment schedule called for in the lease." A number of respondents objected to this definition pointing out that they would not have financed the asset on a secured loan basis and, hence, would be unable to determine such a theoretical rate. Those respondents suggested that the definition be revised to allow the lessee to use a rate consistent with the type of financing that would have been used in the particular circumstances. The Board found merit in those suggestions because it intended that the rate should be both determinable and reasonable. The definition of the lessee's incremental borrowing rate has been revised accordingly. Some respondents pointed out that the use of the lessee's incremental rate, however determined, would in some cases produce an amount to be capitalized that would be greater than the known fair value of the leased asset. It was suggested that in such cases the amount to be capitalized be limited to the fair value. The Board agreed with that recommendation.

.094 The method of amortization of the capitalized asset prescribed in this Statement (see paragraph .011) differs from that called for in *APB Opinion No. 5* in that, except for those leases that meet criterion .007(a) or .007(b), the period of amortization is limited to the lease term. *APB Opinion No. 5* did not so limit the period of amortization since the leases to be capitalized were those that were considered "in substance installment purchases." The Board concluded that, for leases which are capitalized under criterion .007(c) or .007(d) of this Statement, the amortization period should be the lease term. It is presumed for accounting purposes that, in such leases, the lessee's period of use of the assset will end at the expiration of the lease term.

.095 Some respondents asked for clarification and more specific treatment in the Statement with respect to the accounting to be followed in connection with the situations referred to in paragraph .009 having to do with changes in lease provisions that would have resulted in a different classification of the lease at its inception and renewals and extensions of existing leases. The clarification requested has been incorporated in paragraph .014. Additionally, respondents asked for clarification with respect to the accounting to be followed when a guarantee or penalty provision in a lease is rendered inoperative by a renewal or extension. That clarification has been provided in paragraph .012.

Disclosure by Lessees

.096 Users of financial statements have indicated a strong desire for disclosure by lessees of information concerning leasing transactions whether leases are capitalized or not. In some cases, the information desired was similar to that now provided in accordance with *APB Opinion No. 31* or SEC *Accounting Series Release No. 147*. However, some respondents objected to the requirement to disclose future minimum rental payments by periods beyond the next succeeding five years. It was contended that any such projections are apt to be misleading since the accumulating effect of new leases and lease renewals on future payments in those periods is not reflected. In addition, some users and many other respondents opposed requiring disclosure of the estimated effect on net income had certain leases been capitalized. The Board agreed with both of those views except that during the transition period until full retroactive application of this Statement is required, the Board decided that the disclosure called for in paragraph .050 is needed by users of financial statements pending retroactive applica-

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tion. The Board concluded that the disclosures called for in paragraph .016(a) with respect to capital leases would provide information helpful to users of financial statements in assessing the financial condition and results of operations of lessees. In the Board's view, such disclosures are consistent with the information presently required to be disclosed with respect to owned property and to long-term obligations in general. The Board further concluded that users' assessments would be facilitated by the disclosures called for in paragraphs .016(b) and .016(c) with respect to operating leases. The requirement to disclose information concerning commitments for rental payments under operating leases during the succeeding five years is consistent with the similar requirement for capital leases.

Accounting by Lessors

.097 As stated in paragraph .061, the concept underlying the accounting for leases by lessors in this Statement is essentially the same as the concept embodied in *APB Opinions No. 7 and 27*; that is, a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as a sale or financing by the lessor. Accordingly, the accounting provisions of this Statement applicable to lessors, with the principal exceptions noted below, generally follow those of the two APB Opinions.

.098 In computing the manufacturer's or dealer's profit on a sales-type lease, the cost of the property leased will be reduced by the present value of the estimated residual value. This represents a liberalization of the provisions of *APB Opinion No. 27*, which did not permit recognition of any residual value in determining manufacturer's or dealer's profit. Some respondents favored continuing the provisions of Opinion 27 in this regard. Others believed that the present value of the residual should be recognized in profit determination and that the accounting for the financing element of a leasing transaction should be essentially the same in a sales-type lease as in a direct financing lease. The Board agreed with this latter view and concluded that the difference between the estimated residual and its present value should be included in unearned income and recognized in income over the lease term.

.099 This Statement calls for the estimated residual value, along with rentals and other minimum lease payments receivable, to be included in the balance sheet presentation of the investment in

sales-type and in direct financing leases. Under *APB Opinion No. 7,* the estimated residual value was to be included with property, plant, and equipment. Several respondents contended that inclusion of the residual with depreciable assets of the lessor would blur the distinction between property on lease and property used in the lessor's internal operations. Others pointed out that, in the vast majority of leases, the estimated residual value is realized by a sale or re-lease of the property and, for that reason, the residual should be looked upon as a last payment similar to the minimum lease payments. In addition, it was contended, presentation of the estimated residual value as part of the lease investment rather than as part of property, plant, and equipment is necessary to portray the proper relationship between the gross investment in leases and the related unearned income, since a portion of the unearned income relates to the residual value. The Board agreed with those views.

.100 This Statement requires that the selling price in a sales-type lease be determined by computing the present value of payments required under the lease. In this respect, it follows Opinion 27. However, this Statement is more specific than Opinion 27 in identifying the payments that are to be included in the computation, and it requires use of the rate of interest implicit in the lease for discounting instead of an interest rate determined in accordance with the provisions of *APB Opinion No. 21* [section 4111], as called for by Opinion 27. Use of the latter rate was rejected by the Board on the grounds that it would yield an amount to be recorded as the sales price that would be at variance with the known fair value of the leased asset (after adjusting that price for the present value of any investment tax credit or residual retained).

.101 This Statement requires different treatment of initial direct costs (see paragraph .005(m)) as between sales-type leases and direct financing and leveraged leases. In the case of sales-type leases, initial direct costs are to be charged against income of the period in which the sale is recorded, which is consistent with the general practice of accounting for similar costs incurred in connection with installment sales on the basis that such costs are incurred primarily to produce sales revenue. In this respect, the Statement follows *APB Opinion No. 27,* which, although not mentioning initial direct costs specifically, in paragraph 6 called for estimated "future costs" related to leases accounted for as sales to be charged to income of the period in which the sale is recorded. The second Exposure Draft called for initial direct costs incurred in connection with di-

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rect financing leases to be accounted for in the manner that *APB Opinion No. 7,* paragraph 11, described as preferred, that is, to be deferred and allocated to future periods in which the related financing income is reported. This requirement recognized that, unlike the initial direct costs in sales-type leases, such costs in direct financing leases are not primarily related to income of the period in which the costs are incurred. A number of respondents objected to the deferral of initial direct costs incurred in connection with direct financing leases because it is at variance with predominant industry practice and would, it was reported, necessitate a major revision of existing record systems and computer programs with no appreciable effect on net income over the lease term. The predominant industry practice as cited by those respondents consists of expensing such costs as incurred and recognizing as income in the same period a portion of unearned income equal to the amount of the costs expensed. It was pointed out that this method produces essentially the same income effect as if the initial direct costs were deferred and amortized separately, as was called for by the revised Exposure Draft, or as if these costs were charged to unearned income, as is called for in the case of leveraged leases. The Board accepted this recommendation for practical considerations and has revised the accounting prescribed for initial direct costs incurred in connection with direct financing leases accordingly. In the case of leveraged leases, the accounting for initial direct costs is consistent with the central concept underlying the accounting for leveraged leases by the investment with separate phases method, that concept being that the net income should be recognized at a level rate of return on the investment in the lease in the years in which the investment is positive.

.102 As was the case with lessee accounting, respondents requested clarification and more specific guidance as to the accounting to be followed by lessors with respect to the situations referred to in paragraph .095. The requested guidance for lessor accounting for those situations has been provided in paragraphs .017(e) and .017(f). In addition, respondents objected to the provisions of the revised Exposure Draft allowing, in some instances, gain to be recognized immediately on renewals or extensions of sales-type or direct financing leases. Those who objected contended that gain recognition in those circumstances was equivalent to allowing upward revisions of residual value estimates, a practice specifically prohibited in the Statement. The Board found those objections persuasive and, accordingly, revised the accounting for renewals or extensions of sales-type or direct financing leases to prohibit immediate recognition of gain.

Disclosure by Lessors

.103 A number of those respondents who addressed the question of what information should be disclosed by lessors thought that the disclosures called for by *APB Opinion No. 7* were adequate. Some, however, thought there should be consistency, where relevant, between the disclosure requirements for lessors and those for lessees and noted that disclosure requirements for lessees had been recently made more extensive by *APB Opinion No. 31* and SEC *Accounting Series Release No. 147*. The Board agreed with this latter view. As in the case of lessees, the Board believes that the information required to be disclosed by paragraph .023 will be helpful to users of financial statements in assessing the financial condition and results of operations of lessors. Several respondents to the second Exposure Draft objected to the limitation of lessor disclosure requirements to those lessors for which leasing is the predominant activity. It was contended that the disclosures should be required whenever leasing is a significant part of the lessor's business activities rather than only when leasing is predominant. Other respondents thought that a single test of predominance based on revenues was inappropriate and pointed to the difference in the nature of lease rentals as compared to sales revenue of a manufacturing concern. It was recommended that significance be determined in terms of revenue, net income, or assets as separate indicators. The Board found merit in these recommendations and revised the disclosure limitation accordingly.

.104 Some respondents recommended the elimination of the requirement in the Exposure Drafts that the cost or carrying amount of property on operating leases and that of property held for lease be separately disclosed. They contended that in companies having thousands of operating leases it would be difficult, if not impossible, to make such a split. Since the information would be based on one particular point in time, it may well be unrepresentative. The Board found those arguments persuasive and believes, moreover, that a better indication of the productivity of property on or held for lease is its relationship to the minimum future rentals by years and in the aggregate from noncancelable operating leases, which latter information is required by the Statement.

Leases Involving Real Estate

.105 The second Exposure Draft provided that criteria .007(c) and .007(d) were not applicable to leases of land and that, unless criterion .007(a) or .007(b) was met, leases of land should be

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accounted for as operating leases. In a lease involving both land and building, if the land element represented 15 percent or more of the total fair value of the leased property, the land and building elements of the lease were required to be separated and each classified and accounted for as if it were a separate lease. Some respondents objected to this, contending that the recovery criterion, .007(d), should be applicable to land leases the same as to other leases. Others objected to the required separate treatment of the land and building elements in a lease involving both, contending that the property should be classified and accounted for as a unit and that to require separation would be inconsistent with the economic substance of the transaction. Some, particularly in the case of retail leases, cited the difficulties and cost involved in separating the land and building elements for companies with large numbers of such leases. They recommended that separation not be required and that all such leases be classified as operating leases. However, if separation were to continue to be required, some suggested that the 15 percent limitation be raised to permit treating as a unit a greater number of leases in which land would still not represent a major element. The Board's conclusion that, unless criterion .007(a) or .007(b) was met, leases of land should be classified as operating leases is based on the concept that such leases do not transfer substantially all the benefits and risks of ownership. Land normally does not depreciate in value over time, and rental payments for the use of land are not predicated on compensation for depreciation plus interest, as is the case with leases of depreciable assets, but are in the nature of interest only or, as some may prefer to say, interest plus whatever additional profit element may be included. The requirement for separation of the land and building elements in a lease involving both is based on this distinction. The Board found merit, however, in the recommendation that the 15 percent limitation be raised in order to reduce the practical problems involved in separating the land and building elements for large numbers of leases. The Board concluded that the 15 percent limitation established in the second Exposure Draft should accordingly be raised to 25 percent.

.106 A number of respondents pointed out that leases of facilities such as airport and bus terminals and port facilities from governmental units or authorities contain features that render the criteria of paragraph .007 inappropriate for classifying such leases. Leases of such facilities do not transfer ownership or contain bargain purchase options. By virtue of its power to abandon a facility during

the term of a lease, the governmental body can effectively control the lessee's continued use of the property for its intended purpose, thus making its economic life essentially indeterminate. Finally, since neither the leased property nor equivalent property is available for sale, a meaningful fair value cannot be determined, thereby invalidating the 90 percent recovery criterion. For those reasons, the Board concluded that such leases shall be classified as operating leases by both the lessee and lessor.

Sale–Leaseback Transactions

.107 Of those respondents who addressed the issues of accounting for sale-leaseback transactions, opinions were divided between those who favored (a) treatment as a single transaction with deferral of profit on the sale and (b) treatment as two independent transactions unless the lease meets criteria for capitalization by the lessee. Generally, those favoring treatment as a single transaction would make certain exceptions, such as "leasebacks to accommodate a short-term property requirement of the seller" and "leasebacks of only a relatively small part of the property sold." The Board noted that most sale-leasebacks are entered into as a means of financing, for tax reasons, or both and that the terms of the sale and the terms of the leaseback are usually negotiated as a package. Because of this interdependence of terms, no means could be identified for separating the sale and the leaseback that would be both practicable and objective. For that reason, the Board concluded that the present general requirement that gains and losses on sale-leaseback transactions be deferred and amortized should be retained. An exception to that requirement arises when the fair value of the property at the time of the transaction is less than its undepreciated cost. In that case, the Board decided that the loss should be recognized up to the amount of the difference between the undepreciated cost and fair value.

Accounting for Leveraged Leases by Lessors

.108 The first issue concerning leveraged leases in the Discussion Memorandum asked whether leveraged leases are unique in the sense that special standards are required to recognize their economic nature. The affirmative responses to this issue generally gave as reasons the arguments stated in the Discussion Memorandum.

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The essence of those arguments is that the combination of nonrecourse financing and a cash flow pattern that typically enables the lessor to recover his investment in the early years of the lease and thereafter affords him the temporary use of funds from which additional income can be derived produces a unique economic effect. Those respondents who did not agree that leveraged leases are unique generally cited the contra argument in the Discussion Memorandum, namely, that each of the attributes of leveraged leases that serve to support the uniqueness claim has its counterpart in other types of business transactions. Information communicated by respondents, as well as that obtained through staff investigation, indicates that the use of a variety of accounting methods for leveraged leases has grown rapidly. The methods in use generally correspond, although frequently with variations, to those illustrated in the Discussion Memorandum. The Board noted with concern the increasing disparity in practice in accounting for leveraged leases. Despite the fact that each of the attributes of a leveraged lease is found in other types of transactions, the Board believes that in a leveraged lease those attributes are combined in a manner that produces an overall economic effect that is distinct from that of other transactions. Accordingly, the Board concluded that a leveraged lease, as defined in paragraph .042, should be accounted for in a manner that recognizes this overall economic effect. However, the Board emphasizes that the qualification "as defined in paragraph .042" is an important one since the term "leveraged lease" is used by some respondents to refer to any lease involving nonrecourse debt. There is further discussion of this distinction in paragraph .110.

.109 The Discussion Memorandum described and illustrated four different methods of accounting for leveraged leases. Three of those methods are designed to recognize what their adherents see as the economic effect of a leveraged lease, while the other method, the ordinary financing lease method, is that presently prescribed for financing leases by *APB Opinion No. 7*. The Board's conclusions and the reasons therefor concerning the four methods are as follows:

a. *The ordinary financing lease method*. This accounting method makes no distinction between a leveraged lease and an ordinary two-party financing lease. Even though the debt is nonrecourse to the lessor and the lessor has no claim on the debt service payments, the transaction is recorded "gross" with the lessor's investment based on the present value of the gross rentals plus

the residual value as prescribed by *APB Opinion No. 7.* In fact, however, the lessor's real investment is not a function of the amount of the future rental payments, which amount represents neither the funds he has at risk nor the asset from which he derives earnings. Further, no recognition is given to the separate investment phases of a leveraged lease as defined in paragraph .042. This method was rejected by the Board because it is incompatible with the essential features of the transaction.

b. *The three-party financing lease method.* This method does reflect the three-party nature of the transaction in that the lessor's investment is recorded net of the nonrecourse debt, and rental receipts are reduced by the debt service payments. However, it gives no recognition to the fact that a leveraged lease has separate investment phases, which is one of the characteristics included in the definition (see paragraph .042(d)). The lessor's unrecovered investment balance declines during the early years of a leveraged lease from the strong cash inflow in that period. Typically, the cumulative cash inflow during the early years exceeds the investment, producing a negative investment balance during the middle years. The investment returns to a positive balance again in the later years as funds are reinvested and then goes to zero with realization of the residual value at the termination of the lease. This pattern of cash flow results from the fact that income tax reductions from the investment tax credit, accelerated depreciation, and greater interest deductions in earlier years are replaced by additional income taxes in the later years after the investment tax credit has been utilized and as tax benefits from depreciation and interest diminish. By ignoring these separate investment phases, the three-party financing method shows a gradually declining investment balance throughout the years of the lease, with income recognized at a level rate of return on the declining balance. The Board believes that the accounting treatment for a leveraged lease should reflect these separate investment phases, which have different economic effects, and should provide for the recognition of income in appropriate relation to them. To do otherwise, in the Board's view, is to negate the reason for having a separate standard for leveraged leases, that reason being that leveraged leases have a distinct combination of economic features that sets them apart from ordinary financing leases. While the three-party financing lease method reflects the three-party nature of the transaction, it fails to recognize the other economic features referred to above; as a consequence, it produces results that are incon-

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sistent with the manner in which the lessor-investor views the transaction. For those reasons, the Board rejected the three-party financing lease method.

c. *The investment with separate phases method.* This method recognizes the separate investment phases and the reversing cash flow pattern of a leveraged lease. By recognizing income at a level rate of return on net investment in the years in which the net investment is positive, it associates the income with the unrecovered balance of the earning asset in a manner consistent with the investor's view of the transaction. In the middle years of the lease term, the investment balance is generally negative, indicating that the lessor has not only recovered his initial investment but has the temporary use of funds that will be reinvested in the later years. The earnings on these temporary funds are reflected in income as and if they occur in the years in which the investment is negative. The income that is recognized at a level rate of return in the years in which the net investment balance is positive consists only of the so-called "primary" earnings from the lease, as distinct from the earnings on temporary funds to be reinvested, sometimes referred to as "secondary" earnings. The lessor-investor looks upon these secondary earnings from the temporarily held funds as one of the economic benefits inherent in the transaction. The integral investment method discussed in (d) below allocates both the primary and secondary earnings to annual income on a level rate of return basis. It is asserted by some that because of this feature, the integral investment method is more consistent with the manner in which the lessor-investor views the transaction. However, this feature involves estimation of the secondary earnings and recognition of a substantial portion of them in advance of their occurrence, which the Board did not favor for reasons stated below in the discussion of the integral investment method. The Board believes that secondary earnings should be recognized in income only as they occur (in the negative investment years), and that this treatment, coupled with the recognition of primary earnings in the positive investment years, appropriately portrays the economic effects of the separate investment phases. Accordingly, the Board concluded that the investment with separate phases method as prescribed in paragraphs .043-.047 is the appropriate method for accounting for leveraged leases.

d. *The integral investment method.* Several variations of the method illustrated in Schedule 7, page 126, of the Discussion

Memorandum were suggested by respondents who supported its concept. That concept looks upon the earnings from the use of temporarily held funds (discussed in (c) above) as constituting an integral part of the lease income, rather than as secondary earnings to be accounted for as they occur (the treatment called for in the separate phases method). Advocates of the integral method point out that the equity participant (lessor) in a leveraged lease is actually buying a series of cash flows consisting not only of the equity portion of the rental payments, the investment tax credit and other tax benefits, and the amount to be realized from the sale of the residual, but also including the earnings to be obtained from the use of temporarily held funds. Failure to include the latter in the calculation and recognition of lease income, in their view, understates lease income and is inconsistent with the manner in which the lessor-investor views the transaction. In considering these arguments, the Board noted (1) that the earnings in question, in effect, represent an estimate of interest expected to be earned (or interest cost to be saved) in future years through the application of the temporarily held funds; (2) although these earnings will not be realized until future years, their inclusion in lease income under the integral investment method would result in their recognition in substantial amounts beginning with the first year of the lease; and (3) the actual occurrence and amount of those earnings cannot be verified because this would involve tracing the source of specific investment dollars, generally acknowledged to be impractical. The Board noted further that the other cash flows that constitute the source of the primary earnings, with the exception of the residual value, are either contractual or based on existing tax law and thus provide a firmer basis for income recognition than the secondary earnings. Admittedly, there is uncertainty involved in the estimate of residual value to be realized; however, the Board noted that recognition of residual value is consistent with the accounting prescribed for ordinary financing leases, whereas the anticipation of future interest on funds expected to be held temporarily has no support in present generally accepted accounting principles. For the foregoing reasons, the Board rejected the integral investment method.

.110 Some respondents who objected to the inclusion of paragraph .042(d) in the definition of a leveraged lease argued that leveraged leases can have a variety of rental payment arrangements, some of which would not produce the separate investment phases specified as part of the definition, but that, nevertheless, such leases

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should be accorded the accounting method prescribed in the Statement. The Board did not agree with this view, since the method prescribed is designed to recognize the unique economic aspects of the separate investment phases. It concluded that leases not having this characteristic should not be accounted for as leveraged leases and that the presence of nonrecourse debt in a leasing transaction is not by itself justification for special accounting treatment. Nonrecourse debt occurs in many types of transactions other than leases and, as discussed in paragraph .108, it is only the combination of attributes, not the presence of nonrecourse debt alone, that produces an overall economic effect that is distinct from that of other transactions.

.111 Some have contended that the inclusion of deferred taxes in the determination of the lessor's unrecovered investment is what gives rise to the separate investment phases, which is then used to justify the Board's adoption of the separate phases method and its rejection of the three-party financing method. The Board believes that the essential difference between the three-party financing method and the separate phases method is that the latter method closely follows the cash flow of the transaction, whereas the former does not. The three-party financing method portrays a gradually declining investment balance over the entire lease term, thus failing to recognize the short-term nature of the lessor's initial investment, which is typically recovered through the cash flow in the early years of the lease. That this early cash flow comes in large part from tax benefits does not alter the fact that the lessor has recovered his investment and is then provided with the temporary use of funds by which additional income can be generated. It is this feature which provides much of the incentive for the lessor to enter into the transaction in the first place and, in fact, without those tax benefits some leveraged leases would yield negative results. The Board concluded that leveraged leases should be accounted for in a manner that recognizes this cash flow pattern, both in determining the lessor's unrecovered investment balance and in the allocation of income relating to it. The assertion by some that the separate phases method results in an unwarranted "front ending" of income, in the Board's view, fails to take into account that the economic benefits of the transaction are themselves "front-ended," as has been described above. It is precisely this feature and the lack of recognition given it by the three-party financing method that caused the Board to reject that method.

.112 A number of respondents to the second Exposure Draft objected to the exclusion of the 90 percent recovery criterion, .007(d), in determining whether or not a lease meets the requirement of paragraph .042(a) as part of the definition of a leveraged lease. These respondents pointed out that the majority of leveraged leases would not meet any of the other criteria of paragraph .007 and that, if criterion .007(d) was not to be applicable, few leases would meet the definition of a leveraged lease. They took exception to the Board's reasons for having excluded criterion .007(d) as expressed in the second Exposure Draft. In their view, the determination of whether the lease would qualify as a direct financing lease, as required by paragraph .042(a), should be made in the same manner as with any other lease and that the presence of nonrecourse debt should thus not enter into such determination. The Board agreed with this reasoning and has changed the requirement of paragraph .042(a) accordingly.

.113 Some respondents asked that the Board reconsider its decision reflected in the second Exposure Draft that leases meeting the definition of sales-type leases should not be accounted for as leveraged leases. The argument was advanced that manufacturers and dealers often engage in leasing transactions that, except for the exclusion of sales-type leases, would otherwise meet the definition of a leveraged lease as set forth in paragraph .042. Specifically, it was asked why should not a manufacturer record manufacturing profit for a sales-type lease and then also account for it as a leveraged lease, if it otherwise meets the definition? In the Board's view, the recognition of manufacturing profit by the lessor at the beginning of the lease is incompatible with the concept underlying the accounting method prescribed by this Statement for leveraged leases. As stated in paragraph .109(c), that method recognizes income at a level rate of return on the lessor's net investment in the years in which the net investment is positive. The annual cash flow is thus allocated between that portion recognized as income and that applied as a reduction of net investment. Net investment at any point is considered to represent the lessor's unrecovered investment. If manufacturing profit is recognized at the beginning of the lease, an element of the overall profit in the transaction has been abstracted at the outset, thus changing the pattern of income recognition contemplated. The lessor's investment as recorded after recognition of manufacturing profit would not represent his unrecovered investment. That fact plus the deferral of income taxes related to the manufacturing profit recognized would alter both the investment base and the income to be allocated, thus

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departing from the cash flow concept on which the prescribed method is based. For these reasons, the Board did not accept the recommendation.

.114 For much the same reason, the Board concluded that if the investment tax credit is accounted for other than as described in paragraphs .043 and .044, the leveraged lease should not be accounted for by the investment with separate phases method but, instead, by the method prescribed for a direct financing lease. Accounting for the credit other than as prescribed by the investment with separate phases method would abstract an important element of the overall profit in the transaction, thereby changing the lessor's net investment and the pattern of income recognition contemplated by the investment with separate phases method and thus, in the Board's view, rendering the use of that method inappropriate.

Effective Date and Transition

.115 The Board considered three methods of transition in the application of the Statement:

a. Retroactive application with restatement of prior period financial statements

b. Retroactive application without restatement

c. Prospective application

The first alternative maximizes comparability of a company's financial statements with those of other companies and with its own statements for prior periods. However, respondents expressed concern that it would require the accumulation of a considerable amount of information about existing and expired leases and that some companies might have problems relating to restrictive covenants in loan indentures and other contracts. In addition, it requires estimates that in some cases would be made with after-the-fact knowledge. The second alternative reduces the problem of data accumulation but at the cost of impairing interperiod comparability of a company's financial statements before and after the date of retroactive application. Depending on the particular circumstances, it may or may not mitigate the possible problems relating to loan indenture covenants. The third alternative avoids most of the problems of the other two but would result in noncomparability of financial statements, both as among different com-

panies and those of the same company for different periods, for years in the future.

.116 While the majority of respondents favored prospective application, others strongly urged that the Statement be applied retroactively with restatement. The long period of time that would ensue before comparability would be achieved was given as the prime reason by those advocating retroactivity. Some preparers, on the other hand, cited problems involving loan indenture restrictions should the Statement require retroactive application. Some companies with large numbers of leases stated in their responses that the task of gathering the necessary data for retroactive application would be onerous as well as time consuming for existing leases, and that it would be more difficult, if not impossible, to obtain the information on expired leases necessary for restatement.

.117 Included in the responses was the suggestion that a transition period be established during which companies would be given time both for the purpose of accumulating the necessary data for retroactive application and for taking steps toward resolving problems that might arise in connection with restrictive clauses in loan indentures or other agreements.

.118 In considering these conflicting recommendations, the Board was sympathetic to the problems of data accumulation for companies with large numbers of leases and to the problems that some companies believe might be associated with indenture restrictions. On the other hand, the objections raised, particularly by users of financial statements, to the long period of noncomparability of financial statements that would be entailed by prospective application concerned the Board. The Board concluded that the use of a transition period at the end of which full retroactive application would be required would best meet the needs of users while at the same time giving significant recognition to the problems referred to by preparers.

.119 The procedure adopted by the Board calls for immediate prospective application of the Statement (see paragraph .048), with retroactive restatement required after a four-year transition period (see paragraph .049). Thus, companies that might have problems arising from loan indenture restrictions are given at least four full years in which, depending on the nature of the restrictions, resolution of such problems may be possible. Further, restatement is required for periods beginning before December 31, 1976 only to

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the extent that it is practicable (see paragraph .051), in recognition of the fact that some companies may be unable to obtain or reconstruct the necessary information about leases expiring in prior years. Finally, interim disclosures (see paragraph .050) are called for to facilitate comparability before retroactive application of the Statement is required; however, since the Board recognizes that the accumulation of information to make such disclosures may require time, companies are given at least one full year before such disclosure is called for. Although the Board recognizes that the period of time provided for transition will not completely eliminate the problems of retroactive restatement, it believes that those problems will be alleviated under the method outlined above and that the benefit to be gained through comparability of financial statements is substantial.

.120 Upon consideration of the relevant circumstances, the Board concluded that the interests of users of financial statements would be best served by making the statement effective for leasing transactions and lease agreement revisions entered into on or after January 1, 1977, as provided by paragraph .048.

Appendix C

ILLUSTRATIONS OF ACCOUNTING BY LESSEES AND LESSORS

.121 This Appendix contains the following schedules illustrating the accounting requirements of this Statement as applied to a particular example (an automobile lease):

1. Lease example—terms and assumptions, Schedule 1

2. Computation of minimum lease payments (lessee and lessor) and lessor's computation of rate of interest implicit in the lease, Schedule 2

3. Classification of the lease, Schedule 3

4. Journal entries for the first month of the lease as well as for the disposition of the leased property at the end of the lease term, Schedule 4

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SCHEDULE 1

Lease Example
Terms and Assumptions

Lessor's cost of the leased property (automobile)	$5,000
Fair value of the leased property at inception of the lease (1/1/77)	$5,000
Estimated economic life of the leased property	5 years

Lease terms and assumptions: The lease has a fixed noncancelable term of 30 months, with a rental of $135 payable at the beginning of each month. The lessee guarantees the residual value at the end of the 30-month lease term in the amount of $2,000. The lessee is to receive any excess of sales price of property over the guaranteed amount at the end of the lease term. The lessee pays executory costs. The lease is renewable periodically based on a schedule of rentals and guarantees of the residual values decreasing over time. The rentals specified are deemed to be fair rentals (as distinct from bargain rentals), and the guarantees of the residual are expected to approximate realizable values. No investment tax credit is available.

The residual value at the end of the lease term is estimated to be $2,000. The lessee depreciates his owned automobiles on a straight-line basis. The lessee's incremental borrowing rate is 10½% per year. There were no initial direct costs of negotiating and closing the transaction. At the end of the lease term the asset is sold for $2,100.

SCHEDULE 2

Computation of Minimum Lease Payments (Lessee and Lessor)

In accordance with paragraph .005(j), minimum lease payments for both the lessee and lessor are computed as follows:

Minimum rental payments over the lease term ($135 × 30 months)	$4,050
Lessee guarantee of the residual value at the end of the lease term	2,000
Total minimum lease payments	$6,050

Lessor's Computation of Rate of Interest Implicit in the Lease

In accordance with paragraph .005(k), the interest rate implicit in the lease is that rate implicit in the recovery of the fair value of the property at the inception of the lease ($5,000) through the minimum lease payments (30 monthly payments of $135 and the lessee's guarantee of the residual value in the amount of $2,000 at the end of the lease term). That rate is 12.036% (1.003% per month).

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SCHEDULE 3

Classification of the Lease

Criteria set forth in paragraph	
.007(a)	*Not met.* The lease does not transfer ownership of the property to the lessee by the end of the lease term.
.007(b)	*Not met.* The lease does not contain a bargain purchase option.
.007(c)	*Not met.* The lease term is not equal to 75% or more of the estimated economic life of the property. (In this case, it represents only 50% of the estimated economic life of the property.)
.007(d)	*Met.* In the lessee's case, the present value ($5,120) of the minimum lease payments using his incremental borrowing rate (10½%) exceeds 90% of the fair value of the property at the inception of the lease. (See computation on next page.) Even if the lessee knows the implicit rate, he uses his incremental rate because it is lower. The lessee classifies the lease as a capital lease. In the lessor's case, the present value ($5,000) of the minimum lease payments using the implicit rate also exceeds 90% of the fair value of the property. (See computation on next page.) Having met this criterion and assuming that the criteria of paragraph .008 are also met, the lessor will classify the lease as a direct financing lease (as opposed to a sales-type lease) because the cost and fair value of the asset are the same at the inception of the lease. (See paragraph .006(b)(ii).)

SCHEDULE 3 continued

Criteria set forth in paragraph .007(d) continued	Present Values	
	Lessee's computation using his incremental borrowing rate of 10½% (.875% per month)*	Lessor's computation using the implicit interest rate of 12.036% (1.003% per month)
Minimum lease payments:		
Rental payments	$3,580	$3,517
Residual guarantee by lessee	1,540	1,483
Total	$5,120	$5,000
Fair value of the property at inception of the lease	$5,000	$5,000
Minimum lease payments as a percentage of fair value	102%	100%

* In this case, the lessee's incremental borrowing rate is used because it is lower than the implicit rate. (See paragraph .007(d).)

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SCHEDULE 4

Journal Entries for the First Month of the Lease as Well as for the Disposition of the Leased Property at the End of the Lease Term

First Month of the Lease

LESSEE

Date	Account	Debit	Credit
1/1/77	Leased property under capital leases	5,000	
	Obligations under capital leases		5,000
	To record capital lease at the fair value of the property. (Since the present value of the minimum lease payments using the lessee's incremental borrowing rate as the discount rate (see paragraph .007(d) for selection of rate to be used) is greater than the fair value of the property, the lessee capitalizes only the fair value of the property. See paragraph .010.)		
1/1/77	Obligations under capital leases	135	
	Cash		135
	To record first month's rental payment.		

SCHEDULE 4 continued

First Month of the Lease

LESSEE continued

Date	Account / Explanation	Debit	Credit
1/31/77	Interest expense	49	
	Accrued interest on obligations under capital leases		49*
	To recognize interest expense for the first month of the lease. Obligation balance outstanding during month \$4,865 (\$5,000−\$135) × 1.003% (rate implicit in the liquidation of the \$5,000 obligation through (a) 30 monthly payments of \$135 made at the beginning of each month and (b) a \$2,000 guarantee of the residual value at the end of 30 months)=\$49. (See paragraph .012.)		
1/31/77	Depreciation expense	100	
	Leased property under capital leases		100
	To record first month's depreciation on a straight-line basis over 30 months to a salvage value of \$2,000, which is the estimated residual value to the lessee. (See paragraph .011(b).)		

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* In accordance with paragraph .012, the February 1, 1977 rental payment of \$135 will be allocated as follows: \$86 (principal reduction) against obligations under capital leases and \$49 against accrued interest on obligations under capital leases.

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SCHEDULE 4 continued

First Month of the Lease

LESSOR

Date	Account	Debit	Credit
1/1/77	Minimum lease payments receivable	6,050	
	Automobile		5,000
	Unearned income		1,050
	To record lessor's investment in the direct financing lease. (See paragraphs .018(a) and (b).)		
1/1/77	Cash	135	
	Minimum lease payments receivable		135
	To record receipt of first month's rental payment under the lease.		
1/31/77	Unearned income	49	
	Earned income		49
	To recognize the portion of unearned income that is earned during the first month of the lease. Net investment outstanding for month $4,865 (gross investment $5,915 ($6,050−$135) less unearned income $1,050) × 1.003% (monthly implicit rate in the lease) = $49. (See paragraph .018(b).)		

SCHEDULE 4 continued

Disposition of Asset* for $2,100

LESSEE

7/1/79	Cash	100	
	Obligations under capital leases	1,980	
	Accrued interest on obligations under capital leases	20	
	Leased property under capital leases		2,000
	Gain on disposition of leased property		100

To record the liquidation of the obligations under capital leases and receipt of cash in excess of the residual guarantee through the sale of the leased property.

LESSOR

7/1/79	Cash	2,000	
	Minimum lease payments receivable		2,000

To record the receipt of the amount of the lessee's guarantee.

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* See note on next page.

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SCHEDULE 4 continued

Note to Disposition of Asset

Had the lessee elected at July 1, 1979 to renew the lease, it would render inoperative the guarantee as of that date. For that reason, the renewal would not be treated as a new agreement, as would otherwise be the case under paragraph .009, but would instead be accounted for as provided in paragraph .012. The lessee would accordingly adjust the remaining balances of the asset and obligation from the original lease, which at June 30, 1979 were equal, by an amount equal to the difference between the present value of the future minimum lease payments under the revised agreement and the remaining balance of the obligation. The present value of the future minimum lease payments would be computed using the rate of interest used to record the lease initially.

From the lessor's standpoint, the revised agreement would be accounted for in accordance with paragraph .017(e). Accordingly, the remaining balance of minimum lease payments receivable would be adjusted to the amount of the payments called for by the revised agreement, and the adjustment would be credited to unearned income.

Appendix D

ILLUSTRATIONS OF DISCLOSURE BY LESSEES AND LESSORS

.122 This Appendix illustrates one way of meeting the disclosure requirements of this Statement, except for those relating to leveraged leases which are illustrated in Appendix E. The illustrations do not encompass all types of leasing arrangements for which disclosures are required. For convenience, the illustrations have been constructed as if the Statement had been in effect in prior years.

LESSEE'S DISCLOSURE

Company X
BALANCE SHEET

ASSETS	December 31, 1976	December 31, 1975	LIABILITIES	December 31, 1976	December 31, 1975
Leased property under capital leases, less accumulated amortization (Note 2)	XXX	XXX	Current: Obligations under capital leases (Note 2)	XXX	XXX
			Noncurrent: Obligations under capital leases (Note 2)	XXX	XXX

Footnotes appear on the following pages.

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FOOTNOTES

Note 1—Description of Leasing Arrangements

The Company conducts a major part of its operations from leased facilities which include a manufacturing plant, 4 warehouses, and 26 stores. The plant lease, which is for 40 years expiring in 1999, is classified as a capital lease. The warehouses are under operating leases that expire over the next 7 years. Most of the leases of store facilities are classified as capital leases. All of the leases of store facilities expire over the next 15 years.

Most of the operating leases for warehouses and store facilities contain one of the following options: (a) the Company can, after the initial lease term, purchase the property at the then fair value of the property or (b) the Company can, at the end of the initial lease term, renew its lease at the then fair rental value for periods of 5 to 10 years. These options enable the Company to retain use of facilities in desirable operating areas. The rental payments under a store facility lease are based on a minimum rental plus a percentage of the store's sales in excess of stipulated amounts. Portions of store space and warehouse space are sublet under leases expiring during the next 5 years.

In addition, the Company leases transportation equipment (principally trucks) and data processing equipment under operating leases expiring during the next 3 years.

In most cases, management expects that in the normal course of business, leases will be renewed or replaced by other leases.

The plant lease prohibits the Company from entering into future lease agreements if, as a result of new lease agreements, aggregate annual rentals under all leases will exceed $XXX.

Note 2—Capital Leases

The following is an analysis of the leased property under capital leases by major classes:

Classes of Property	Asset Balances at December 31, 1976	1975
Manufacturing plant	$ XXX	$ XXX
Store facilities	XXX	XXX
Other	XXX	XXX
	XXX	XXX
Less: Accumulated amortization	(XXX)	(XXX)
	$ XXX	$ XXX

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Note 2—continued

The following is a schedule by years of future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of December 31, 1976:

Year ending December 31:	
1977	$ XXX
1978	XXX
1979	XXX
1980	XXX
1981	XXX
Later years	XXX
Total minimum lease payments[1]	XXX
Less: Amount representing estimated executory costs (such as taxes, maintenance, and insurance), including profit thereon, included in total minimum lease payments	(XXX)
Net minimum lease payments	XXX
Less: Amount representing interest[2]	(XXX)
Present value of net minimum lease payments[3]	$ XXX

[1] Minimum payments have not been reduced by minimum sublease rentals of $XXX due in the future under noncancelable subleases. They also do not include contingent rentals which may be paid under certain store leases on the basis of a percentage of sales in excess of stipulated amounts. Contingent rentals amounted to $XXX in 1976 and $XXX in 1975.

[2] Amount necessary to reduce net minimum lease payments to present value calculated at the Company's incremental borrowing rate at the inception of the leases.

[3] Reflected in the balance sheet as current and noncurrent obligations under capital leases of $XXX and $XXX, respectively.

Note 3—Operating Leases

The following is a schedule by years of future minimum rental payments required under operating leases that have initial or remaining noncancelable lease terms in excess of one year as of December 31, 1976:

Year ending December 31:	
1977	$ XXX
1978	XXX
1979	XXX
1980	XXX
1981	XXX
Later years	XXX
Total minimum payments required*	$ XXX

The following schedule shows the composition of total rental expense for all operating leases except those with terms of a month or less that were not renewed:

	Year ending December 31,	
	1976	1975
Minimum rentals	$ XXX	$ XXX
Contingent rentals	XXX	XXX
Less: Sublease rentals	(XXX)	(XXX)
	$ XXX	$ XXX

* Minimum payments have not been reduced by minimum sublease rentals of $XXX due in the future under noncancelable subleases.

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LESSOR'S DISCLOSURE (Other Than for Leveraged Leases)

Company X
BALANCE SHEET

ASSETS	December 31,	
	1976	1975
Current assets:		
Net investment in direct financing and sales-type leases (Note 2)	XXX	XXX
Noncurrent assets:		
Net investment in direct financing and sales-type leases (Note 2)	XXX	XXX
Property on operating leases and property held for leases (net of accumulated depreciation of $XXX and $XXX for 1976 and 1975, respectively) (Note 3)	XXX	XXX

Footnotes appear on the following pages.

FOOTNOTES

Note 1—Description of Leasing Arrangements

The Company's leasing operations consist principally of the leasing of various types of heavy construction and mining equipment, data processing equipment, and transportation equipment. With the exception of the leases of transportation equipment, the bulk of the Company's leases are classified as direct financing leases. The construction equipment and mining equipment leases expire over the next ten years and the data processing equipment leases expire over the next eight years. Transportation equipment (principally trucks) is leased under operating leases that expire during the next three years.

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Note 2—Net Investment in Direct Financing and Sales-Type Leases

The following lists the components of the net investment in direct financing and sales-type leases as of December 31:

	1976	1975
Total minimum lease payments to be received*	$ XXX	$ XXX
Less: Amounts representing estimated executory costs (such as taxes, maintenance, and insurance), including profit thereon, included in total minimum lease payments	(XXX)	(XXX)
Minimum lease payments receivable	XXX	XXX
Less: Allowance for uncollectibles	(XXX)	(XXX)
Net minimum lease payments receivable	XXX	XXX
Estimated residual values of leased property (unguaranteed)	XXX	XXX
Less: Unearned income	(XXX)	(XXX)
Net investment in direct financing and sales-type leases	$ XXX	$ XXX

* Minimum lease payments do not include contingent rentals which may be received under certain leases of data processing equipment on the basis of hours of use in excess of stipulated minimums. Contingent rentals amounted to $XXX in 1976 and $XXX in 1975. At December 31, 1976, minimum lease payments for each of the five succeeding fiscal years are as follows: $XXX in 1977, $XXX in 1978, $XXX in 1979, $XXX in 1980, and $XXX in 1981.

Note 3—Property on Operating Leases and Property Held for Lease

The following schedule provides an analysis of the Company's investment in property on operating leases and property held for lease by major classes as of December 31, 1976:

Construction equipment	$ XXX
Mining equipment	XXX
Data processing equipment	XXX
Transportation equipment	XXX
Other	XXX
	XXX
Less: Accumulated depreciation	(XXX)
	$ XXX

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Note 4—Rentals under Operating Leases

The following is a schedule by years of minimum future rentals on noncancelable operating leases as of December 31, 1976:

Year ending December 31:	
1977	$ XXX
1978	XXX
1979	XXX
1980	XXX
1981	XXX
Later years	XXX
Total minimum future rentals*	$ XXX

* This amount does not include contingent rentals which may be received under certain leases of data processing equipment on the basis of hours of use in excess of stipulated minimums. Contingent rentals amounted to $XXX in 1976 and $XXX in 1975.

Appendix E

ILLUSTRATIONS OF ACCOUNTING AND FINANCIAL STATEMENT PRESENTATION FOR LEVERAGED LEASES

.123 This Appendix illustrates the accounting requirements of this Statement and one way of meeting its disclosure requirements as applied to a leveraged lease. The illustrations do not encompass all circumstances that may arise in connection with leveraged leases; rather, the illustrations are based on a single example of a leveraged lease, the terms and assumptions for which are stated in Schedule 1. The elements of accounting and reporting illustrated for this example of a leveraged lease are as follows:

1. Leveraged lease example—terms and assumptions, Schedule 1

2. Cash flow analysis by years, Schedule 2

3. Allocation of annual cash flow to investment and income, Schedule 3

4. Journal entries for lessor's initial investment and first year of operation, Schedule 4

5. Financial statements including footnotes at end of second year

6. Accounting for a revision in the estimated residual value of the leased asset assumed to occur in the eleventh year of the lease (from $200,000 to $120,000):

   a. Revised allocation of annual cash flow to investment and income, Schedule 5

   b. Balances in investment accounts at beginning of the eleventh year before revised estimate, Schedule 6

   c. Journal entries, Schedule 7

   d. Adjustment of investment accounts, Schedule 8

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SCHEDULE 1

Leveraged Lease Example
Terms and Assumptions

Cost of leased asset (equipment)	$1,000,000
Lease term	15 years, dating from January 1, 1975
Lease rental payments	$90,000 per year (payable last day of each year)
Residual value	$200,000 estimated to be realized one year after lease termination. In the eleventh year of the lease the estimate is reduced to $120,000.
Financing:	
Equity investment by lessor	$400,000
Long-term nonrecourse debt	$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of $74,435.30
Depreciation allowable to lessor for income tax purposes	Seven-year ADR life using double-declining-balance method for the first two years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to $100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or $100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration.

SCHEDULE 2

Cash Flow Analysis by Years

	1	2	3	4
Year	Gross lease rentals and residual value	Depreciation (for income tax purposes)	Loan interest payments	Taxable income (loss) (col. 1−2−3)
Initial investment	—	—	—	—
1	$ 90,000	$ 142,857	$ 54,000	$ (106,857)
2	90,000	244,898	52,161	(207,059)
3	90,000	187,075	50,156	(147,231)
4	90,000	153,061	47,971	(111,032)
5	90,000	119,048	45,589	(74,637)
6	90,000	53,061	42,993	(6,054)
7	90,000	—	40,163	49,837
8	90,000	—	37,079	52,921
9	90,000	—	33,717	56,283
10	90,000	—	30,052	59,948
11	90,000	—	26,058	63,942
12	90,000	—	21,704	68,296
13	90,000	—	16,957	73,043
14	90,000	—	11,785	78,215
15	90,000	—	6,145	83,855
16	200,000	100,000	—	100,000
Totals	$1,550,000	$1,000,000	$516,530	$ 33,470

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SCHEDULE 2 continued

5 Income tax credits (charges) (col. 4 × 50.4%)	6 Loan principal payments	7 Investment tax credit realized	8 Annual cash flow (col. 1−3+5−6+7)	9 Cumulative cash flow
—	—	—	$(400,000)	$(400,000)
$ 53,856	$ 20,435	$100,000	169,421	(230,579)
104,358	22,274	—	119,923	(110,656)
74,204	24,279	—	89,769	(20,887)
55,960	26,464	—	71,525	50,638
37,617	28,846	—	53,182	103,820
3,051	31,442	—	18,616	122,436
(25,118)	34,272	—	(9,553)	112,883
(26,672)	37,357	—	(11,108)	101,775
(28,367)	40,719	—	(12,803)	88,972
(30,214)	44,383	—	(14,649)	74,323
(32,227)	48,378	—	(16,663)	57,660
(34,421)	52,732	—	(18,857)	38,803
(36,813)	57,478	—	(21,248)	17,555
(39,420)	62,651	—	(23,856)	(6,301)
(42,263)	68,290	—	(26,698)	(32,999)
(50,400)	—	—	149,600	116,601
$(16,869)	$600,000	$100,000	$116,601	

SCHEDULE 3

Allocation of Annual Cash Flow to Investment and Income

	1	2	3	4
		Annual Cash Flow		
Year	Lessor's net investment at beginning of year	Total (from Schedule 2, col. 8)	Allocated to investment	Allocated to income[1]
1	$400,000	$169,421	$134,833	$ 34,588
2	265,167	119,923	96,994	22,929
3	168,173	89,769	75,227	14,542
4	92,946	71,525	63,488	8,037
5	29,458	53,182	50,635	2,547
6	(21,177)	18,616	18,616	—
7	(39,793)	(9,553)	(9,553)	—
8	(30,240)	(11,108)	(11,108)	—
9	(19,132)	(12,803)	(12,803)	—
10	(6,329)	(14,649)	(14,649)	—
11	8,320	(16,663)	(17,382)	719
12	25,702	(18,857)	(21,079)	2,222
13	46,781	(21,248)	(25,293)	4,045
14	72,074	(23,856)	(30,088)	6,232
15	102,162	(26,698)	(35,532)	8,834
16	137,694	149,600	137,694	11,906
Totals		$516,601	$400,000	$116,601

[1] Lease income is recognized as 8.647% of the unrecovered investment at the beginning of each year in which the net investment is positive. The rate is that rate which when applied to the net investment in the years in which the net investment is positive will distribute the net income (net cash flow) to those years. The rate for allocation used in this Schedule is calculated by a trial and error process. The allocation is calculated based upon an initial estimate of the rate as a starting point. If the total thus allocated to income (column 4) differs under the estimated rate from the net cash flow (Schedule 2, column 8) the estimated rate is increased or decreased, as appropriate, to derive a revised allocation. This process is repeated until a rate is selected which develops a total amount allocated to income that is precisely equal to the net cash flow. As a practical matter, a computer program is used to calculate Schedule 3 under successive iterations until the correct rate is determined.

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SCHEDULE 3 continued

5	6	7
Components of Income[2]		
Pretax income	Tax effect of pretax income	Investment tax credit
$ 9,929	$ (5,004)	$ 29,663
6,582	(3,317)	19,664
4,174	(2,104)	12,472
2,307	(1,163)	6,893
731	(368)	2,184
—	—	—
—	—	—
—	—	—
—	—	—
—	—	—
206	(104)	617
637	(321)	1,906
1,161	(585)	3,469
1,789	(902)	5,345
2,536	(1,278)	7,576
3,418	(1,723)	10,211
$33,470	$(16,869)	$100,000

[2] Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4.

SCHEDULE 4

Illustrative Journal Entries for Year Ending December 31, 1975

Lessor's Initial Investment

Rentals receivable (Schedule 2, total of column 1 less residual value, less totals of columns 3 and 6)	233,470	
Investment tax credit receivable (Schedule 2, column 7)	100,000	
Estimated residual value (Schedule 1)	200,000	
Unearned and deferred income (Schedule 3, totals of columns 5 and 7)		133,470
Cash		400,000
Record lessor's initial investment		

First Year of Operation

Journal Entry 1

Cash	15,565	
Rentals receivable (Schedule 2, column 1 less columns 3 and 6)		15,565
Collection of first year's net rental		

Journal Entry 2

Cash*	100,000	
Investment tax credit receivable (Schedule 2, column 7)		100,000
Receipt of investment tax credit		

* Receipts of the investment tax credit and other tax benefits are shown as cash receipts for simplicity only. Those receipts probably would not be in the form of immediate cash inflow. Instead, they likely would be in the form of reduced payments of taxes on other income of the lessor or on the combined income of the lessor and other entities whose operations are joined with the lessor's operations in a consolidated tax return.

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SCHEDULE 4 continued

Journal Entry 3

Unearned and deferred income	9,929	
Income from leveraged leases (Schedule 3, column 5)		9,929

Recognition of first year's portion of pretax income allocated in the same proportion as the allocation of total income

$$\left(\frac{34{,}588}{116{,}601} \times 33{,}470 = 9{,}929\right)$$

Journal Entry 4

Unearned and deferred income	29,663	
Investment tax credit recognized (Schedule 3, column 7)		29,663

Recognition of first year's portion of investment tax credit allocated in the same proportion as the allocation of total income

$$\left(\frac{34{,}588}{116{,}601} \times 100{,}000 = 29{,}663\right)$$

Journal Entry 5

Cash (Schedule 2, column 5)*	53,856	
Income tax expense (Schedule 3, column 6)	5,004	
Deferred taxes		58,860

To record receipt of first year's tax credit from lease operation, to charge income tax expense for tax effect of pretax accounting income, and to recognize as deferred taxes the tax effect of the difference between pretax accounting income and the tax loss for the year, calculated as follows:

Tax loss (Schedule 2, column 4)	$(106,857)
Pretax accounting income	9,929
Difference	$(116,786)
Deferred taxes ($116,786 × 50.4%)	$ 58,860

* See note on preceding page.

ILLUSTRATIVE PARTIAL FINANCIAL STATEMENTS INCLUDING FOOTNOTES

BALANCE SHEET

ASSETS	December 31, 1976	December 31, 1975	LIABILITIES	December 31, 1976	December 31, 1975
Investment in leveraged leases	$334,708	$324,027	Deferred taxes arising from leveraged leases	$166,535	$58,860

INCOME STATEMENT

(Ignoring all income and expense items other than those relating to leveraged leasing)

	1976	1975
Income from leveraged leases	$ 6,582	$ 9,929
Income before taxes and investment tax credit	6,582	9,929
Less: Income tax expense*	(3,317)	(5,004)
	3,265	4,925
Investment tax credit recognized*	19,664	29,663
Net income	$22,929	$34,588

Footnotes appear on the following page.

* These two items may be netted for purposes of presentation in the income statement, provided that the separate amounts are disclosed in a note to the financial statements.

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FOOTNOTES

Investment in Leveraged Leases

The Company is the lessor in a leveraged lease agreement entered into in 1975 under which mining equipment having an estimated economic life of 18 years was leased for a term of 15 years. The Company's equity investment represented 40 percent of the purchase price; the remaining 60 percent was furnished by third-party financing in the form of long-term debt that provides for no recourse against the Company and is secured by a first lien on the property. At the end of the lease term, the equipment is turned back to the Company. The residual value at that time is estimated to be 20 percent of cost. For federal income tax purposes, the Company receives the investment tax credit and has the benefit of tax deductions for depreciation on the entire leased asset and for interest on the long-term debt. Since during the early years of the lease those deductions exceed the lease rental income, substantial excess deductions are available to be applied against the Company's other income. In the later years of the lease, rental income will exceed the deductions and taxes will be payable. Deferred taxes are provided to reflect this reversal.

The Company's net investment in leveraged leases is composed of the following elements:

	December 31, 1976	December 31, 1975
Rentals receivable (net of principal and interest on the nonrecourse debt)	$202,340	$217,905
Estimated residual value of leased assets	200,000	200,000
Less: Unearned and deferred income	(67,632)	(93,878)
Investment in leveraged leases	334,708	324,027
Less: Deferred taxes arising from leveraged leases	(166,535)	(58,860)
Net investment in leveraged leases	$168,173	$265,167

SCHEDULE 5

Allocation of Annual Cash Flow to Investment and Income Revised to Include New Residual Value Estimate

	1	2	3	4
		Annual Cash Flow		
Year	Lessor's net investment at begnning of year	Total	Allocated to investment	Allocated to income[1]
1	$400,000	$169,421	$142,458	$26,963
2	257,542	119,923	102,563	17,360
3	154,979	89,769	79,323	10,446
4	75,656	71,525	66,425	5,100
5	9,231	53,182	52,560	622
6	(43,329)	18,616	18,616	—
7	(61,945)	(9,553)	(9,553)	—
8	(52,392)	(11,108)	(11,108)	—
9	(41,284)	(12,803)	(12,803)	—
10	(28,481)	(14,649)	(14,649)	—
11	(13,832)	(16,663)	(16,663)	—
12	2,831	(18,857)	(19,048)	191
13	21,879	(21,248)	(22,723)	1,475
14	44,602	(23,856)	(26,862)	3,006
15	71,464	(26,698)	(31,515)	4,817
16	102,979	109,920	102,979	6,941
Totals		$476,921	$400,000	$76,921

[1] The revised allocation rate is 6.741%.

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SCHEDULE 5 continued

5	6	7
Components of Income		
Pretax loss	Tax effect of pretax loss	Investment tax credit
$(16,309)	$ 8,220	$ 35,052
(10,501)	5,293	22,568
(6,319)	3,184	13,581
(3,085)	1,555	6,630
(377)	190	809
—	—	—
—	—	—
—	—	—
—	—	—
—	—	—
—	—	—
(115)	58	248
(892)	450	1,917
(1,819)	916	3,909
(2,914)	1,469	6,262
(4,199)	2,116	9,024
$(46,530)	$23,451	$100,000

SCHEDULE 6

Balances in Investment Accounts Before Revised Estimate of Residual Value

	1	2	3
	Rentals receivable[1]	Estimated residual value	Investment tax credit receivable
Initial investment	$233,470	$200,000	$100,000
Changes in year of operation			
1	(15,565)	—	(100,000)
2	(15,565)	—	—
3	(15,565)	—	—
4	(15,565)	—	—
5	(15,565)	—	—
6	(15,565)	—	—
7	(15,565)	—	—
8	(15,564)	—	—
9	(15,564)	—	—
10	(15,565)	—	—
Balances, beginning of eleventh year	$ 77,822	$200,000	$ —

[1] Schedule 2, column 1, excluding residual value, less columns 3 and 6.

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SCHEDULE 6 continued

4	5	6	7
Unearned & Deferred Income			Net investment (col. 1+2+3) less (col. 4+5+6)
Pretax income (loss)[2]	Investment tax credit[3]	Deferred taxes[4]	
$33,470	$100,000	$ —	$400,000
(9,929)	(29,663)	58,860	(134,833)
(6,582)	(19,664)	107,675	(96,994)
(4,174)	(12,472)	76,308	(75,227)
(2,307)	(6,893)	57,123	(63,488)
(731)	(2,184)	37,985	(50,635)
—	—	3,051	(18,616)
—	—	(25,118)	9,553
—	—	(26,672)	11,108
—	—	(28,367)	12,803
—	—	(30,214)	14,649
$ 9,747	$ 29,124	$230,631	$ 8,320

[2] Schedule 3, column 5.
[3] Schedule 3, column 7.
[4] 50.4% of difference between taxable income (loss), Schedule 2, column 4, and pretax accounting income (loss), Schedule 3, column 5.

SCHEDULE 7

Illustrative Journal Entries
Reduction in Residual Value in Eleventh Year

Journal Entry 1

Pretax income (or loss)		60,314	
Unearned and deferred income		27,450	
Pretax income (loss):			
Balance at end of 10th year	9,747[1]		
Revised balance	(9,939)[2]		
Adjustment	(19,686)		
Deferred investment tax credit:			
Balance at end of 10th year	29,124[3]		
Revised balance	21,360[4]		
Adjustment	(7,764)		
Investment tax credit recognized			7,764
Estimated residual value			80,000

To record:

i. The cumulative effect on pretax income and the effect on future income resulting from the decrease in estimated residual value:

Reduction in estimated residual value	$80,000
Less portion attributable to future years (unearned and deferred income)	(19,686)
Cumulative effect (charged against current income)	$60,314

ii. The cumulative and future effect of the change in allocation of the investment tax credit resulting from the reduction in estimated residual value

[1] Schedule 6, column 4.
[2] Schedule 5, total of column 5 less amounts applicable to the first 10 years.
[3] Schedule 6, column 5.
[4] Schedule 5, total of column 7 less amounts applicable to the first 10 years.

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SCHEDULE 7 continued

Journal Entry 2

Deferred taxes	30,398	
Income tax expense		30,398

To recognize deferred taxes for the difference between pretax accounting income (or loss) and taxable income (or loss) for the effect of the reduction in estimated residual value.

Pretax accounting loss per journal entry 1	$(60,314)
Tax income (or loss)	—
Difference	$(60,314)
Deferred taxes ($60,314 × 50.4%)	$(30,398)

SCHEDULE 8

Adjustment of Investment Accounts for Revised Estimate of Residual Value in Eleventh Year

	1 Rentals receivable	2 Estimated residual value
Balances, beginning of eleventh year (Schedule 6)	$77,822	$200,000
Adjustment of estimated residual value and unearned and deferred income (Schedule 7 – journal entry 1)	—	(80,000)
Adjustment of deferred taxes for the cumulative effect on pretax accounting income (Schedule 7 – journal entry 2)	—	—
Adjusted balances, beginning of eleventh year	$77,822	$120,000

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SCHEDULE 8 continued

3	4	5	6
Unearned & Deferred Income			Net investment
Pretax income (loss)	Investment tax credit	Deferred taxes	(col. 1+2) less (col. 3+4+5)
$ 9,747	$29,124	$230,631	$ 8,320
(19,686)	(7,764)	—	(52,550)
—	—	(30,398)	30,398
$ (9,939)	$21,360	$200,233	$(13,832)[1]

The next page is 8445.

[1] Schedule 5, column 1.

AC Section 4053-1

Lessee Guarantee of the Residual Value of Leased Property: An Interpretation of Section 4053

[Source: FASB Interpretation No. 19.]

October 1977

INTRODUCTION

.01 The FASB has been asked to clarify whether a particular kind of lease provision constitutes a guarantee by the lessee of the residual value of leased property at the expiration of the lease term to be included in *minimum lease payments* in accordance with paragraph 5(j)(i)(b) of *FASB Statement No. 13* [section 4053.005(j)(i)(b)], "Accounting for Leases," and to clarify whether certain provisions in lease agreements and certain other circumstances limit the amount of a lessee guarantee to be included in minimum lease payments to an amount less than a stipulated residual value of the leased property at the end of the lease term. Paragraph 5(j)(i)(b) of the Statement states that minimum lease payments from the standpoint of the lessee shall include a "guarantee by the lessee . . . of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property. . . . When the lessee agrees to make up any deficiency below a stated amount in the lessor's realization of the residual value, the guarantee to be included in the minimum lease payments shall be the stated amount, rather than an estimate of the deficiency to be made up."

.02 Specifically, the Board has been asked the following three questions:

a. Does a lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage (e. g., excessive mileage on a leased vehicle) constitute a lessee guarantee of the residual value such that the estimated residual value of the leased property at the end of the lease term should be included in minimum lease payments under paragraph 5(j)(i)(b) of *FASB Statement No. 13* [section 4053.005(j)(i)(b)]?

b. Some lease agreements limit the amount of a residual value deficiency that a lessee can be required to make up to an amount that is (1) less than the stipulated residual value

of the leased property at the end of the lease term but (2) clearly in excess of any reasonable estimate of a deficiency that might be expected to arise in normal circumstances. In those cases, is the amount of the lessee's guarantee to be included in minimum lease payments under paragraph 5(j)(i)(b) of *FASB Statement No. 13* [section 4053.005 (j)(i)(b)] limited to the specified maximum deficiency that the lessee can be required to make up, or is it the stipulated residual value of the leased property at the end of the lease term?

c. If a lessee who is obligated to make up a deficiency in the lessor's realization of the residual value obtains a guarantee of the residual value from an unrelated third party, may the lessee reduce the amount of his minimum lease payments under paragraph 5(j)(i)(b) of *FASB Statement No. 13* [section 4053.005(j)(i)(b)] by the amount of the third-party guarantee?

INTERPRETATION

.03 A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to contingent rentals in that the amount is not determinable at the inception of the lease.[1] Such a provision does not constitute a lessee guarantee of the residual value for purposes of paragraph 5(j)(i)(b) of *FASB Statement No. 13* [section 4053.005 (j)(i)(b)].

.04 If a lease limits the amount of the lessee's obligation to make up a residual value deficiency to an amount less than the stipulated residual value of the leased property at the end of the lease term, the amount of the lessee's guarantee to be included in minimum lease payments under paragraph 5(j) (i)(b) of *FASB Statement No. 13* [section 4053.005(j)(i)(b)] shall be limited to the specified maximum deficiency the lessee can be required to make up. In other words, the "stated amount" referred to in the last sentence of paragraph 5(j)(i)(b) is the specified maximum deficiency that the lessee is obligated to make up. If that maximum deficiency clearly exceeds any reasonable estimate of a deficiency that might be expected to arise in normal circumstances, the lessor's risk associated with

[1] Contingent rentals are not included in *minimum lease payments* as defined in paragraph 5(j) of *FASB Statement No. 13* [section 4053.005(j)]. Contingent rentals are to be recognized as period costs when incurred (or revenue when receivable). (See paragraphs 12, 17(b), and 18(b) of Statement No. 13 [sections 4053.012, 4053.017(b), and 4053.018(b)].)

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the portion of the residual in excess of the maximum may appear to be negligible. However, the fact remains that the lessor must look to the resale market or elsewhere rather than to the lessee to recover the unguaranteed portion of the stipulated residual value of the leased property. The lessee has not guaranteed full recovery of the residual value, and the parties should not base their accounting on the assumption that the lessee has guaranteed it. The 90 percent test specified in criterion (d) of paragraph 7 of Statement No. 13 [section 4053.007(d)] is stated as a lower limit rather than as a guideline.

.05 A guarantee of the residual value obtained by the lessee from an unrelated third party for the benefit of the lessor shall not be used to reduce the amount of the lessee's minimum lease payments under paragraph 5(j)(i)(b) of *FASB Statement No. 13* [section 4053.005(j)(i)(b)] except to the extent that the lessor explicitly releases the lessee from obligation, including secondary obligation if the guarantor defaults, to make up a residual value deficiency. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and are not included in the lessee's minimum lease payments.

EFFECTIVE DATE AND TRANSITION

.06 The provisions of this Interpretation shall be effective for leasing transactions and lease agreement revisions (see paragraph 9 of *FASB Statement No. 13* [section 4053.009]) entered into on or after January 1, 1978. Earlier application is encouraged. In addition, the provisions of this Interpretation shall be applied retroactively at the same time and in the same manner as the provisions of *FASB Statement No. 13* [section 4053] are applied retroactively (see paragraphs 49 and 51 of the Statement [sections 4053.049 and 4053.051]). Enterprises that have already applied the provisions of Statement No. 13 [section 4053] retroactively and have published financial statements based on the retroactively adjusted accounts before the effective date of this Interpretation may, but are not required to, apply the provisions of this interpretation retroactively.

The next page is 8449.

AC Section 4053-2

Accounting for Leases in a Business Combination: An Interpretation of Section 4053

[Source: FASB Interpretation No. 21.]

April 1978

INTRODUCTION AND BACKGROUND INFORMATION

.01 The FASB has been asked to clarify the application of *FASB Statement No. 13* [section 4053], "Accounting for Leases," in business combinations. Specifically, this involves the following questions:

a. Does the consummation of a business combination require the combined enterprise to treat leases of the combining companies as new leases to be classified according to the criteria set forth in Statement No. 13 [section 4053], based on conditions as of the date of the combination?

b. If the consummation of a business combination does not require enterprises to treat leases of the combining companies as new leases as of the date of the combination, how should Statement No. 13 [section 4053] be applied [1] to the leases of the combined enterprise?

c. How do the requirements of *APB Opinion No. 16* [section 1091], "Business Combinations," for assigning amounts to the assets acquired and liabilities assumed in a business combination that is accounted for by the purchase method affect the application of Statement No. 13 [section 4053] by the combined enterprise to leases of the acquired company?

.02 Paragraph 40 of *FASB Statement No. 13* [section 4053.040] requires the new lessee under a sublease or similar transaction to classify the lease in accordance with the criteria in Statement No. 13 [section 4053] and to account for it as a new lease. Subparagraphs (b) and (c) of paragraph 35 of Statement No. 13 [section 4053.035(b) and (c)] describe the transactions similar to subleases that are subject to the requirements of paragraph 40 [section 4053.040] of the Statement as follows:

b. A new lessee is substituted under the original lease agreement. The new lessee becomes the primary obligor under

[1] See paragraphs 49 and 51 of *FASB Statement No. 13* [sections 4053.049 and 4053.051] regarding retroactive application of Statement No. 13 [section 4053].

the agreement, and the original lessee may or may not be secondarily liable.

c. A new lessee is substituted through a new agreement, with cancellation of the original lease agreement.

The question has been raised as to whether the provisions of paragraphs 35 and 40 [sections 4053.035 and 4053.040] ever require that leases in a business combination be treated as new leases by the combined enterprise.

.03 In connection with a business combination, changes may be made in the provisions of existing leases of a combining enterprise. Paragraph 9 of *FASB Statement No. 13* [section 4053.009] discusses changes in the provisions of leases as follows:

> If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7 and 8 had the changed terms been in effect at the inception of the lease, the revised agreement shall be considered as a new agreement over its term, and the criteria in paragraphs 7 and 8 shall be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered inoperative as described in paragraphs 12 and 17(e), any action that extends the lease beyond the expiration of the existing lease term (see paragraph 5(f)), such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the provisions of paragraphs 6-8. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, shall not give rise to a new classification of a lease for accounting purposes.

.04 Paragraph 88 of *APB Opinion No. 16* [section 1091.88] provides "general guides for assigning amounts to the individual assets acquired and liabilities assumed, except goodwill . . ." in a business combination that is accounted for by the purchase method. The guides in subparagraphs of paragraph 88 [section 1091.88] indicate the method of valuation to be used for various types of assets and liabilities. The concepts underlying *FASB Statement No. 13* [section 4053] that govern classification of leases differ in some respects from the concepts of prior APB Opinions on accounting for leases. Thus, the subparagraphs of paragraph 88 of Opinion No. 16 [section 1091.88] that were applied prior to Statement No. 13 [section 4053] may not be the appropriate subparagraphs to be applied under Statement No. 13 [section 4053]. In addition, some provisions of Statement No. 13 [section 4053] (e.g., interest rates used) may suggest that certain of the general guidelines in paragraph 88

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[section 1091.88] should be applied differently from the way they may have been applied in the past.

.05 An Exposure Draft of a proposed Interpretation on "Accounting for Leases in a Business Combination" was issued on December 19, 1977. The Board received 27 letters of comment in response to the Exposure Draft. Certain of those comments and the Board's consideration of them are discussed in paragraphs .06-.10 below.

.06 One respondent requested that the Interpretation provide for circumstances in which determinations at the inception of the lease are not possible. The Board is aware that in some cases it is difficult to obtain accurate data relating to the remote past of an acquired enterprise but believes that reasonable estimates can be derived based on the information that is available.

.07 Some respondents expressed the belief that the concept of purchase accounting in *APB Opinion No. 16* [section 1091] requires the acquiring enterprise to classify the acquired enterprise's leases as new leases at the date of a business combination that is accounted for by the purchase method and stated that the acquiring enterprise should apply the criteria of *FASB Statement No. 13* [section 4053] for classifying the acquired leases at the date of the acquisition. The Board does not believe that Opinion No. 16 [section 1091] requires reconsideration of the classification of existing leases that are already classified in conformity with Statement No. 13 [section 4053]; rather, the Board views Opinion No. 16 [section 1091] as requiring valuation of the existing assets and obligations of the acquired company, including assets and obligations pertaining to leases, and allocation of cost to those assets and obligations. Also, the Board views the procedures suggested as contrary to Statement No. 13 [section 4053]. Paragraph .08 below describes the basis for classification of a lease under Statement No. 13 [section 4053].

.08 Paragraph 7 of *FASB Statement No. 13* [section 4053.007] states that "the criteria for classifying leases set forth in this paragraph and in paragraph 8 derive from the concept set forth in paragraph 60." Paragraph 60 of Statement No. 13 [section 4053.060] describes the underlying concept as follows:

> The provisions of this Statement derive from the view that a *lease that transfers* substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. . . . [Emphasis added.]

Statement No. 13 [section 4053] requires that the classification of a lease (an agreement between a lessee and a lessor) be determined at the inception of *the lease.* Once that determination is made, the classification of the lease is not reexamined unless either (a) both parties to the lease agree to a revision that would have resulted in a different classification of the lease had the changed terms been in effect at the inception of the lease or (b) the lease is extended or renewed. Paragraphs 36-40 of Statement No. 13 [section 4053.036-.040] apply similar procedures with respect to classification to the parties affected by a sublease, as follows:

a. *The original lessor* retains the classification of the original lease unless it is replaced by a new agreement.

b. *The original lessee* retains the original classification of the original lease unless the original lessee is relieved of the primary obligation. (If the lessee is relieved of the primary obligation, the original lessor will have agreed to a revision.)

c. *The new lessee* has agreed to the terms of a lease, either with the original lessee (in effect, a sublease) or with the original lessor (a new lease). Accordingly, the new lessee is required to classify the new lease at the date of the new agreement.

Statement No. 13 [section 4053] applies the same rationale to an enterprise that purchases the lessor's interest in an existing lease from the original lessor. The Statement does not permit an enterprise that purchases property from a lessor while the property is leased to a third party lessee to classify the acquired lease as a new lease at the acquisition date. The lessee is not a party to the transaction and the original lessor ceases to be a party to the lease; thus, there has been no new agreement between a lessee and a lessor and the purchase date is not the inception of a new lease requiring classification at that date. The Board views the substance of a business combination that is accounted for under the purchase method to be the purchase of the lessor's or lessee's interest in an existing lease. The original lessor or lessee does not become a party to a new agreement; accordingly, there is no new agreement to be classified, and Statement No. 13 [section 4053] does not permit reclassification of the existing lease unless the provisions of the lease are modified. The Board is aware that the identity of a party to a lease may change in a business combination and that the lease may be modified to reflect that change. If the provisions of the lease are not changed (see paragraph .03 above), the modification does not represent a new agreement

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between the lessee and lessor in substance, and the lease should not be reclassified.

.09 Some respondents suggested that the Board expand the scope of this Interpretation to address asset acquisitions that are not business combinations. As explained in paragraph .08 above, the Board believes that *FASB Statement No. 13* [section 4053] provides adequate guidance for those transactions.

.10 Some enterprises have already applied the provisions of *FASB Statement No. 13* [section 4053] retroactively and have published financial statements based on the retroactively adjusted accounts. The Exposure Draft proposed that those enterprises would be permitted, but not required, to apply the provisions of this Interpretation retroactively. Some respondents' comments indicated that they interpreted the reference to "published financial statements" in the Exposure Draft to include financial summaries of interim results. The Board had intended the reference to "published financial statements" to exclude those summaries. Upon further consideration, the Board modified the wording of paragraph .18 to "published *annual* financial statements."

.11 This Interpretation applies to the accounting for leases by combined enterprises at the date of and subsequent to a business combination.

INTERPRETATION

Summary

.12 The classification of a lease in accordance with the criteria of *FASB Statement No. 13* [section 4053] shall not be changed as a result of a business combination unless the provisions of the lease are modified. (See paragraph .13.)

Changes in the Provisions of the Lease

.13 If in connection with a business combination, whether accounted for by the purchase method or by the pooling of interests method, the provisions of a lease are modified in a way that would require the revised agreement to be considered a new agreement under paragraph 9 of *FASB Statement No. 13* [section 4053.009], the new lease shall be classified by the combined enterprise according to the criteria set forth in Statement No. 13 [section 4053], based on conditions as of the date of the modification of the lease.

Application of Section 4053 in a Pooling of Interests

.14 In a business combination that is accounted for by the pooling of interests method, each lease shall retain its previous

classification under *FASB Statement No. 13* [section 4053] unless the provisions of the lease are modified as indicated in paragraph .13 above and shall be accounted for by the combined enterprise in the same manner that it would have been classified and accounted for by the combining enterprise.

Application of Section 4053 in a Purchase Combination

.15 In a business combination that is accounted for by the purchase method, the acquiring enterprise shall retain the previous classification in accordance with *FASB Statement No. 13* [section 4053] for the leases of an acquired enterprise unless the provisions of the lease are modified as indicated in paragraph .13 above.[2] The amounts assigned to individual assets acquired and liabilities assumed at the date of the combination shall be determined in accordance with the general guides for that type of asset or liability in paragraph 88 of *APB Opinion No. 16* [section 1091.88]. Subsequent to the recording of the amounts called for by Opinion No. 16 [section 1091], the leases shall thereafter be accounted for in accordance with Statement No. 13 [section 4053].[3] Paragraph .16 below explains the application of this paragraph to a leveraged lease by an enterprise that acquires a lessor.

.16 In a business combination that is accounted for by the purchase method, the acquiring enterprise shall apply the following procedures to the acquired enterprise's investment as a lessor in a leveraged lease. The acquiring enterprise shall retain the classification of a leveraged lease at the date of the combination. The acquiring enterprise shall assign an amount to the acquired net investment in the leveraged lease in accordance with the general guides in paragraph 88 of *APB Opinion No. 16* [section 1091.88], based on the remaining future cash flows and giving appropriate recognition to the estimated future tax effects of those cash flows. Once determined, that net investment shall be broken down into its component parts, namely, net rentals receivable, estimated residual value, and unearned income including discount to adjust other components to present value. The acquiring enterprise thereafter shall account for that investment in a leveraged lease in ac-

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[2] If the acquired enterprise has not applied *FASB Statement No. 13* [section 4053] retroactively at the date of the business combination, the acquiring enterprise shall classify the leases of the acquired enterprise as they would have been classified if the acquired enterprise had applied Statement No. 13 [section 4053] retroactively at that date.

[3] *FASB Statement No. 13* [section 4053] does not address the subsequent accounting for amounts recorded for favorable or unfavorable operating leases. Accordingly, present practice is not changed with respect to the amortization of those amounts.

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cordance with the provisions of *FASB Statement No. 13* [section 4053]. Appendix A illustrates the application of this paragraph.

.17 When an enterprise that has acquired another enterprise in a business combination accounted for by the purchase method prior to the effective date of this Interpretation applies the provisions of *FASB Statement No. 13* [section 4053] retroactively, leases acquired in the business combination shall be classified as they would have been classified if the acquired enterprise had applied Statement No. 13 [section 4053] retroactively at the date of the business combination. The amounts retroactively recorded for those leases shall be the amounts that would have been allocated under *APB Opinion No. 16* [section 1091] by the acquiring enterprise at the purchase date if the leases had been classified in accordance with the provisions of Statement No. 13 [section 4053] at that date. The following examples illustrate the application of this paragraph:

a. In the case of a lease for which the lessee's classification is changed by the retroactive application of Statement No. 13 [section 4053] from an operating lease to a capital lease, the favorable or unfavorable amount recorded under Opinion No. 16 [section 1091] at the date of the combination shall be restated to record an asset and a liability, each to be assigned an amount in accordance with Opinion No. 16 [section 1091]. The net of the restated asset and liability may equal the amount previously recorded for a favorable or unfavorable operating lease. However, if the net of the restated asset and liability differs from the amount that was originally recorded under Opinion No. 16 [section 1091] for that lease, the difference is a retroactive adjustment of the allocation of the cost of the acquired enterprise with an offsetting retroactive adjustment, usually to goodwill.

b. In the case of a lease for which the lessor's classification is changed by the retroactive application of Statement No. 13 [section 4053] from an operating lease to a direct financing lease, the carrying amount of the leased asset and any favorable or unfavorable amount recorded under Opinion No. 16 [section 1091] at the date of the combination shall be restated to record a net investment in the direct financing lease determined in accordance with Opinion No. 16 [section 1091] and consisting of the gross receivable, residual value, and unearned income. If the restated amount allocated to the net investment in the direct financing lease differs from the net amount that was originally recorded for that lease, the difference is a retro-

active adjustment of the allocation of the cost of the acquired enterprise with an offsetting retroactive adjustment, usually to goodwill.

Effective Date and Transition

.18 The provisions of this Interpretation shall be effective for business combinations that are initiated[4] on or after May 1, 1978. Earlier application is encouraged. In addition, the provisions of this Interpretation shall be applied retroactively at the same time and in the same manner as the provisions of *FASB Statement No. 13* [section 4053] are applied retroactively (see paragraphs 49 and 51 of Statement No. 13 [sections 4053.049 and 4053.051]). Enterprises that have already applied the provisions of Statement No. 13 [section 4053] retroactively and have published annual financial statements based on the retroactively adjusted accounts before the effective date of this Interpretation may, but are not required to, apply the provisions of this Interpretation retroactively.

The next page is 8449-11.

[4] See paragraph 46(a) of *APB Opinion No. 16* [section 1091.46(a)] for the definition of "initiated."

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Appendix A

ILLUSTRATION OF THE ACCOUNTING FOR A LEVERAGED LEASE IN A PURCHASE COMBINATION

.19 This Appendix illustrates one way that a lessor's investment in a leveraged lease might be valued by the acquiring enterprise in a business combination accounted for by the purchase method and the subsequent accounting for the investment in accordance with *FASB Statement No. 13* [section 4053]. The elements of accounting and reporting illustrated for this example are as follows:

1. Leveraged lease example—terms and assumptions, Schedule 1
2. Acquiring enterprise's cash flow analysis by years, Schedule 2
3. Acquiring enterprise's valuation of investment in the leveraged lease, Schedule 3
4. Acquiring enterprise's allocation of annual cash flow to investment and income, Schedule 4
5. Journal entry for recording allocation of purchase price to net investment in the leveraged lease, Schedule 5
6. Journal entries for the year ending December 31, 1984 (year 10 of the lease), Schedule 6

SCHEDULE 1

Leveraged Lease Example
Term and Assumptions

Cost of leased asset (equipment)	$1,000,000
Lease term	15 years, dating from January 1, 1975
Lease rental payments	$90,000 per year (payable last day of each year)
Residual value	$200,000 estimated to be realized one year after lease termination
Financing:	
Equity investment by lessor	$400,000
Long-term nonrecourse debt	$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of $74,435.30
Depreciation allowable to lessor for income tax purposes	Seven-year ADR life using double-declining-balance method for the first two years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to $100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or $100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration.

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SCHEDULE 1 continued

Date of business combination	January 1, 1982
Tax status of business combination	Non-taxable transaction
Appropriate interest rate for valuing net-of-tax return on investment	4½%

SCHEDULE 2

Acquiring Enterprise's Cash Flow Analysis by Years

	1	2	3
Year	Gross lease rentals and residual value	Depreciation (for income tax purposes)	Loan interest payments
8	$ 90,000	—	$ 37,079
9	90,000	—	33,717
10	90,000	—	30,052
11	90,000	—	26,058
12	90,000	—	21,704
13	90,000	—	16,957
14	90,000	—	11,785
15	90,000	—	6,145
16	200,000	$100,000	—
Totals	$920,000	$100,000	$183,497

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SCHEDULE 2 continued

4 Taxable income (col. 1−2−3)	5 Income tax (charges) (col. 4 × 50.4%)	6 Loan principal payments	7 Annual cash flow (col. 1−3+ 5−6)
$ 52,921	$ (26,672)	$ 37,357	$ (11,108)
56,283	(28,367)	40,719	(12,803)
59,948	(30,214)	44,383	(14,649)
63,942	(32,227)	48,378	(16,663)
68,296	(34,421)	52,732	(18,857)
73,043	(36,813)	57,478	(21,248)
78,215	(39,420)	62,651	(23,856)
83,855	(42,263)	68,290	(26,698)
100,000	(50,400)	—	149,600
$636,503	$(320,797)	$411,988	$ 3,718

→ *The next page is 8449-17.* ←

SCHEDULE 3

Acquiring Enterprise's Valuation of Investment in the Leveraged Lease

Cash flow	Present value at 4½% net-of-tax rate
1. Rentals receivable (net of principal and interest on the nonrecourse debt) ($15,564.70 at the end of each year for 8 years)	$102,663
2. Estimated residual value ($200,000 realizable at the end of 9 years)	134,581
3. Future tax payments (various amounts payable over 9 years — see Schedule 2)	(253,489)
Net present value	$ (16,245)

SCHEDULE 4

Acquiring Enterprise's Allocation of Annual Cash Flow to Investment and Income

	1	2	3	4
		Annual Cash Flow		
Year	Net investment at beginning of year	Total from Schedule 2, col. 7	Allocated to investment	Allocated to income[1]
8	$ (16,245)	$ (11,108)	$(11,108)	—
9	(5,137)	(12,803)	(12,803)	—
10	7,666	(14,649)	(14,973)	$ 324
11	22,639	(16,663)	(17,621)	958
12	40,260	(18,857)	(20,561)	1,704
13	60,821	(21,248)	(23,822)	2,574
14	84,643	(23,856)	(27,439)	3,583
15	112,082	(26,698)	(31,443)	4,745
16	143,525	149,600	143,525	6,075
Totals		$ 3,718	$(16,245)	$19,963

[1] Lease income is recognized as 4.233% of the unrecovered investment at the beginning of each year in which the net investment is positive. The rate is that rate which when applied to the net investment in the years in which the net investment is positive will distribute the net income (net cash flow) to those years. The rate for allocation used in this Schedule is calculated by a trial and error process. The allocation is calculated based upon an initial estimate of the rate as a starting point. If the total thus allocated to income (column 4) differs under the estimated rate from the net cash flow (column 2 less column 3) the estimated rate is increased or decreased, as appropriate, to derive a revised allocation. This process is repeated until a rate is selected which develops a total amount allocated to income that is precisely equal to the net cash flow. As a practical matter, a computer program is used to calculate Schedule 4 under successive iterations until the correct rate is determined.

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SCHEDULE 4 continued

5	6
Components of Income[2]	
Pretax income	Tax effect of pretax income
—	—
—	—
$ 5,530	$ (5,206)
16,353	(15,395)
29,087	(27,383)
43,937	(41,363)
61,160	(57,577)
80,995	(76,250)
103,698	(97,623)
$340,760	$(320,797)

[2] Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4. Journal Entry 2 in Schedule 6 of this Appendix includes an example of this computation.

SCHEDULE 5

Illustrative Journal Entry for Recording Allocation of Purchase Price to Net Investment in the Leveraged Lease

Rentals receivable (Schedule 2, total of column 1 less residual value, less totals of columns 3 and 6)	$124,515	
Estimated residual value (Schedule 1)	200,000	
Purchase price allocation clearing account (Schedule 3, present value)	16,245	
Unearned and deferred income (Schedule 3, present value, less total of rentals receivable and estimated residual value)		$340,760

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SCHEDULE 6

Illustrative Journal Entries for Year Ending December 31, 1984

Third Year of Operation after the Business Combination
(Year 10 of the Lease)

Journal Entry 1

Cash	$15,565	
Rentals receivable (Schedule 2, column 1 less columns 3 and 6)		$15,565
Collection of year's net rental		

Journal Entry 2

Unearned and Deferred Income	$ 5,530	
Income from Leveraged Leases (Schedule 4, column 5)		$ 5,530

Recognition of pretax income for the year allocated in the same proportion as the allocation of total income

$$\left(\frac{\$\ \ 324}{\$19{,}963} \times \$340{,}760 = \$5{,}530\right)$$

Journal Entry 3

Deferred taxes (Schedule 2, column 5, less Schedule 4, column 6)	$25,008	
Income tax expense (Schedule 4, column 6)	5,206	
Cash (Schedule 2, column 5)		$30,214

To record payment of tax for the year

The next page is 8451.

AC Section 4054

Accounting for Leases— Initial Direct Costs

an amendment of section 4053

[Source: FASB Statement No. 17.]

November 1977

INTRODUCTION AND BACKGROUND INFORMATION

.01 *FASB Statement No. 13* [section 4053], "Accounting for Leases," issued by the Board in November 1976, defined *initial direct costs* in paragraph 5(m) [section 4053.005(m)] as follows:

> Those incremental direct costs incurred by the lessor in negotiating and consummating leasing transactions (e. g., commissions and legal fees).

.02 Since issuance of *FASB Statement No. 13* [section 4053] the Board has received a number of requests to interpret the definition of *initial direct costs,* specifically to clarify the meaning of "incremental direct costs." On April 7, 1977, the Board submitted a proposed Interpretation of the definition to the members of the Financial Accounting Standards Advisory Council for comment. The proposed Interpretation stated that *direct* referred to those costs that are incurred in connection with specific leasing transactions and *incremental* limited such costs to those that vary directly with the number or dollar amount of leasing transactions, as distinct from ongoing, recurring expenses that ordinarily do not vary with the number or dollar amount of leasing transactions. Twenty-five letters of comment were received from Council members and from others representing businesses that would be affected by the Interpretation. Many respondents to the proposed Interpretation urged the Board to include in the definition of initial direct costs sales salaries and other costs that do not vary directly with specific leasing transactions but that do vary with the general level of leasing business acquired. The Board concluded that it should amend the definition of initial direct costs to encompass costs that are directly related to consummated leasing transactions and that vary either with specific

leasing transactions or with the general level of leasing business acquired.

.03 An Exposure Draft of a proposed Statement on "Accounting for Leases—Initial Direct Costs" was issued on August 8, 1977. The Board received 42 letters of comment in response to the Exposure Draft. Certain of those comments and the Board's consideration of them are discussed in paragraphs .04-.06 below.

.04 Some respondents recommended that the Board conform the accounting for initial direct costs of leases to the existing practices for other financing activities of finance companies; other respondents recommended that the Board conform the accounting for initial direct costs of leases to the existing practices for other financing activities of banks. The *AICPA Industry Audit Guide,* "Audits of Finance Companies," permits the use of any of three overall methods of recognizing finance income. All of the methods require that direct and indirect acquisition costs applicable to loans be charged to operations when incurred. Two of the methods require that an amount of deferred finance income equal to estimated acquisition costs be transferred to operations in the same period; such a transfer is prohibited under the other permitted method. Banks often charge all loan origination costs to expense without offsetting revenue recognition. Conforming the accounting for initial direct costs of leases to the accounting for initial direct costs of other financing activities of various types of enterprises would require alternative methods of accounting for similar leasing transactions. Still other respondents recommended that the Board permit the option of charging initial direct costs to expense without offsetting revenue recognition. The Board concluded that it should not prescribe alternative methods of accounting for similar leasing transactions.

.05 Some respondents to the Exposure Draft stated that the cost of identifying the portion of salespersons' salaries that relates to specific completed leasing transactions would be excessive. The Board believes that salespersons can estimate the portion of their time that results in completed leases and the portion spent in negotiations for leases that were not consummated and in other activities and that reasonable allocations of other costs can be made based on similar estimates. In some enterprises, the determinations can be made by periodic statistical samples. The Board believes that enterprises can perform the required allocations without excessive cost.

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.06 Some respondents to the Exposure Draft asked if the Board intended that a provision for bad debts be included in initial direct costs. The Board does not intend that initial direct costs, as defined, include a provision for bad debts. Accounting for bad debts that are expected to result from leases and other financing activities is a pervasive issue that the Board did not address in *FASB Statement No. 13* [section 4053]. The Board has not studied that question and did not intend that Statement No. 13 [section 4053] would change existing practices in accounting for bad debts.

.07 The Board concluded that on the basis of existing data it could make an informed decision on the matter addressed in this Statement without a public hearing and that the effective date and transition prescribed in paragraph .09 are advisable.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to Section 4053

.08 Paragraph 5(m) of *FASB Statement No. 13* [section 4053.005(m)] is superseded by the following:

> *Initial direct costs.* Those costs incurred by the lessor that are directly associated with negotiating and consummating completed leasing transactions. Those costs include, but are not necessarily limited to, commissions, legal fees, costs of credit investigations, and costs of preparing and processing documents for new leases acquired. In addition, that portion of salespersons' compensation, other than commissions, and the compensation of other employees that is applicable to the time spent in the activities described above with respect to completed leasing transactions shall also be included in initial direct costs. That portion of salespersons' compensation and the compensation of other employees that is applicable to the time spent in negotiating leases that are not consummated shall not be included in initial direct costs. No portion of supervisory and administrative expenses or other indirect expenses, such as rent and facilities costs, shall be included in initial direct costs.

Effective Date and Transition

.09 The provisions of this amendment to *FASB Statement No. 13* [section 4053] shall be effective for leasing transactions and lease agreement revisions (see paragraph 9 of Statement No. 13 [section 4053.009]) entered into on or after January 1, 1978. Earlier application is encouraged. In addition, the provisions of this Statement shall be applied retroactively at the same time and in the same manner as the provisions of Statement No. 13 [section 4053] are applied retroactively (see paragraphs 49 and 51 of Statement No. 13 [sections 4053.049 and 4053.051]). Enterprises that have already applied the provisions of Statement No. 13 [section 4053] retroactively and have published financial statements based on the retroactively adjusted accounts before the effective date of this Statement may, but are not required to, apply the provisions of this Statement retroactively.

The provisions of this Statement need not be applied to immaterial items.

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AC Section 4055

Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt

an amendment of section 4053
[Source: FASB Statement No. 22.]

June 1978

INTRODUCTION AND BACKGROUND INFORMATION

.01 The FASB has been asked to reconcile an apparent inconsistency between *FASB Statement No. 13* [section 4053], "Accounting for Leases," and *APB Opinion No. 26* [section 5362], "Early Extinguishment of Debt," arising from refundings of tax-exempt debt, including advance refundings [1] that are accounted for as early extinguishments of debt. In some situations tax-exempt debt is issued to finance construction of a facility, such as a plant or hospital, that is transferred to a user of the facility by either lease or sale. A lease or, in the case of sale, a mortgage note generally serves as collateral for the guarantee of payments equivalent to those required to service the tax-exempt debt. Payments required by the terms of the lease or mortgage note are essentially the same, as to both amount and timing, as those required by the tax-exempt debt. In practice, a liability equivalent to the amount of the tax-exempt debt often has been included in the accounts of the lessee or the mortgagor. Some issuers of tax-exempt debt recently have entered into refundings and, concurrently, the terms of the related lease or mortgage note have been changed to conform with the terms of the refunding issue. If a refunding of tax-exempt debt results in a change in the provisions of a lease and the revised lease is classified as a capital lease by a lessee or a direct financing lease by a lessor, gain or loss is not recognized

[1] An advance refunding involves the issuance of new debt to replace existing debt with the proceeds from the new debt placed in trust or otherwise restricted to retire the existing debt at a determinable future date or dates. Descriptions of advance refundings that are and are not accounted for as early extinguishments of debt are presented in the AICPA Statement of Position on "Accounting for Advance Refundings of Tax-Exempt Debt."

under Statement No. 13 [section 4053] (see paragraphs 14(a) and 17(f)(i) [sections 4053.014(a) and 4053.017(f)(i)] of the Statement). If a refunding of tax-exempt debt results in a change in the terms of a mortgage note, any gain or loss arising from the transaction because of the change in the carrying amount of the debt would be recognized currently in accordance with the provisions of Opinion No. 26 [section 5362].

Lessee Accounting

.02 Paragraph 14(a) of *FASB Statement No. 13* [section 4053.014(a)] sets forth the accounting by a lessee for a change in the provisions, a renewal, or an extension of an existing lease if the revised lease agreement is classified as a capital lease as follows:

> If the provisions of the lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (i) does not give rise to a new agreement . . . or (ii) does give rise to a new agreement but such agreement is also classified as a capital lease, the present balances of the asset and the obligation shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised or new agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised or new agreement shall be computed using the rate of interest used to record the lease initially.

.03 In accounting for an early extinguishment of debt, paragraph 20 of *APB Opinion No. 26* [section 5362.20] requires that "a difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains. . . ." In this regard, paragraph 8 of *FASB Statement No. 4* [section 2013.08], "Reporting Gains and Losses from Extinguishment of Debt," requires that "gains and losses from extinguishment of debt that are included in the determination of net income shall be aggregated and, if material, . . . classified as an extraordinary item, net of related income tax effect."

.04 If a refunding of tax-exempt debt results in a change in the provisions of a capital lease that passes the perceived economic advantages of the refunding through to the lessee, paragraph 14(a) of *FASB Statement No. 13* [section 4053.014(a)] requires the lessee to adjust both the asset and related obligation for any difference caused by a change in the provisions of a lease. If the perceived economic advantages of the same refunding had been passed through by a change in the terms of a mortgage note, the accounting specified by *APB Opinion No. 26* [section 5362] would result in the recognition of a gain or loss.

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.05 The Board considered the possibility of amending *APB Opinion No. 26* [section 5362] to defer recognition of gain or loss. That would not completely eliminate the inconsistency unless the gain or loss were included as an adjustment to the cost of the related property, because *FASB Statement No. 13* [section 4053] specifies that any difference resulting from a change in the provisions of a capital lease should be accounted for as an adjustment of the leased asset. In the interest of a timely resolution of the conflict, the Board decided that paragraph 14 of Statement No. 13 [section 4053.014] should be amended so that the accounting will be compatible with that specified by Opinion No. 26 [section 5362].

Lessor Accounting

.06 Paragraph 17(f)(i) of *FASB Statement No. 13* [section 4053.017(f)(i)] specifies the accounting by a lessor for a change in the provisions, a renewal, or an extension of an existing lease if the revised lease agreement is classified as a direct financing lease as follows:

> If the provisions of a lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (a) does not give rise to a new agreement . . . or (b) does give rise to a new agreement but such agreement is classified as a direct financing lease, the balance of the minimum lease payments receivable and the estimated residual value, if affected, shall be adjusted to reflect the change . . . and the net adjustment shall be charged or credited to unearned income.

.07 If a refunding of tax-exempt debt results in a change in the provisions of a lease that passes the perceived economic advantages of the refunding through to the lessee and the revised agreement is classified as a direct financing lease, paragraphs 18(c) and 17(f)(i) of *FASB Statement No. 13* [sections 4053.018(c) and 4053.017(f)(i)] require the lessor to adjust the balance of the minimum lease payments receivable and unearned income. The lessor, on the other hand, would look to *APB Opinion No. 26* [section 5362] for guidance in accounting for a refunding. That Opinion requires recognition of a gain or loss concurrent with early extinguishments of debt. The Board has concluded that the accounting for changes in the provisions of a lease in connection with a refunding of tax-exempt debt should be compatible with the accounting for the refunding of the debt itself. The Board has, therefore, decided to amend paragraph 17(f) of Statement No. 13 [section 4053.017(f)] so that any gain or loss resulting from a change in the provisions of a lease agreement in con-

nection with a refunding of tax-exempt debt is recognized when the tax-exempt debt is considered to have been extinguished.

Other Matters

.08 An Exposure Draft of a proposed Statement on "Accounting for Leases: Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt" was issued on December 19, 1977. The Board received 26 letters of comment in response to the Exposure Draft, most of which expressed general agreement.

.09 Several respondents recommended that the final Statement should apply to all types of refundings and not be limited to refundings involving only tax-exempt debt. The Board noted that, typically, lessors in tax-exempt debt refundings are governmental or quasi-governmental agencies that are not affected by state or federal income tax regulations. For the most part, the governmental lessor's borrowing serves only to obtain necessary financing for the construction of the leased facilities. Refundings that do not involve tax-exempt debt may involve considerations beyond those normally present in the lessor/lessee relationship discussed above. The Board considered these recommendations and concluded that further consideration of the subject of refundings should not delay the issuance of this Statement.

.10 The Board has concluded that on the basis of existing information it can reach an informed decision without a public hearing, and the effective date and transition specified in paragraph .16 are advisable in the circumstances.

.11 The addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit'," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process" and discusses the application of generally accepted accounting principles to regulated industries. Accordingly, the provisions of the Addendum shall govern the application of this Statement to those operations of a company that are regulated for rate-making purposes on an individual-company-cost-of-service basis.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

.12 If prior to the expiration of the lease term a change in the provisions of a lease results from a refunding by the lessor

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of tax-exempt debt, including an advance refunding,[2] in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a capital lease by the lessee or a direct financing lease by the lessor, the change shall be accounted for as follows:

a. Lessee accounting:

  i. If a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding that is accounted for as an early extinguishment of debt, the lessee shall adjust the lease obligation to the present value of the future minimum lease payments under the revised lease using the effective interest rate applicable to the revised agreement and shall recognize any resulting gain or loss currently as a gain or loss on early extinguishment of debt. Any gain or loss so determined shall be classified in accordance with *FASB Statement No. 4* [section 2013].

  ii. If the provisions of a lease are changed in connection with an advance refunding by the lessor of tax-exempt debt that is not accounted for as an early extinguishment of debt at the date of the advance refunding and the lessee is obligated to reimburse the lessor for any costs related to the debt to be refunded that have been or will be incurred, such as unamortized discount or issue costs or a call premium, the lessee shall accrue those costs by the "interest" method [3] over the period from the date of the advance refunding to the call date of the debt to be refunded.

b. Lessor accounting: [4]

  i. If a change in the provisions of a lease results from a refunding of tax-exempt debt, including an advance refunding that is accounted for as an early extinguishment of debt, the lessor shall adjust the balance of the minimum lease payments receivable and the estimated residual value, if affected (i. e., the gross investment in the lease) in accordance with the requirements of para-

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[2] See footnote 1.
[3] See paragraph 12 of *FASB Statement No. 13* [section 4053.012] and footnote 11 thereto.
[4] This paragraph prescribes the accounting for a direct financing lease by governmental units that classify and account for leases of that kind.

graphs 18(c) and 17(f)(i) of *FASB Statement No. 13* [sections 4053.018(c) and 4053.017(f)(i)]. The adjustment of unearned income shall be the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement. The combined adjustment resulting from applying the two preceding sentences shall be recognized as a gain or loss in the current period.

ii. If a change in the provisions of a lease results from an advance refunding that is not accounted for as an early extinguishment of debt at the date of the advance refunding, the lessor shall systematically recognize, as revenue, any reimbursements to be received from the lessee for costs related to the debt to be refunded, such as unamortized discount or issue costs or a call premium, over the period from the date of the advance refunding to the call date of the debt to be refunded.

.13 The accounting prescribed in subparagraphs .12(a)(i) and .12(b)(i) for a refunding of tax-exempt debt is illustrated in Appendix A.

Amendments to Section 4053

.14 The introduction to paragraph 14 of *FASB Statement No. 13* [section 4053.014] is amended to read as follows:

> Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a capital lease (see *FASB Statement No. 22* [section 4055]), a change in the provisions of a lease, a renewal or extension [14] of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows:

.15 The introduction to paragraph 17(f) of *FASB Statement No. 13* [section 4053.017(f)] is amended to read as follows:

> Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a direct financing lease (see *FASB Statement No. 22* [section 4055]), a change in the provisions of a lease, a renewal or extension [19] of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows:

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Effective Date and Transition

.16 This Statement shall be effective for lease agreement revisions entered into on or after July 1, 1978. Earlier application is encouraged. In addition, the provisions of this Statement shall be applied retroactively at the same time and in the same manner as the provisions of *FASB Statement No. 13* [section 4053] are applied retroactively (see paragraphs 49 and 51 of Statement No. 13 [sections 4053.049 and 4053.051]). Enterprises that have already applied the provisions of Statement No. 13 [section 4053] retroactively and have published annual financial statements based on the retroactively adjusted accounts before the effective date of this Statement may, but are not required to, apply the provisions of this Statement retroactively.

The provisions of this Statement need not be applied to immaterial items.

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Appendix A

ILLUSTRATION OF LESSOR AND LESSEE ACCOUNTING REQUIRED BY PARAGRAPH .12 OF THIS STATEMENT

.17 The following example illustrates the application of the requirements of subparagraphs .12(a)(i) and .12(b)(i) of this Statement when a refunding of tax-exempt debt results in a change in the provisions of a lease agreement and the revised lease is classified as a direct financing lease by the lessor and as a capital lease by the lessee.

Computation Information

The following table summarizes the total debt service requirements of the serial obligation to be refunded and of the refunding obligation. It is presumed that the perceived economic advantages of the refunding results from the lower interest rate applicable to the refunding obligation. The resulting reduction in total debt service requirements will be passed through to the lessee by changing the terms of the related lease to conform with the debt service requirements of the refunding obligation. All costs that have been or that will be incurred by the lessor in connection with the refunding transaction will be passed through to the lessee.

Fifteen Year Serial Debt Service Requirements ($000 omitted):

Obligation to Be Refunded			Refunding Obligation*			
Face Amount	Interest 7%	Total	Face Amount	Interest 5%	Total	Difference
$50,000	$32,300	$82,300	$52,000	$23,150	$75,150	$7,150

* The face amount of the refunding obligation ($52,000,000) is equal to the face amount of the obligation to be refunded ($50,000,000) plus the redemption premium applicable to the obligation to be refunded ($1,500,000) and the costs of issuance ($500,000).

LESSOR ACCOUNTING

Computation of Required Adjustments to Reflect Changes in the Terms of a Lease Resulting from a Refunding of Tax-Exempt Debt

Adjustment to Balance of Minimum Lease Payments Receivable:

Present balance of minimum lease payments receivable (equal to debt service requirements of obligation to be refunded)	$82,300,000
Minimum lease payments receivable under revised agreement (equal to debt service requirements of refunding obligation)	75,150,000
Adjustment to reflect reduction in minimum lease payments receivable	$ 7,150,000

Adjustment to Unearned Income:

Change in the sum of the present value of the two components of the gross investment using the interest rate applicable to each agreement	$ 2,000,000
Change in the balance of minimum lease payments receivable	7,150,000
Adjustment to reflect reduction in balance of unearned income	$ 9,150,000

Summary of Adjustments ($000 omitted):

	Minimum Lease Payments Receivable	Unearned Income	Net Investment
Balance before Refunding	$82,300	$32,300	$50,000
Adjustment	(7,150)	(9,150)	2,000
Balance after Refunding	$75,150	$23,150	$52,000

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Journal Entries to Record the Refunding and the Changes in the Terms of the Lease Resulting from the Refunding of Tax-Exempt Debt

Recoverable deferred issue costs	500,000	
Loss resulting from refunding of tax-exempt debt	1,500,000	
7% Outstanding obligation	50,000,000	
5% Refunding obligation		52,000,000

To record loss from refunding $50,000,000 - 7% obligation with $52,000,000 - 5% refunding obligation in accordance with the provisions of *APB Opinion No. 26*

Unearned income	9,150,000	
Minimum lease payments receivable		7,150,000
Gain resulting from adjustment of lease terms		1,500,000
Recoverable deferred issue costs		500,000

To adjust unearned income by the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement in accordance with *FASB Statement No. 22.*

LESSEE ACCOUNTING

Computation of Required Adjustment to Lease Obligation to Reflect Changes in the Terms of the Lease Resulting from a Refunding of Tax-Exempt Debt

Adjustment to Balance of Lease Obligation:

Present balance of lease obligation under original agreement	$50,000,000
Present value of future minimum lease payments under revised agreement	51,500,000
Adjustment to lease obligation	$ 1,500,000

Journal Entry to Record Adjustment to Lease Obligation Resulting from a Refunding of Tax-Exempt Debt

Loss resulting from revision to lease agreement	1,500,000	
Obligation under capital lease		1,500,000

To record the loss resulting from changes in the lease terms resulting from a refunding of tax-exempt debt. For purposes of calculating the present value of the future minimum lease payments, deferred issue costs were considered as additional interest in determining the effective interest rate applicable to the revised agreement. (The loss shall be classified in accordance with *FASB Statement No. 4.*)

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AC Section 4061

Compensation Involved in Stock Option and Stock Purchase Plans

[Source: ARB No. 43, Chap. 13B, as amended.]

Issue date, unless otherwise indicated: June, 1953[1]

.01 The practice of granting to officers and other employees options to purchase or rights to subscribe for shares of a corporation's capital stock has been followed by a considerable number of corporations over a period of many years. To the extent that such options and rights involve a measurable amount of compensation, this cost of services received should be accounted for as such. The amount of compensation involved may be substantial and omission of such costs from the corporation's accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given herein to the accounting treatment of compensation represented by stock options or purchase rights granted to officers and other employees.[1]

.02 For convenience, this section will discuss primarily the problems of compensation raised by stock option plans. However, the committee feels that substantially the same problems may be encountered in connection with stock purchase plans made available to employees, and the discussion below is applicable to such plans also.

[1] Bulletin 37, "Accounting for Compensation in the Form of Stock Options," was issued in November, 1948. Issuance of a revised bulletin in 1953 and its expansion to include stock purchase plans were prompted by the very considerable increase in the use of certain types of option and purchase plans following the enactment in 1950 of Section 130A of the Internal Revenue Code. This section granted specialized tax treatment to employee stock options if certain requirements were met as to the terms of the option, as to the circumstances under which the option was granted and could be exercised and as to the holding and disposal of the stock acquired thereunder. In general, the effect of Section 130A was to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of such restricted options. In 1951, Federal Salary Stabilization Board issued rules and regulations relating to stock options and purchase rights granted to employees whereby options generally comparable in nature to the restricted stock options specified in Section 130A might be considered for its purposes not to involve compensation, or to involve compensation only in limited amounts. [Ed. note: changed to past tense.]

RIGHTS INVOLVING COMPENSATION

.03 Stock options involving an element of compensation usually arise out of an offer or agreement by an employer corporation to issue shares of its capital stock to one or more officers or other employees (hereinafter referred to as grantees) at a stated price. The grantees are accorded the right to require issuance of the shares either at a specified time or during some determinable period. In some cases the grantee's options are exercisable only if at the time of exercise certain conditions exist, such as that the grantee is then or until a specified date has been an employee. In other cases, the grantees may have undertaken certain obligations, such as to remain in the employment of the corporation for at least a specified period, or to take the shares only for investment purposes and not for resale.

RIGHTS NOT INVOLVING COMPENSATION [2]

.04 Stock option plans in many cases may be intended not primarily as a special form of compensation but rather as an important means of raising capital, or as an inducement to obtain greater or more widespread ownership of the corporation's stock among its officers and other employees. In general, the terms under which such options are granted, including any conditions as to exercise of the options or disposal of the stock acquired, are the most significant evidence ordinarily available as to the nature and purpose of a particular stock option or stock option plan. In practice, it is often apparent that a particular option or plan involves elements of two or more of the above purposes. Where the inducements are not larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital, no compensation need be presumed to be involved.

.05 Stock purchase plans also are frequently an integral part of a corporation's program to secure equity capital or to obtain widespread ownership among employees, or both. In such cases, no element of compensation need be considered to be present if the purchase price is not

[2] Four essential characteristics of a noncompensatory plan are described in section 4062.07.

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lower than is reasonably required to interest employees generally or to secure the contemplated funds.

TIME OF MEASUREMENT OF COMPENSATION

.06 In the case of stock options involving compensation, the principal problem is the measurement of the compensation. This problem involves selection of the date as of which measurement of any element of compensation is to be made and the manner of measurement. The date as of which measurement is made is of critical importance since the fair value of the shares under option may vary materially in the often extended period during which the option is outstanding. There may be at least six dates to be considered for this purpose: (a) the date of the adoption of an option plan, (b) the date on which an option is granted to a specific individual, (c) the date on which the grantee has performed any conditions precedent to exercise of the option, (d) the date on which the grantee may first exercise the option, (e) the date on which the option is exercised by the grantee, and (f) the date on which the grantee disposes of the stock acquired.

.07 Of the six dates mentioned two are not relevant to the question considered in this section—cost to the corporation which is granting the option. The date of adoption of an option plan clearly has no relevance, inasmuch as the plan per se constitutes no more than a proposed course of action which is ineffective until options are granted thereunder. The date on which a grantee disposes of the shares acquired under an option is equally immaterial since this date will depend on the desires of the individual as a shareholder and bears no necessary relation to the services performed.[3]

.08 The date on which the option is exercised has been advocated as the date on which a cost may be said to have been incurred. Use of this date is supported by the argument that only then will it be known whether or not the option will be exercised. However, beginning with the time at which the grantee may first exercise the op-

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[3] This was the date on which income or gain taxable to the grantee might arise under Section 130A. Use of this date for tax purposes was doubtless based on considerations as to the ability of the optionee to pay taxes prior to sale of the shares. [Ed. note: changed to past tense.]

tion he is in effect speculating for his own account. His delay has no discernible relation to his status as an employee but reflects only his judgment as an investor.

.09 The date on which the grantee may first exercise the option will generally coincide with, but in some cases may follow, the date on which the grantee will have performed any conditions precedent to exercise of the option. Accordingly this date presents no special problems differing from those to be discussed in the next paragraph.

.10 There remain to be considered the date on which an option is granted to a specific individual and the date on which the grantee has fulfilled any conditions precedent to exercise of the option. When compensation is paid in a form other than cash the *amount* of compensation is ordinarily determined by the fair value of the property which was agreed to be given in exchange for the services to be rendered. The time at which such fair value is to be determined may be subject to some difference of opinion but it appears that the date on which an option is granted to a specific individual would be the appropriate point at which to evaluate the cost to the employer, since it was the value at that date which the employer may be presumed to have had in mind. In most of the cases under discussion, moreover, the only important contingency involved is the continuance of the grantee in the employment of the corporation, a matter very largely within the control of the grantee and usually the main objective of the grantor. Under such circumstances it may be assumed that if the stock option were granted as a part of an employment contract, both parties had in mind a valuation of the option at the date of the contract; and accordingly, value at that date should be used as the amount to be accounted for as compensation. If the option were granted as a form of supplementary compensation otherwise than as an integral part of an employment contract, the grantor is nevertheless governed in determining the option price and the number of shares by conditions then existing. It follows that it is the value of the option at that time, rather than the grantee's ultimate gain or loss on the transaction, which for accounting purposes constitutes whatever compensation the grantor intends to pay. The committee

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therefore concludes that in most cases, including situations where the right to exercise is conditional upon continued employment, valuation should be made of the option as of the date of grant.

.11 The date of grant also represents the date on which the corporation foregoes the principal alternative use of the shares which it places subject to option, i.e., the sale of such shares at the then prevailing market price. Viewed in this light, the *cost* of utilizing the shares for purposes of the option plan can best be measured in relation to what could then have been obtained through sale of such shares in the open market. However, the fact that the grantor might, as events turned out, have obtained at some later date either more or less for the shares in question than at the date of the grant does not bear upon the measurement of the compensation which can be said to have been in contemplation of the parties at the date the option was granted.[4]

MANNER OF MEASUREMENT

.12 Freely exercisable option rights, even at prices above the current market price of the shares, have been traded in the public markets for many years, but there is no such objective means for measuring the value of an option which is not transferable and is subject to such other restrictions as are usually present in options of the nature here under discussion. Although there is, from the standpoint of the grantee, a value inherent in a restricted future right to purchase shares at a price at or even above the fair value of shares at the grant date, the committee believes it is impracticable to measure any such value. As to the grantee any positive element may, for practical purposes, be deemed to be largely or wholly offset by the negative effect of the restrictions ordinarily present in options of the type under discussion. From the viewpoint of the grantor corporation no measurable cost can be said to have been incurred because it could not at the grant date have realized more than the *fair value* of the optioned shares, the concept of fair value as here used encompassing the possibility and prospect of future developments. On the other hand, it follows in the opinion of the committee that

[4] Also see section 4062.10b for the definition of the *measurement date*.

the value to the grantee and the related cost to the corporation of a restricted right to purchase shares at a price *below* the fair value of the shares at the grant date may for the purposes here under discussion be taken as the excess of the then fair value of the shares over the option price.[5]

.13 While market quotations of shares are an important and often a principal factor in determining the fair value of shares, market quotations at a given date are not necessarily conclusive evidence.[6] Where significant market quotations cannot be obtained, other recognized methods of valuation have to be used. Furthermore, in determining the fair value [7] of shares for the purpose of measuring the cost incurred by a corporation in the issuance of an option, it is appropriate to take into consideration such modifying factors as the range of quotations over a reasonable period and the fact that the corporation by selling shares pursuant to an option may avoid some or all of the expenses otherwise incurred in a sale of shares. The absence of a ready market, as in the case of shares of closely-held corporations, should also be taken into account and may require the use of other means of arriving at fair value than by reference to an occasional market quotation or sale of the security.[8]

OTHER CONSIDERATIONS

.14 If the period for which payment for services is being made by the issuance of the stock option is not specifically indicated in the offer or agreement, the value of the option should be apportioned over the period of service for which the payment of the compensation seems appropriate in the existing circumstances. Accrual of the compensation over the period selected should be made by means of charges against the income account.[9] Upon exer-

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[5] Section 4062.10 states that "Compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay." [As amended by APB Opinion No. 25, effective after December 31, 1972.]

[6] Whether treasury or unissued shares are to be used to fulfill the obligation is not material to a determination of value. (However, see section 4062.11a.)

[7] See section 4062.10 in which *quoted market price* is substituted for *fair value*.

[8] See section 4062.10a.

[9] See sections 4062.12-.15.

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cise of an option the sum of the cash received and the amount of the charge to income should be accounted for as the consideration received on issuance of the stock.

.15 In connection with financial statements, disclosure should be made as to the status of the option or plan at the end of the period of report, including the number of shares under option, the option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof.

The next page is 8481.

AC Section 4062

Accounting for Stock Issued to Employees

[Source: APB Opinion No. 25.]

Effective for all stock option, purchase, award, and bonus rights granted after December 31, 1972, unless otherwise indicated [1]

INTRODUCTION

Scope of Section

.01 Many corporations have adopted various plans, contracts, and agreements to compensate officers and other employees by issuing to them stock of the employer corporation. Under traditional stock option and stock purchase plans an employer corporation grants options to purchase a fixed number of shares of stock of the corporation at a stated price during a specified period or grants rights to purchase shares of stock of the corporation at a stated price, often at a discount from the market price of the stock at the date the rights are granted. Stock options and purchase rights are normally granted for future services of employees. Section 4061, *Compensation Involved in Stock Option and Stock Purchase Plans* (1953), contains the principles of accounting for those plans.

.02 Among traditional plans not described in section 4061 are plans in which an employer corporation awards to employees shares of stock of the corporation for current or future services. Some corporations have replaced or supplemented traditional plans with more complex plans, contracts, and agreements for issuing stock. An arrangement may be based on variable factors that depend on future events; for example, a corporation may award a variable number of shares of stock or may grant a stock option with a variable option price. Other arrangements combine the characteristics of two or more types of plans, and some give an employee an election.

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[1] See paragraph .20.

.03 Accounting for employee services received as consideration for stock issued is included in Accounting Research Study No. 15, *Stockholders' Equity.*[2]

.04 This section deals with some aspects of accounting for stock issued to employees through both noncompensatory and compensatory plans (a plan is any arrangement to issue stock to officers and employees, as a group or individually). Section 4061 remains in effect for traditional stock option and stock purchase plans except that the measure of compensation is redefined in this section. This section recognizes certain practices that evolved after section 4061 was adopted and applies the principles of that section to other plans in which the number of shares of stock that may be acquired by or awarded to an employee and the option or purchase price, if any, are known or determinable at the date of grant or award. It also specifies the accounting for (a) plans in which either the number of shares of stock or the option or purchase price depends on future events and (b) income tax benefits related to stock issued to employees through stock option, purchase, and award plans. Section 4062A illustrates measuring and accounting for compensation under typical plans.

Differing Views

.05 Some accountants believe that compensation cost for all compensatory plans should be recorded at the date of grant or not later than the date of exercise. They believe that past experience and outside evidence of values can overcome difficulties in measuring compensation. Other accountants believe that compensation need not be recorded if an employee pays an amount that is at least equal to the market price of the stock at the date of grant and that problems in accounting for compensation plans pertain to plans in which the number of shares of stock or the option or purchase price cannot be determined until after the date of grant or award. Still other accountants, although they agree in principle with the first group, believe that progress will result from specifying the accounting for plans with variable factors but leaving section 4061 in effect with modifications while the entire topic of accounting for compensation involving stock is studied.

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[2] Accounting research studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.

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.06 Some accountants believe that a tax benefit attributable to compensation that is deductible in computing taxable income but is not recorded as an expense of any period results from a permanent difference. The benefit should therefore be recorded under section 4091.32-.33, *Accounting for Income Taxes*, as a reduction of income tax expense for the period that the benefit is received. Other accountants believe that the tax benefit results from issuing stock and should be accounted for as an adjustment of capital in addition to par or stated value of capital stock in accordance with section 4091.51.

OPINION

Noncompensatory Plans

.07 Sections 4061.04-.05 describe stock option and stock purchase plans that may not be intended primarily to compensate employees. An employer corporation recognizes no compensation for services in computing consideration received for stock that is issued through noncompensatory plans. The Board concludes that at least four characteristics are essential in a noncompensatory plan: (a) substantially all full-time employees meeting limited employment qualifications may participate (employees owning a specified percent of the outstanding stock and executives may be excluded), (b) stock is offered to eligible employees equally or based on a uniform percentage of salary or wages (the plan may limit the number of shares of stock that an employee may purchase through the plan), (c) the time permitted for exercise of an option or purchase right is limited to a reasonable period, and (d) the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others. An example of a noncompensatory plan is the "statutory" employee stock purchase plan that qualifies under Section 423 of the Internal Revenue Code.

Compensatory Plans

.08 Plans that do not possess the four characteristics of noncompensatory plans are classified as compensatory plans. Since the major principles of section 4061 are not

changed, classification as a compensatory plan does not necessarily require that compensation cost be recognized.[3]

.09 *Services as Consideration for Stock Issued.* The consideration that a corporation receives for stock issued through a stock option, purchase, or award plan consists of cash or other assets, if any, plus services received from the employee.

.10 *Measuring Compensation for Services.* Compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay. That is the principle in section 4061 with two modifications: (a) the meaning of fair value of stock for compensatory plans is narrowed and (b) the measurement date for plans with a variable number of shares of stock or a variable option or purchase price is different.

a. *Quoted market price* is substituted for *fair value.* The Board acknowledges the conclusion in section 4061 that "market quotations at a given date are not necessarily conclusive evidence" of fair value of shares of stock but concludes that, for purposes of this section, the unadjusted quoted market price of a share of stock of the same class that trades freely in an established market should be used in measuring compensation. An employee's right to acquire or receive shares of stock is presumed to have a value and that value stems basically from the value of the stock to be received under the right. However, the value of the right is also affected by various other factors, some of which tend to diminish its value and some of which tend to enhance it. Those opposing factors include a known future purchase price (or no payment), restrictions on the employee's right to receive stock, absence of commissions on acquisition, different risks as compared

[3] All compensation arrangements involving stock, regardless of the name given, should be accounted for according to their substance. For example, an arrangement in which the consideration for stock issued to an employee is a nonrecourse note secured by the stock issued may be in substance the same as the grant of a stock option and should be accounted for accordingly. The note should be classified as a reduction of stockholders' equity rather than as an asset.

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with those of a stockholder, tax consequences to the employee, and restrictions on the employee's ability to transfer stock issued under the right. The effects of the opposing factors are difficult to measure, and a practical solution is to rely on quoted market price to measure compensation cost related to issuing both restricted (or letter) and unrestricted stock through stock option, purchase, or award plans. If a quoted market price is unavailable, the best estimate of the market value of the stock should be used to measure compensation.

b. *The measurement date* for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee and is therefore unchanged from section 4061. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after date of grant or award.

Thus a corporation recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted market price of the stock at the measurement date.

.11 *Applying the measurement principle*—The following supplements paragraph .10 for special situations in some plans.

a. Measuring compensation by the cost to an employer corporation of reacquired (treasury) stock that is distributed through a stock option, purchase, or award plan is not acceptable practice. The only exception is that compensation cost under a plan with all the provisions described in paragraph .11(c) may be measured by the cost of stock that the corporation (1) reacquires during the fiscal period for which the stock is to be awarded and (2) awards shortly thereafter to employees for services during that period.

b. The measurement date is not changed from the grant or award date to a later date solely by provisions that termination of employment reduces the number of shares of stock that may be issued to an employee.

c. The measurement date of an award of stock for current service may be the end of the fiscal period, which is normally the effective date of the award, instead of the date that the award to an employee is determined if (1) the award is provided for by the terms of an established formal plan, (2) the plan designates the factors that determine the total dollar amount of awards to employees for the period (for example, a percent of income), although the total amount or the individual awards may not be known at the end of the period, and (3) the award pertains to current service of the employee for the period.

d. Renewing a stock option or purchase right or extending its period establishes a new measurement date as if the right were newly granted.

e. Transferring stock or assets to a trustee, agent, or other third party for distribution of stock to employees under the terms of an option, purchase, or award plan does not change the measurement date from a later date to the date of transfer unless the terms of the transfer provide that the stock (1) will not revert to the corporation, (2) will not be granted or awarded later to the same employee on terms different from or for services other than those specified in the original grant or award, and (3) will not be granted or awarded later to another employee.

f. The measurement date for a grant or award of convertible stock or (stock that is otherwise exchangeable for other securities of the corporation) is the date on which the ratio of conversion (or exchange) is known unless other terms are variable at that date (paragraph .10b). The higher of the quoted market price at the measurement date of (1) the convertible stock granted or awarded or (2) the securities into which the original grant or award

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is convertible should be used to measure compensation.

g. Cash paid to an employee to settle an earlier award of stock or to settle a grant of option to the employee should measure compensation cost. If the cash payment differs from the earlier measure of the award of stock or grant of option, compensation cost should be adjusted (paragraph .15). The amount that a corporation pays to an employee to purchase stock previously issued to the employee through a compensation plan is "cash paid to an employee to settle an earlier award of stock or to settle a grant of option" if stock is reacquired shortly after issuance. Cash proceeds that a corporation receives from sale of awarded stock or stock issued on exercise of an option and remits to the taxing authorities to cover required withholding of income taxes on an award is not "cash paid to an employee to settle an earlier award of stock or to settle a grant of option" in measuring compensation cost.

h. Some plans are a combination of two or more types of plans. An employer corporation may need to measure compensation for the separate parts. Compensation cost for a combination plan permitting an employee to elect one part should be measured according to the terms that an employee is most likely to elect based on the facts available each period.

.12 *Accruing Compensation Cost.* Compensation cost in stock option, purchase, and award plans should be recognized as an expense of one or more periods in which an employee performs services and also as part or all of the consideration received for stock issued to the employee through a plan. The grant or award may specify the period or periods during which the employee performs services, or the period or periods may be inferred from the terms or from the past pattern of grants or awards (section 4061.14; section 4064.01).

.13 An employee may perform services in several periods before an employer corporation issues stock to him for those services. The employer corporation should accrue compensation expense in each period in which the services

are performed. If the measurement date is later than the date of grant or award, an employer corporation should record the compensation expense each period from date of grant or award to date of measurement based on the quoted market price of the stock at the end of each period.

.14 If stock is issued in a plan before some or all of the services are performed,[4] part of the consideration recorded for the stock issued is unearned compensation and should be shown as a separate reduction of stockholders' equity. The unearned compensation should be accounted for as expense of the period or periods in which the employee performs service.

.15 Accruing compensation expense may require estimates, and adjustment of those estimates in later periods may be necessary (section 1051.31-.33, *Accounting Changes*). For example, if a stock option is not exercised (or awarded stock is returned to the corporation) because an employee fails to fulfill an obligation, the estimate of compensation expense recorded in previous periods should be adjusted by decreasing compensation expense in the period of forfeiture.

.16 *Accounting for Income Tax Benefits.* An employer corporation may obtain an income tax benefit related to stock issued to an employee through a stock option, purchase, or award plan. A corporation is usually entitled to a deduction for income tax purposes of the amount that an employee reports as ordinary income, and the deduction is allowable to the corporation in the year in which the amount is includable in the gross income of the employee. Thus, a deduction for income tax purposes may differ from the related compensation expense that the corporation recognizes,[5] and the deduction may be allowable in a period that differs from the one in which the corporation recognizes compensation expense in measuring net income.

.17 An employer corporation should reduce income tax expense for a period by no more of a tax reduction under a stock option, purchase, or award plan than the proportion of the tax reduction that is related to the compensation expense for the period. Compensation expenses that are

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[4] State law governs the issuance of a corporation's stock including the acceptability of issuing stock for future services.

[5] A corporation may be entitled to a deduction for income tax purposes even though it recognizes no compensation expense in measuring net income.

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deductible in a tax return in a period different from the one in which they are reported as expenses in measuring net income are timing differences (section 4091.33-.36), and deferred taxes should be recorded. The remainder of the tax reduction, if any, is related to an amount that is deductible for income tax purposes but does not affect net income. The remainder of the tax reduction should not be included in income but should be added to capital in addition to par or stated value of capital stock in the period of the tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the corporation may deduct the difference from additional capital in the period of the tax reduction to the extent that tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in additional capital.

.18 A corporation may, either by cash payment or otherwise—for example, by allowing a reduction in the purchase price of stock—reimburse an employee for his action related to a stock option, purchase, or award plan that results in a reduction of income taxes of the corporation. The corporation should include the reimbursement in income as an expense.

.19 *Disclosure.* Section 4061.15 specifies the disclosures related to stock option and stock purchase plans that should be made in financial statements.[6]

EFFECTIVE DATE

.20 This section applies to all stock option, purchase, award, and bonus rights granted by an employer corporation to an individual employee after December 31, 1972 under both existing and new arrangements and to reductions of income taxes resulting from deductions as of a date after December 31, 1972 that are related to stock option, purchase, award, and bonus rights granted before as well as after the effective date of this section.

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[6] Other disclosure requirements are in Regulation S-X for financial statements filed with the Securities and Exchange Commission and in listing agreements of the stock exchanges for financial statements included in annual reports to stockholders.

AC Section 4062A

Accounting for Stock Issued to Employees—Appendix A

MEASURING AND ACCOUNTING FOR COMPENSATION UNDER TYPICAL PLANS (FOR ILLUSTRATION ONLY)

.01 Corporations issue stock to officers and other employees through plans with a variety of names and a multiplicity of terms. Plans in which employees pay cash, either directly or through payroll withholding, as all or a significant part of the consideration for stock they receive, are commonly designated by names such as stock option, stock purchase, or stock thrift or savings plans. Plans in which employees receive stock for current or future services without paying cash (or with a nominal payment) are commonly designated by names such as stock bonus or stock award plans. Stock bonus and award plans are invariably compensatory. Stock thrift and savings plans are compensatory to the extent of contributions of an employer corporation. Stock option and purchase plans may be either compensatory or noncompensatory. The combination of terms in some plans tend to make various types of plans shade into one another, and an assigned name may not describe the nature of a plan.

.02 This section is organized according to the most vital distinction in section 4062—compensatory plans are divided between plans in which the cost of compensation is measured at the date of grant or award and those in which the cost of compensation depends on events after the date of grant or award. Combination plans are described briefly in a final section.

Compensation Cost Measured at Date of Grant or Award

.03 *Accounting.* Total compensation cost is measured by the difference between the quoted market price of the stock at the date of grant or award and the price, if any, to be paid by an employee and is recognized as expense over the period the employee performs related services. The sum of compensation and cash paid by the employee is the consideration received for the stock issued. Compensation cost

related to an award of stock may be adjusted for a later cash settlement (section 4062.11(g)).

.04 *Typical Plans with Fixed and Determinable Terms.* The characteristic that identifies plans in this group is that the terms fix and provide means for determining at the date of grant or award both the number of shares of stock that may be acquired by or awarded to an employee and the cash, if any, to be paid by the employee. Plans usually presume or provide that the employee perform current or future services. The right to transfer stock received is sometimes restricted for a specified period.

.05 *Stock option and stock purchase plans*—Typical terms provide for an employer corporation to grant to an employee the right to purchase a fixed number of shares of stock of the employer corporation at a stated price during a specified period.

.06 *Stock bonus or award plans*—Typical terms provide for an employer corporation to award to an employee a fixed number of shares of stock of the employer corporation without a cash payment (or with a nominal cash payment) by the employee. Often the award is specified as a fixed dollar amount but is distributable in stock with the number of shares determined by the quoted market price of the stock at the date of award, the effective date of award (section 4062.11(c)), or the date treasury stock is acquired (section 4062.11(a)).

Compensation Cost Measured at Other Than Date of Grant or Award

.07 *Accounting.* Compensation cost is accounted for the same as for plans in the first group with one exception. The quoted market price used in the measurement is not the price at date of grant or award but the price at the date on which both the number of shares of stock that may be acquired by or awarded to an individual employee and the option or purchase price are known. Total compensation cost is measured by the difference between that quoted market price of the stock and the amount, if any, to be paid by an employee and is recognized as expense over the period the employee performs related services. The sum of compensation and cash paid by the employee is the consideration received for the stock issued. Compensation cost re-

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lated to an award of stock may be adjusted for a later cash settlement (section 4062.11(g)).

.08 Estimates of compensation cost are recorded before the measurement date based on the quoted market price of the stock at intervening dates. Recorded compensation expense between the date of grant or award and the measurement date may either increase or decrease because changes in quoted market price of the stock require recomputations of the estimated compensation cost.

.09 *Typical Plans with Variable Terms.* The characteristic that identifies plans in this group is that the terms prevent determining at the date of grant or award either the number of shares of stock that may be acquired by or awarded to an employee or the price to be paid by the employee, or both. The indeterminate factors usually depend on events that are not known or determinable at the date of grant or award. Plans usually presume or provide that the employee perform current or future services. The right to transfer stock received is sometimes restricted for a specified period.

.10 *Stock option and stock purchase plans*—Some terms provide for an employer corporation to grant to an employee the right to purchase shares of stock of the employer corporation during a specified period. The number of shares of stock, the option or purchase price, or both may vary depending on various factors during a specified period, such as market performance of the stock, equivalents of dividends distributed, or level of earnings of the employer corporation.

.11 *Stock bonus or award plans*—Some terms provide for an employer corporation to award to an employee the right to receive shares of stock of the employer corporation but the number of shares is not determinable at the date of award. Often the award is specified as a fixed dollar amount but is distributable in stock with the number of shares of stock determined by the market price of the stock at the date distributed, or the award may be of an undesignated number of shares of stock and that number is to be determined by variable factors during a specified period.

.12 The terms of some plans, often called *phantom stock* or *shadow stock* plans, base the obligations for com-

pensation on increases in market price of or dividends distributed on a specified or variable number of shares of stock of the employer corporation but provide for settlement of the obligation to the employee in cash, in stock of the employer corporation, or a combination of cash and stock.

Combination and Elective Plans

.13 *Accounting.* In general, compensation is measured for the separate parts of combination or elective plans. Compensation expense is the sum of the parts that apply. An employer corporation may need to measure compensation at various dates as the terms of separate parts become known. For example, if an employee is entitled to dividend equivalents, compensation cost is the sum of the costs measured at the dates the dividends are credited to the employee in accordance with the terms of the plan. If an employee may choose between alternatives, compensation expense is accrued for the alternative that the employee is most likely to elect based on the facts available at the date of accrual.

.14 *Typical Combination and Elective Plans.* Some plans provide for an employer corporation to grant or award to an employee rights with more than one set of terms. Often an employee may elect the right to be exercised. The combination of rights may be granted or awarded simultaneously or an employee who holds a right may subsequently be granted or awarded a second but different right. The rights may run concurrently or for different periods. An illustration is: an employee holding an option to purchase a fixed number of shares of stock at a fixed price during a specified period is granted an alternative option to purchase the same number of shares at a different price or during a different specified period. Instead of a second option, the award may be the right to elect to receive cash or shares of stock without paying cash. Often the election to acquire or receive stock under either right decreases the other right. Plans combining rights are often called *tandem stock* or *alternate stock* plans; the second right may be of the type that is sometimes called a *phantom stock* plan.

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AC Section 4063

Accounting for the Cost of Pension Plans

[Source: APB Opinion No. 8.]

Effective for fiscal periods beginning after December 31, 1966, unless otherwise indicated

INTRODUCTION

.01 Pension plans have developed in an environment characterized by a complex array of social concepts and pressures, legal considerations, actuarial techniques, income tax laws and regulations, business philosophies, and accounting concepts and practices. Each plan reflects the interaction of the environment with the interests of the persons concerned with its design, interpretation and operation. From these factors have resulted widely divergent practices in accounting for the cost of pension plans.

.02 An increased significance of pension cost in relation to the financial position and results of operations of many businesses has been brought about by the substantial growth of private pension plans, both in numbers of employees covered and in amounts of retirement benefits. The assets accumulated and the future benefits to employees under these plans have reached such magnitude that changes in actuarial assumptions concerning pension fund earnings, employee mortality and turnover, retirement age, etc., and the treatment of differences between such assumptions and actual experience, can have important effects on the pension cost recognized for accounting purposes from year to year.

.03 In Accounting Research Bulletin No. 47, *Accounting for Costs of Pension Plans,* the committee on accounting procedure stated its preferences that "costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees" and that "costs based on past services should be charged off over some reasonable period, provided the

allocation is made on a systematic and rational basis and does not cause distortion of the operating results in any one year.'' In recognition of the divergent views then existing, however, the committee also said ''as a minimum, the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in the employees, reduced, in the case of the balance sheet, by any accumulated trusteed funds or annuity contracts purchased.'' The committee did not explain what was meant by the term ''vested'' and did not make any recommendations concerning appropriate actuarial cost methods or recognition of actuarial gains and losses.

.04 Despite the issuance of Accounting Research Bulletin No. 47, accounting for the cost of pension plans has varied widely among companies and has sometimes resulted in wide year-to-year fluctuations in the provisions for pension cost of a single company. Generally, companies have provided pension cost equivalent to the amounts paid to a pension fund or used to purchase annuities. In many cases such payments have included amortization of past service cost (and prior service cost arising on amendment of a plan) over periods ranging from about ten to forty years; in other cases the payments have not included amortization but have included an amount equivalent to interest (see definition of *interest* in section 4063B.27) on unfunded prior service cost. In some cases payments from year to year have varied with fluctuations in company earnings or with the availability of funds. In other cases payments have been affected by the Federal income tax rates in effect at a particular time. The recognition of actuarial gains and losses in the year of their determination, or intermittently, has also caused year-to-year variations in such payments.

.05 Because of the increasing importance of pensions and the variations in accounting for them, the Accounting Principles Board authorized Accounting Research Study No. 8, *Accounting for the Cost of Pension Plans* (referred to hereinafter as the ''Research Study''). The Research Study was published in May 1965 by the American Institute

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of Certified Public Accountants and has been widely distributed. The Board has carefully examined the recommendations of the Research Study and considered many comments and articles about it. The Board's conclusions agree in most respects with, but differ in some from, those in the Research Study.

.06 The Board has concluded that this section is needed to clarify the accounting principles and to narrow the practices applicable to accounting for the cost of pension plans.

.07 The computation of pension cost for accounting purposes requires the use of actuarial techniques and judgment. Generally pension cost should be determined from a study by an actuary, giving effect to the conclusions set forth in this section. It should be noted that the actuarial cost methods and their application for accounting purposes may differ from those used for funding purposes. A discussion of actuarial valuations, assumptions and cost methods is included in section 4063A. The terminology used in this section to describe pension cost and actuarial cost methods is consistent with that generally used by actuaries and others concerned with pension plans. A Glossary of such terminology is included in section 4063B.

PENSION PLANS COVERED BY THIS SECTION

.08 For the purposes of this section, a pension plan is an arrangement whereby a company undertakes to provide its retired employees with benefits that can be determined or estimated in advance from the provisions of a document or documents or from the company's practices. Ordinarily, such benefits are monthly pension payments but, in many instances, they include death and disability payments. However, death and disability payments under a separate arrangement are not considered in this section. The section applies both to written plans and to plans whose existence may be implied from a well-defined, although perhaps unwritten, company policy. A company's practice of paying retirement benefits to selected employees in amounts determined on a case-by-case basis at or after retirement does not constitute a pension plan under this section. The section applies to pension cost incurred outside the United States under plans that are reasonably

similar to those contemplated by this section, when included in financial statements intended to conform with generally accepted accounting principles in the United States. The section applies to unfunded plans as well as to insured plans and trust fund plans. It applies to defined-contribution plans as well as to defined-benefit plans. It applies also to deferred compensation contracts with individual employees if such contracts, taken together, are equivalent to a pension plan. It does not apply to deferred profit-sharing plans except to the extent that such a plan is, or is part of, an arrangement that is in substance a pension plan.

BASIC ACCOUNTING METHOD

Discussion

.09 This section is concerned with the determination of the amount of pension cost for accounting purposes. In considering the discussions and conclusions in this section, it is important to keep in mind that the annual pension cost to be charged to expense ("the provision for pension cost") is not necessarily the same as the amount to be funded for the year. The determination of the amount to be funded is a financial matter not within the purview of this section.

.10 The pension obligations assumed by some companies are different from those assumed by other companies. In some plans the company assumes direct responsibility for the payment of benefits described in the plan. In these cases, if the pension fund is inadequate to pay the benefits to which employees are entitled, the company is liable for the deficiency. In contrast, the terms of most funded plans limit the company's legal obligation for the payment of benefits to the amounts in the pension fund. In these cases, if the pension fund is inadequate to pay the benefits to which employees are otherwise entitled, such benefits are reduced in a manner stated in the plan and the company has no further legal obligation.

.11 There is broad agreement that pension cost, including related administrative expense, should be accounted for on the accrual basis. There is not general agreement, however, about the nature of pension cost. Some view pensions solely as a form of supplemental benefit to employees in service at a particular time. Others see a broader purpose in pensions; they consider pensions to be in large part

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(a) a means of promoting efficiency by providing for the systematic retirement of older employees or (b) the fulfillment of a social obligation expected of business enterprises, the cost of which, as a practical matter, constitutes a business expense that must be incurred. Those who hold this second viewpoint associate pension cost, to a large extent, with the plan itself rather than with specific employees. In addition, the long-range nature of pensions causes significant uncertainties about the total amount of pension benefits ultimately to be paid and the amount of cost to be recognized. These differences in viewpoint concerning the nature of pension cost, the uncertainties regarding the amount of the estimates, and the use of many actuarial approaches, compound the difficulty in reaching agreement on the total amount of pension cost over a long period of years and on the time to recognize any particular portion applicable to an employee or group of employees. It is only natural, therefore, that different views exist concerning the preferable way to recognize pension cost. The major views are described in the following four paragraphs.

.12 One view is that periodic pension cost should be provided on an actuarial basis that takes into account all estimated prospective benefit payments under a plan with respect to the existing employee group, whether such payments relate to employee service rendered before or after the plan's adoption or amendment, and that no portion of the provision for such payments should be indefinitely deferred or treated as though, in fact, it did not exist. Those holding this view believe that the recurring omission of a portion of the provision, because of the time lag between making the provision and the subsequent benefit payments under a plan, is a failure to give accrual accounting recognition to the cost applicable to the benefits accrued over the service lives of all employees. Among those holding this view there is general agreement that cost relating to service following the adoption or amendment of a plan should be recognized ratably over the remaining service lives of employees. There is some difference of opinion, however, concerning the period of time to use in allocating that portion of the cost which the computations under some actuarial methods assign to employee service rendered before a plan's adoption or amendment. As to this cost, (a) those

viewing pensions as relating solely to the existing employee group believe that it should be accounted for over the remaining service lives of those in the employ of the company at the time of the plan's adoption or amendment, whereas (b) some of those holding the broader view of pensions, referred to in paragraph .11, believe that this cost is associated to a large extent with the plan itself and hence that the period of providing for it need not be limited to the remaining service lives of a particular group of employees but may be extended somewhat beyond that period. However, this difference of opinion relates only to the period of time over which such cost should be provided.

.13 An opposing view stresses that pension cost is related to the pension benefits to be paid to the continuing employee group as a whole. Those holding this view emphasize that, in the application of accrual accounting, charges against income must be based on actual transactions and events—past, present or reasonably anticipated. They stress the long-range nature of pensions, referred to in paragraph .11, and emphasize the uncertainties concerning the total cost of future benefits. They point out that, in the great majority of cases, provision for normal cost plus an amount equivalent to interest on unfunded prior service cost will be adequate to meet, on a continuing basis, all benefit payments under a plan. Those holding this view believe that following the view expressed in paragraph .12 can result, over a period of years, in charging income with, and recording a balance-sheet accrual for, amounts that will not be paid as benefits. They see no reason therefore to urge employers to provide more than normal cost plus an amount equivalent to interest on unfunded prior service cost in these circumstances, because additional amounts never expected to be paid by a going concern are not corporate costs, and thus are not appropriate charges against income. They acknowledge, however, that corporations can and do make payments to pension funds for past and prior service cost, with the result that reductions will be effected in future charges for the equivalent of interest on unfunded amounts, but they consider this to be solely a matter of financial management rather than a practice dictated by accounting considerations.

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.14 In many pension plans, cost recorded on the basis described in paragraph .13 will accumulate an amount (whether funded or not) at least equal to the actuarially computed value of vested benefits (see definition of *vested benefits* in section 4063B.43). However, this result might not be achieved in some cases (for example, if the average age of the employee group is high in relation to that of expected future employee groups, or if benefits vest at a relatively early age). Some hold the view that when periodic provisions are based on normal cost plus an amount equivalent to interest such periodic provisions should be increased if they will not, within a reasonable period of time, accumulate an amount (whether funded or not) at least equal to the actuarially computed value of vested benefits. Others would require the increases in provisions only if the company has a legal obligation for the payment of such benefits.

.15 Another view is that, if the company has no responsibility for paying benefits beyond the amounts in the pension fund, pension cost is discretionary and should be provided for a particular accounting period only when the company has made or has indicated its intent to make a contribution to the pension fund for the period. Others believe that pension cost is discretionary even if the company has a direct responsibility for the payment of benefits described in the plan.

Opinion

.16 The Board recognizes that a company may limit its legal obligation by specifying that pensions shall be payable only to the extent of the assets in the pension fund. Experience shows, however, that with rare exceptions pension plans continue indefinitely and that termination and other limitations of the liability of the company are not invoked while the company continues in business. Consequently, the Board believes that, in the absence of convincing evidence that the company will reduce or discontinue the benefits called for in a pension plan, the cost of the plan should be accounted for on the assumption that the company will continue to provide such benefits. This assumption implies a long-term undertaking, the cost of which should be recognized annually whether or not funded.

Therefore, accounting for pension cost should not be discretionary.

.17 All members of the Board believe that the entire cost of benefit payments ultimately to be made should be charged against income subsequent to the adoption or amendment of a plan and that no portion of such cost should be charged directly against retained earnings. Differences of opinion exist concerning the measure of the cost of such ultimate payments. The Board believes that the approach stated in paragraph .12 is preferable for measuring the cost of benefit payments ultimately to be made. However, some members of the Board believe that the approach stated in paragraph .13, in some cases with the modifications described in paragraph .14, is more appropriate for such measurement. The Board has concluded, in the light of such differences in views and of the fact that accounting for pension cost is in a transitional stage, that the range of practices would be significantly narrowed if pension cost were accounted for at the present time within limits based on paragraphs .12, .13 and .14. Accordingly, the Board believes that the annual provision for pension cost should be based on an accounting method that uses an acceptable actuarial cost method (as defined in paragraphs .23 and .24) and results in a provision between the minimum and maximum stated below. The accounting method and the actuarial cost method should be consistently applied from year to year.

a. *Minimum.* The annual provision for pension cost should not be less than the total of (1) normal cost, (2) an amount equivalent to interest on any unfunded prior service cost and (3) if indicated in the following sentence, a provision for vested benefits. A provision for vested benefits should be made if there is an excess of the actuarially computed value of vested benefits (see definition of *vested benefits* in section 4063 B.43) [1] over the total of (1) the pension fund and (2) any balance-sheet pension accruals, less (3) any balance-sheet pension prepayments or deferred charges, at the end of the year, and such excess is not at least 5 per cent less than the comparable excess

[1] The actuarially computed value of vested benefits would ordinarily be based on the actuarial valuation used for the year even though such valuation would usually be as of a date other than the balance sheet date.

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at the beginning of the year. The provision for vested benefits should be the lesser of (A) the amount, if any, by which 5 per cent of such excess at the beginning of the year is more than the amount of the reduction, if any, in such excess during the year or (B) the amount necessary to make the aggregate annual provision for pension cost equal to the total of (1) normal cost, (2) an amount equivalent to amortization, on a 40-year basis, of the past service cost (unless fully amortized), (3) amounts equivalent to amortization, on a 40-year basis, of the amounts of any increases or decreases in prior service cost arising on amendments of the plan (unless fully amortized) and (4) interest equivalents under paragraph .42 or .43 on the difference between provisions and amounts funded.[2]

b. *Maximum.* The annual provision for pension cost should not be greater than the total of (1) normal cost, (2) 10 per cent of the past service cost (until fully amortized), (3) 10 per cent of the amounts of any increases or decreases in prior service cost arising on amendments of the plan (until fully amortized) and (4) interest equivalents under paragraph .42 or .43 on the difference between provisions and amounts funded. The 10 per cent limitation is considered necessary to prevent unreasonably large charges against income during a short period of years.

.18 The difference between the amount which has been charged against income and the amount which has been paid should be shown in the balance sheet as accrued or prepaid pension cost. If the company has a legal obligation for pension cost in excess of amounts paid or accrued, the excess should be shown in the balance sheet as both a liability and a deferred charge. Except to the extent indicated in the preceding sentences of this paragraph, unfunded prior service cost is not a liability which should be shown in the balance sheet.

ACTUARIAL COST METHODS

Discussion

.19 A number of actuarial cost methods have been developed to determine pension cost. These methods are designed primarily as funding techniques, but many of them

[2] For purposes of this sentence, amortization should be computed as a level annual amount, including the equivalent of interest.

are also useful in determining pension cost for accounting purposes. Pension cost can vary significantly, depending on the actuarial cost method selected; furthermore, there are many variations in the application of the methods, in the necessary actuarial assumptions concerning employee turnover, mortality, compensation levels, pension fund earnings, etc., and in the treatment of actuarial gains and losses.

.20 The principal actuarial cost methods currently in use are described in section 4063A. These methods include an accrued benefit cost method and several projected benefit cost methods.

a. Under the accrued benefit cost method (unit credit method), the amount assigned to the current year usually represents the present value of the increase in present employees' retirement benefits resulting from that year's service. For an individual employee, this method results in an increasing cost from year to year because both the present value of the annual increment in benefits and the probability of reaching retirement increase as the period to retirement shortens; also, in some plans, the retirement benefits are related to salary levels, which usually increase during the years. However, the aggregate cost for a total work force of constant size tends to increase *only* if the average age or average compensation of the entire work force increases.

b. Under the projected benefit cost methods (entry age normal, individual level premium, aggregate and attained age normal methods), the amount assigned to the current year usually represents the level amount (or an amount based on a computed level percentage of compensation) that will provide for the estimated projected retirement benefits over the service lives of either the individual employees or the employee group, depending on the method selected. Cost computed under the projected benefit cost methods tends to be stable or to decline year by year, depending on the method selected. Cost computed under the entry age normal method is usually more stable than cost computed under any other method.

.21 Some actuarial cost methods (individual level premium and aggregate methods) assign to subsequent

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years the cost arising at the adoption or amendment of a plan. Other methods (unit credit, entry age normal and attained age normal methods) assign a portion of the cost to years prior to the adoption or amendment of a plan, and assign the remainder to subsequent years. The portion of cost assigned to each subsequent year is called *normal cost.* At the adoption of a plan, the portion of cost assigned to prior years is called *past service cost.* At any later valuation date, the portion of cost assigned to prior years (which includes any remaining past service cost) is called *prior service cost.* The amount assigned as past or prior service cost and the amount assigned as normal cost vary depending on the actuarial cost method. The actuarial assignment of cost between past or prior service cost and normal cost is not indicative of the periods in which such cost should be recognized for accounting purposes.

.22 In some cases, past service cost (and prior service cost arising on amendment of a plan) is funded in total; in others it is funded in part; in still others it is not funded at all. In practice, the funding of such cost is influenced by the Federal income tax laws and related regulations, which generally limit the annual deduction for such cost to 10 per cent of the initial amount. There is no tax requirement that such cost be funded, but there are requirements that effectively prohibit the unfunded cost from exceeding the total of past service cost and prior service cost arising on amendment of the plan. The practical effect of the tax requirements is that on a cumulative basis normal cost plus an amount equivalent to the interest on any unfunded prior service cost must be funded. Funding of additional amounts is therefore discretionary for income tax purposes. However, neither funding nor the income tax laws and related regulations are controlling for accounting purposes.

Opinion

.23 To be acceptable for determining cost for accounting purposes, an actuarial cost method should be rational and systematic and should be consistently applied so that it results in a reasonable measure of pension cost from year to year. Therefore, in applying an actuarial cost method that separately assigns a portion of cost as past or prior

service cost, any amortization of such portion should be based on a rational and systematic plan and generally should result in reasonably stable annual amounts. The equivalent of interest on the unfunded portion may be stated separately or it may be included in the amortization; however, the total amount charged against income in any one year should not exceed the maximum amount described in paragraph .17.

.24 Each of the actuarial cost methods described in section 4063A, except terminal funding, is considered acceptable when the actuarial assumptions are reasonable and when the method is applied in conformity with the other conclusions of this Opinion. The terminal funding method is not acceptable because it does not recognize pension cost prior to retirement of employees. For the same reason, the pay-as-you-go method (which is not an actuarial cost method) is not acceptable. The acceptability of methods not discussed herein should be determined from the guidelines in this and the preceding paragraph.

ACTUARIAL GAINS AND LOSSES

Discussion

.25 Actuarial assumptions necessarily are based on estimates of future events. Actual events seldom coincide with events estimated; also, as conditions change, the assumptions concerning the future may become invalid. Adjustments may be needed annually therefore to reflect actual experience, and from time to time to revise the actuarial assumptions to be used in the future. These adjustments constitute actuarial gains and losses. They may be regularly recurring (for example, minor deviations between experience and actuarial assumptions) or they may be unusual or recurring at irregular intervals (for example, substantial investment gains or losses, changes in the actuarial assumptions, plant closings, etc.).

.26 In dealing with actuarial gains and losses, the primary question concerns the timing of their recognition in providing for pension cost. In practice, three methods are in use; immediate-recognition, spreading and averaging. Under the immediate-recognition method (not ordinarily used at present for net losses), net gains are applied to reduce pension cost in the year of occurrence or the

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following year. Under the spreading method, net gains or losses are applied to current and future cost, either through the normal cost or through the past service cost (or prior service cost on amendment). Under the averaging method, an average of annual net gains and losses, developed from those that occurred in the past with consideration of those expected to occur in the future, is applied to the normal cost.

.27 The use of the immediate-recognition method sometimes results in substantial reductions in, or the complete elimination of, pension cost for one or more years. For Federal income tax purposes, when the unit credit actuarial cost method is used, and in certain other instances, actuarial gains reduce the maximum pension-cost deduction for the year of occurrence or the following year.

.28 Unrealized appreciation and depreciation in the value of investments in a pension fund are forms of actuarial gains and losses. Despite short-term market fluctuations, the overall rise in the value of equity investments in recent years has resulted in the investments of pension funds generally showing net appreciation. Although appreciation is not generally recognized at present in providing for pension cost, it is sometimes recognized through the interest assumption or by introducing an assumed annual rate of appreciation as a separate actuarial assumption. In other cases, appreciation is combined with other actuarial gains and losses and applied on the immediate-recognition, spreading or averaging method.

.29 The amount of any unrealized appreciation to be recognized should also be considered. Some actuarial valuations recognize the full market value. Others recognize only a portion (such as 75 per cent) of the market value or use a moving average (such as a five-year average) to minimize the effects of short-term market fluctuations. Another method used to minimize such fluctuations is to recognize appreciation annually based on an expected long-range growth rate (such as 3 per cent) applied to the cost (adjusted for appreciation previously so recognized) of common stocks; when this method is used, the total of cost and recognized appreciation usually is not permitted to exceed a specified percentage (such as 75 per cent) of the market value. Unrealized depreciation is recognized in

full or on a basis similar to that used for unrealized appreciation.

Opinion

.30 The Board believes that actuarial gains and losses, including realized investment gains and losses, should be given effect in the provision for pension cost in a consistent manner that reflects the long-range nature of pension cost. Accordingly, except as otherwise indicated in paragraphs .31 and .33, actuarial gains and losses should be spread over the current year and future years or recognized on the basis of an average as described in paragraph .26. If this is not accomplished through the routine application of the method (for example, the unit credit method—see paragraph .27), the spreading or averaging should be accomplished by separate adjustments of the normal cost resulting from the routine application of the method. Where spreading is accomplished by separate adjustments, the Board considers a period of from 10 to 20 years to be reasonable. Alternatively, an effect similar to spreading or averaging may be obtained by applying net actuarial gains as a reduction of prior service cost in a manner that reduces the annual amount equivalent to interest on, or the annual amount of amortization of, such prior service cost, and does not reduce the period of amortization.

.31 Actuarial gains and losses should be recognized immediately if they arise from a single occurrence not directly related to the operation of the pension plan and not in the ordinary course of the employer's business. An example of such occurrences is a plant closing, in which case the actuarial gain or loss should be treated as an adjustment of the net gain or loss from that occurrence and not as an adjustment of pension cost for the year. Another example of such occurrences is a merger or acquisition accounted for as a purchase, in which case the actuarial gain or loss should be treated as an adjustment of the purchase price.[8] However, if the transaction is accounted for as a pooling of interests, the actuarial gain or loss should generally be treated as described in paragraph .30.

.32 The Board believes unrealized appreciation and depreciation should be recognized in the determination of the provision for pension cost on a rational and systematic

[8] See section 1091.88h.

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basis that avoids giving undue weight to short-term market fluctuations (as by using a method similar to those referred to in paragraph .29). Such recognition should be given either in the actuarial assumptions or as described in paragraph .30 for other actuarial gains and losses. Ordinarily appreciation and depreciation need not be recognized for debt securities expected to be held to maturity and redeemed at face value.

.33 Under variable annuity and similar plans the retirement benefits vary with changes in the value of a specified portfolio of equity investments. In these cases, investment gains or losses, whether realized or unrealized, should be recognized in computing pension cost only to the extent that they will not be applied in determining retirement benefits.

EMPLOYEES INCLUDED IN COST CALCULATIONS

Discussion

.34 Under some plans employees become eligible for coverage when they are employed; other plans have requirements of age or length of service or both. Some plans state only the conditions an employee must meet to receive benefits but do not otherwise deal with coverage. Ordinarily actuarial valuations exclude employees likely to leave the company within a short time after employment. This simplifies the actuarial calculations. Accordingly, actuarial calculations ordinarily exclude employees on the basis of eligibility requirements and, in some cases, exclude covered employees during the early years of service.

.35 If provisions are not made for employees from the date of employment, pension cost may be understated. On the other hand, the effect of including all employees would be partially offset by an increase in the turnover assumption; therefore, the inclusion of employees during early years of service may expand the volume of the calculations without significantly changing the provisions for pension cost.

Opinion

.36 The Board believes that all employees who may reasonably be expected to receive benefits under a pension plan should be included in the cost calculations, giving ap-

propriate recognition to anticipated turnover. As a practical matter, however, when the effect of exclusion is not material it is appropriate to omit certain employees from the calculations.

COMPANIES WITH MORE THAN ONE PLAN

Opinion

.37 A company that has more than one pension plan need not use the same actuarial cost method for each one; however, the accounting for each plan should conform to this Opinion. If a company has two or more plans covering substantial portions of the same employee classes and if the assets in any of the plans ultimately can be used in paying present or future benefits of another plan or plans, such plans may be treated as one plan for purposes of determining pension cost.

DEFINED-CONTRIBUTION PLANS

Opinion

.38 Some defined-contribution plans state that contributions will be made in accordance with a specified formula and that benefit payments will be based on the amounts accumulated from such contributions. For such a plan the contribution applicable to a particular year should be the pension cost for that year.

.39 Some defined-contribution plans have defined benefits. In these circumstances, the plan requires careful analysis. When the substance of the plan is to provide the defined benefits, the annual pension cost should be determined in accordance with the conclusions of this Opinion applicable to defined-benefit plans.

INSURED PLANS

Opinion

.40 Insured plans are forms of funding arrangements and their use should not affect the accounting principles applicable to the determination of pension cost. Cost under individual policy plans is ordinarily determined by the individual level premium method, and cost under group deferred annuity contracts is ordinarily determined by the unit credit method. Cost under deposit administration contracts, which operate similarly to trust-fund plans, may be

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determined on any of several methods. Some elements of pension cost, such as the application of actuarial gains (dividends, termination credits, etc.), may at times cause differences between the amounts being paid to the insurance company and the cost being recognized for accounting purposes. The Board believes that pension cost under insured plans should be determined in conformity with the conclusions of this section.

.41 Individual annuity or life insurance policies and group deferred annuity contracts are often used for plans covering small employee groups. Employers using one of these forms of funding exclusively do not ordinarily have ready access to actuarial advice in determining pension cost. Three factors to be considered in deciding whether the amount of net premiums paid is the appropriate charge to expense are dividends, termination credits and pension cost for employees not yet covered under the plan. Usually, the procedures adopted by insurance companies in arriving at the amount of dividends meet the requirements of paragraph .30; consequently, in the absence of wide year-to-year fluctuations such dividends should be recognized in the year credited. Termination credits should be spread or averaged in accordance with paragraph .30. Unless the period from date of employment to date of coverage under the plan is so long as to have a material effect on pension cost, no provision need be made for employees expected to become covered under the plan. If such a provision is made, it need not necessarily be based on the application of an actuarial cost method.

EFFECT OF FUNDING

Opinion

.42 This section is written primarily in terms of pension plans that are funded. The accounting described applies also to plans that are unfunded. In unfunded plans, pension cost should be determined under an acceptable actuarial cost method in the same manner as for funded plans; however, because there is no fund to earn the assumed rate of interest, the pension-cost provision for the current year should be increased by an amount equivalent to the interest that would have been earned in the current year if the prior-year provisions had been funded.

.43 For funded plans, the amount of the pension cost determined under this section may vary from the amount funded. When this occurs, the pension-cost provision for the year should be increased by an amount equivalent to interest on the prior-year provisions not funded or be decreased by an amount equivalent to interest on prior-year funding in excess of provisions.

.44 A pension plan may become overfunded (that is, have fund assets in excess of all prior service cost assigned under the actuarial method in use for accounting purposes) as a result of contributions or as a result of actuarial gains. In determining provisions for pension cost, the effects of such overfunding are appropriately recognized in the current and future years through the operation of paragraph .30 or .43. As to a plan that is overfunded on the effective date of this section see paragraph .48.

INCOME TAXES

Opinion

.45 When pension cost is recognized for tax purposes in a period other than the one in which recognized for financial reporting, appropriate consideration should be given to allocation of income taxes among accounting periods. (See section 4091.)

DISCLOSURE

Opinion

.46 The Board believes that pension plans are of sufficient importance to an understanding of financial position and results of operations that the following disclosures should be made in financial statements or their notes:

1. A statement that such plans exist, identifying or describing the employee groups covered.
2. A statement of the company's accounting and funding policies.
3. The provision for pension cost for the period.
4. The excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance-sheet pension accruals, less any pension prepayments or deferred charges.

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5. Nature and effect of significant matters affecting comparability for all periods presented, such as changes in accounting methods (actuarial cost method, amortization of past and prior service cost, treatment of actuarial gains and losses, etc.), changes in circumstances (actuarial assumptions, etc.), or adoption or amendment of a plan.

An example of what the Board considers to be appropriate disclosure is as follows:

> The company and its subsidiaries have several pension plans covering substantially all of their employees, including certain employees in foreign countries. The total pension expense for the year was $........................, which includes, as to certain of the plans, amortization of prior service cost over periods ranging from 25 to 40 years. The company's policy is to fund pension cost accrued. The actuarially computed value of vested benefits for all plans as of December 31, 19......, exceeded the total of the pension fund and balance-sheet accruals less pension prepayments and deferred charges by approximately $........................ A change during the year in the actuarial cost method used in computing pension cost had the effect of reducing net income for the year by approximately $........................

CHANGES IN ACCOUNTING METHOD

Opinion

.47 On occasion a company may change its method of accounting for pension cost from one acceptable method under this section to another. Such a change might be a change in the actuarial cost method, in the amortization of past and prior service cost, in the treatment of actuarial gains and losses, or in other factors. When such a change is made subsequent to the effective date of this section, a question arises about the accounting for the difference between the cost actually provided under the old method and the cost that would have been provided under the new method. The Board believes that pension cost provided under an acceptable method of accounting in prior periods should not be changed subsequently. Therefore, the effect on prior-year cost of a change in accounting method should be applied prospectively to the cost of the current year and

future years, in a manner consistent with the conclusions of this section, and not retroactively as an adjustment of retained earnings or otherwise. The change and its effect should be disclosed as indicated in paragraph .46.

TRANSITION TO RECOMMENDED PRACTICES

Opinion

.48 For purposes of this section, any unamortized prior service cost (computed under the actuarial cost method to be used for accounting purposes in the future) on the effective date of this section may be treated as though it arose from an amendment of the plan on that date rather than on the actual dates of adoption or amendment of the plan. If the pension plan is overfunded (see paragraph .44) on the effective date of this section, the amount by which it is overfunded (computed under the actuarial cost method to be used for accounting purposes in the future) should be treated as an actuarial gain realized on that date and should be accounted for as described in paragraph .30.

.49 The effect of any changes in accounting methods made as a result of the issuance of this section should be applied prospectively to the cost of the current year and future years in a manner consistent with the conclusions of this section, and not retroactively by an adjustment of retained earnings or otherwise. The change and its effect should be disclosed as indicated in paragraph .46.

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AC Section 4063A

Accounting for the Cost of Pension Plans— Appendix A

ACTUARIAL VALUATIONS, ASSUMPTIONS AND COST METHODS

ACTUARIAL VALUATIONS

.01 An actuarial valuation of a pension plan is the process used by actuaries for determining the amounts an employer is to contribute (pay, fund) under a pension plan (except where an insured arrangement calls for payment of specified premiums). A valuation is made as of a specific date, which need not coincide with the end of the period for which a payment based on the valuation will be made. Indeed, it is uncommon for such a coincidence of dates to exist. Among other factors, a time lag is necessary in order to compile the data and to permit the actuary to make the necessary calculations. Although annual valuations are, perhaps, the rule, some employers have valuations made at less frequent intervals, in some cases as infrequently as every five years. The calculations are made for a closed group — ordinarily, employees presently covered by the plan, former employees having vested rights and retired employees currently receiving benefits.

.02 An initial step in making a valuation is to determine the present value on the valuation date of benefits to be paid over varying periods of time in the future to employees after retirement (plus any other benefits under the plan). An actuarial cost method (see description in a later section of this Appendix) is then applied to this present value to determine the contributions to be made by the employer.

.03 The resulting determinations are estimates, since in making a valuation a number of significant uncertainties concerning future events must be resolved by making several actuarial assumptions.

NOTE: For further discussion see Appendix C of Accounting Research Study No. 8, *Accounting for the Cost of Pension Plans* by Ernest L. Hicks, CPA, published by the American Institute of Certified Public Accountants in 1965.

ACTUARIAL ASSUMPTIONS

.04 The uncertainties in estimating the cost of a pension plan relate to (1) interest (return on funds invested), (2) expenses of administration and (3) the amounts and timing of benefits to be paid with respect to presently retired employees, former employees whose benefits have vested and present employees.

Interest (Return on Funds Invested)

.05 The rate of interest used in an actuarial valuation is an expression of the average rate of earnings that can be expected on the funds invested or to be invested to provide for the future benefits. Since in most instances the investments include equity securities as well as debt securities, the earnings include dividends as well as interest; gains and losses on investments are also a factor. For simplicity, however, the rate is ordinarily called the interest rate.

Expenses of Administration

.06 In many instances the expenses of administering a pension plan—for example, fees of attorneys, actuaries and trustees, and the cost of keeping pension records—are borne directly by the employer. In other cases, such expenses, or some of them, are paid by a trust or insurance company from funds contributed by the employer. In the latter cases, expenses to be incurred in the future must be estimated in computing the employer's pension cost.

Benefits

.07 Several assumptions must be made as to the amounts and timing of the future benefits whose present value is used in expressing the cost of a pension plan. The principal assumptions are as follows:

a. *Future compensation levels.* Benefits under some pension plans depend in part on future compensation levels. Under plans of this type, an estimate is ordinarily made of normal increases expected from the progression of employees through the various earnings-rate categories, based on the employer's experience. General earnings-level increases, such as those which may result from inflation, are usually excluded from this actuarial assumption.

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b. *Cost-of-living.* To protect the purchasing power of retirement benefits, some plans provide that the benefits otherwise determined will be adjusted from time to time to reflect variations in a specific index, such as the Consumer Price Index of the United States Bureau of Labor Statistics. In estimating the cost of such a plan, expected future changes in the cost-of-living index may be included in the actuarial assumptions.

c. *Mortality.* The length of time an employee covered by a pension plan will live is an important factor in estimating the cost of the benefit payments he will receive. If an employee dies before he becomes eligible for pension benefits, he receives no payments, although in some plans his beneficiaries receive lump-sum or periodic benefits. The total amount of pension benefits for employees who reach retirement is determined in large part by how long they live thereafter. Estimates regarding mortality are based on mortality tables.

d. *Retirement age.* Most plans provide a normal retirement age, but many plans permit employees to work thereafter under certain conditions. Some plans provide for retirement in advance of the normal age in case of disability, and most plans permit early retirement at the employee's option under certain conditions. When there are such provisions, an estimate is made of their effect on the amount and timing of the benefits which will ultimately be paid.

e. *Turnover.* In many plans, some employees who leave employment with the employer before completing vesting requirements forfeit their rights to receive benefits. In estimating the amount of future benefits, an allowance for the effect of turnover may be made.

f. *Vesting.* Many plans provide that after a stated number of years of service an employee becomes entitled to receive benefits (commencing at his normal retirement age and usually varying in amount with his number of years of service) even though he leaves the company for a reason other than retirement. This is taken into consideration in estimating the effect of turnover.

g. *Social security benefits.* For plans providing for a reduction of pensions by all or part of social security

benefits, it is necessary in estimating future pension benefits to estimate the effect of future social security benefits. Ordinarily, this estimate is based on the assumption that such benefits will remain at the level in effect at the time the valuation is being made.

Actuarial Gains and Losses

.08 The likelihood that actual events will coincide with each of the assumptions used is so remote as to constitute an impossibility. As a result, the actuarial assumptions used may be changed from time to time as experience and judgment dictate. In addition, whether or not the assumptions as to events in the future are changed, it is often necessary to recognize in the calculations the effect of differences between actual prior experience and the assumptions used in the past.

ACTUARIAL COST METHODS

.09 Actuarial cost methods have been developed by actuaries as funding techniques to be used in actuarial valuations. As indicated in paragraph .19 of section 4063, many of the actuarial cost methods are also useful for accounting purposes. The following discussion of the principal methods describes them as funding techniques (to simplify the discussion, references to prior service cost arising on amendment of a plan have been omitted; such cost would ordinarily be treated in a manner consistent with that described for past service cost). Their application for accounting purposes is described in section 4063.

Accrued Benefit Cost Method—Unit Credit Method

.10 Under the unit credit method, future service benefits (pension benefits based on service after the inception of a plan) are funded as they accrue—that is, as each employee works out the service period involved. Thus, the normal cost under this method for a particular year is the present value of the units of future benefit credited to employees for service in that year (hence unit credit). For example, if a plan provides benefits of $5 per month for each year of credited service, the normal cost for a particular employee for a particular year is the present value (adjusted for mortality and usually for turnover) of an

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annuity of $5 per month beginning at the employee's anticipated retirement date and continuing throughout his life.

.11 The past service cost under the unit credit method is the present value at the plan's inception date of the units of future benefit credited to employees for service prior to the inception date.

.12 The annual contribution under the unit credit method ordinarily comprises (1) the normal cost and (2) an amount for past service cost. The latter may comprise only an amount equivalent to interest on the unfunded balance or may also include an amount intended to reduce the unfunded balance.

.13 As to an individual employee, the annual normal cost for an equal unit of benefit each year increases because the period to the employee's retirement continually shortens and the probability of reaching retirement increases; also, in some plans, the retirement benefits are related to salary levels, which usually increase during the years. As to the employees collectively, however, the step-up effect is masked, since older employees generating the highest annual cost are continually replaced by new employees generating the lowest. For a mature employee group, the normal cost would tend to be the same each year.

.14 The unit credit method is almost always used when the funding instrument is a group annuity contract and may also be used in trusteed plans and deposit administration contracts where the benefit is a stated amount per year of service. This method is not frequently used where the benefit is a fixed amount (for example, $100 per month) or where the current year's benefit is based on earnings of a future period.

Projected Benefit Cost Methods

.15 As explained above, the accrued benefit cost method (unit credit method) recognizes the cost of benefits only when they have accrued (in the limited sense that the employee service on which benefits are based has been rendered). By contrast, the projected benefit cost methods look forward. That is, they assign the entire cost of an employee's *projected* benefits to past, present and future periods. This is done in a manner not directly related to the

periods during which the service on which the benefits are based has been or will be rendered. The principal projected benefit cost methods are discussed below.

.16 *Entry age normal method.* Under the entry age normal method, the normal costs are computed on the assumption (1) that every employee entered the plan (thus, entry age) at the time of employment or at the earliest time he would have been eligible if the plan had been in existence and (2) that contributions have been made on this basis from the entry age to the date of the actuarial valuation. The contributions are the level annual amounts which, if accumulated at the rate of interest used in the actuarial valuation, would result in a fund equal to the present value of the pensions at retirement for the employees who survive to that time.

.17 Normal cost under this method is the level amount to be contributed for each year. When a plan is established after the company has been in existence for some time, past service cost under this method at the plan's inception date is theoretically the amount of the fund that would have been accumulated had annual contributions equal to the normal cost been made in prior years.

.18 In theory, the entry age normal method is applied on an individual basis. It may be applied, however, on an aggregate basis, in which case separate amounts are not determined for individual employees. Further variations in practice often encountered are (1) the use of an average entry age, (2) the use, particularly when benefits are based on employees' earnings, of a level percentage of payroll in determining annual payments and (3) the computation of past service cost as the difference between the present value of employees' projected benefits and the present value of the employer's projected normal cost contributions. In some plans, the normal cost contribution rate may be based on a stated amount per employee. In other plans the normal cost contribution itself may be stated as a flat amount.

.19 In valuations for years other than the initial year the past service cost may be frozen (that is, the unfunded amount of such cost is changed only to recognize payments and the effect of interest). Accordingly, actuarial gains and losses are spread into the future, entering into the normal

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cost for future years. If past service cost is not frozen, the unfunded amount includes the effects of actuarial gains and losses realized prior to the date of the valuation being made.

.20 The annual contribution under the entry age normal method ordinarily comprises (1) the normal cost and (2) an amount for past service cost. The latter may comprise only an amount equivalent to interest on the unfunded balance or may also include an amount intended to reduce the unfunded balance.

.21 The entry age normal method is often used with trusteed plans and deposit administration contracts.

.22 *Individual level premium method.* The individual level premium method assigns the cost of each employee's pension in level annual amounts, or as a level percentage of the employee's compensation, over the period from the inception date of a plan (or the date of his entry into the plan, if later) to his retirement date. Thus, past service cost is not determined separately but is included in normal cost.

.23 The most common use of the individual level premium method is with funding by individual insurance or annuity policies. It may be used, however, with trusteed plans and deposit administration contracts.

.24 In plans using individual annuity policies, the employer is protected against actuarial losses, since premiums paid are not ordinarily subject to retroactive increases. The insurance company may, however, pass part of any actuarial gains along to the employer by means of dividends. Employee turnover may be another source of actuarial gains under such insured plans, since all or part of the cash surrender values of policies previously purchased for employees leaving the employer for reasons other than retirement may revert to the company (or to the trust). Dividends and cash surrender values are ordinarily used to reduce the premiums payable for the next period.

.25 The individual level premium method generates annual costs which are initially very high and which ultimately drop to the level of the normal cost determined under the entry age normal method. The high initial costs

arise because the past service cost (although not separately identified) for employees near retirement when the plan is adopted is in effect amortized over a very short period.

.26 *Aggregate method.* The aggregate method applies on a collective basis the principle followed for individuals in the individual level premium method. That is, the entire unfunded cost of future pension benefits (including benefits to be paid to employees who have retired as of the date of the valuation) is spread over the average future service lives of employees who are active as of the date of the valuation. In most cases this is done by the use of a percentage of payroll.

.27 The aggregate method does not deal separately with past service cost (but includes such cost in normal cost). Actuarial gains and losses enter into the determination of the contribution rate and, consequently, are spread over future periods.

.28 Annual contributions under the aggregate method decrease, but the rate of decrease is less extreme than under the individual level premium method. The aggregate cost method amortizes past service cost (not separately identified) over the average future service lives of employees, thus avoiding the very short individual amortization periods of the individual level premium method.

.29 The aggregate method may be modified by introducing past service cost. If the past service cost is determined by the entry age normal method, the modified aggregate method is the same as the entry age normal method applied on the aggregate basis. If the past service cost is determined by the unit credit method, the modified aggregate method is called the attained age normal method (discussed below).

.30 The aggregate method is used principally with trusteed plans and deposit administration contracts.

.31 *Attained age normal method.* The attained age normal method is a variant of the aggregate method or individual level premium method in which past service cost, determined under the unit credit method, is recognized separately. The cost of each employee's benefits assigned to years after the inception of the plan is spread

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over the employee's future service life. Normal cost contributions under the attained age normal method, usually determined as a percentage of payroll, tend to decline but less markedly than under the aggregate method or the individual level premium method.

.32 As with the unit credit and entry age normal methods, the annual contribution for past service cost may comprise only an amount equivalent to interest on the unfunded balance or may also include an amount intended to reduce the unfunded balance.

.33 The attained age normal method is used with trusteed plans and deposit administration contracts.

Terminal Funding

.34 Under terminal funding, funding for future benefit payments is made only at the end of an employee's period of active service. At that time the employer either purchases a single-premium annuity which will provide the retirement benefit or makes an actuarially equivalent contribution to a trust. (Note—This method is not acceptable for determining the provision for pension cost under section 4063.)

The next page is 8571.

AC Section 4063B

Accounting for the Cost of Pension Plans—Appendix B

GLOSSARY

.01 **Accrue (Accrual).** When *accrue (accrual)* is used in accounting discussions in section 4063, it has the customary accounting meaning. When used in relation to actuarial terms or procedures, however, the intended meaning differs somewhat. When actuaries say that pension benefits, actuarial costs or actuarial liabilities have *accrued,* they ordinarily mean that the amounts are associated, either specifically or by a process of allocation, with years of employee service before the date of a particular valuation of a pension plan. Actuaries do not ordinarily intend their use of the word *accrue* to have the more conclusive accounting significance.

.02 **Accrued Benefit Cost Method.** An *actuarial cost method.* See section 4063A.

.03 **Actuarial Assumptions.** Factors which actuaries use in tentatively resolving uncertainties concerning future events affecting pension cost; for example, mortality rate, employee turnover, compensation levels, investment earnings, etc. See section 4063A.

.04 **Actuarial Cost Method.** A particular technique used by actuaries for establishing the amount and incidence of the annual actuarial cost of pension plan benefits, or benefits and expenses, and the related actuarial liability. Sometimes called *funding method.* See section 4063A.

.05 **Actuarial Gains (Losses).** The effects on actuarially calculated pension cost of (a) deviations between actual prior experience and the actuarial assumptions used or (b) changes in actuarial assumptions as to future events.

.06 **Actuarial Liability.** The excess of the present value, as of the date of a pension plan valuation, of pro-

spective pension benefits and administrative expenses over the sum of (1) the amount in the pension fund and (2) the present value of future contributions for normal cost determined by any of several actuarial cost methods. (Sometimes referred to as *unfunded actuarial liability.*)

.07 **Actuarial Valuation.** The process by which an actuary estimates the present value of benefits to be paid under a pension plan and calculates the amounts of employer contributions or accounting charges for pension cost. See section 4063A.

.08 **Actuarially Computed Value.** See *present value.*

.09 **Actuarially Computed Value of Vested Benefits.** See *vested benefits.*

.10 **Actuary.** There are no statutory qualifications required for actuaries. Membership in the American Academy of Actuaries, a comprehensive organization of the profession in the United States, is generally considered to be acceptable evidence of professional qualification.

.11 **Aggregate Method.** An *actuarial cost method.* See section 4063A.

.12 **Assumptions.** See *actuarial assumptions.*

.13 **Attained Age Normal Method.** An *actuarial cost method.* See section 4063A.

.14 **Benefits (Pension Benefits) (Retirement Benefits).** The pensions and any other payments to which employees or their beneficiaries may be entitled under a pension plan.

.15 **Contribute (Contribution).** When used in connection with a pension plan, *contribute* ordinarily is synonymous with pay.

.16 **Deferred Compensation Plan.** An arrangement whereby specified portions of the employee's compensation are payable in the form of retirement benefits.

.17 **Deferred Profit-Sharing Plan.** An arrangement whereby an employer provides for future retirement benefits for employees from specified portions of the earnings of the business; the benefits for each employee are usually the amounts which can be provided by accumulated amounts specifically allocated to him.

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.18 Defined-Benefit Plan. A pension plan stating the benefits to be received by employees after retirement, or the method of determining such benefits. The employer's contributions under such a plan are determined actuarially on the basis of the benefits expected to become payable.

.19 Defined-Contribution Plan. A pension plan which (a) states the benefits to be received by employees after retirement or the method of determining such benefits (as in the case of a defined-benefit plan) and (b) accompanies a separate agreement that provides a formula for calculating the employer's contributions (for example, a fixed amount for each ton produced or for each hour worked, or a fixed percentage of compensation). Initially, the benefits stated in the plan are those which the contributions expected to be made by the employer can provide. If later the contributions are found to be inadequate or excessive for the purpose of funding the stated benefits on the basis originally contemplated, either the contributions or the benefits, or both, may be subsequently adjusted. In one type of defined-contribution plan (money-purchase plan) the employer's contributions are determined for, and allocated with respect to, specific individuals, usually as a percentage of compensation; the benefits for each employee are the amounts which can be provided by the sums contributed for him.

.20 Deposit Administration Contract. A funding instrument provided by an insurance company under which amounts contributed by an employer are not identified with specific employees until they retire. When an employee retires, the insurance company issues an annuity which will provide the benefits stipulated in the pension plan and transfers the single premium for the annuity from the employer's accumulated contributions.

.21 Entry Age Normal Method. An *actuarial cost method.* See section 4063A.

.22 Fund. Used as a verb, *fund* means to pay over to a funding agency. Used as a noun, *fund* refers to assets accumulated in the hands of a funding agency for the purpose of meeting retirement benefits when they become due.

.23 **Funded.** The portion of pension cost that has been paid to a funding agency is said to have been *funded.*

.24 **Funding Agency.** An organization or individual, such as a specific corporate or individual trustee or an insurance company, which provides facilities for the accumulation of assets to be used for the payment of benefits under a pension plan; an organization, such as a specific life insurance company, which provides facilities for the purchase of such benefits.

.25 **Funding Method.** See *actuarial cost method.*

.26 **Individual Level Premium Method.** An *actuarial cost method.* See section 4063A.

.27 **Interest.** The return earned or to be earned on funds invested or to be invested to provide for future pension benefits. In calling the return *interest,* it is recognized that in addition to interest on debt securities the earnings of a pension fund may include dividends on equity securities, rentals on real estate, and realized and unrealized gains or (as offsets) losses on fund investments. See section 4063A.

.28 **Mortality Rate.** Death rate—the proportion of the number of deaths in a specified group to the number living at the beginning of the period in which the deaths occur. Actuaries use mortality tables, which show death rates for each age, in estimating the amount of future retirement benefits which will become payable. See section 4063A.

.29 **Normal Cost.** The annual cost assigned, under the actuarial cost method in use, to years subsequent to the inception of a pension plan or to a particular valuation date. See *past service cost, prior service cost.*

.30 **Past Service Cost.** Pension cost assigned, under the actuarial cost method in use, to years prior to the inception of a pension plan. See *normal cost, prior service cost.*

.31 **Pay-As-You-Go.** A method of recognizing pension cost only when benefits are paid to retired employees. (Note—This is not an acceptable method for accounting purposes under section 4063.)

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.32 **Pension Fund.** See *fund.*

.33 **Present Value (Actuarially Computed Value).** The current worth of an amount or series of amounts payable or receivable in the future. *Present value* is determined by discounting the future amount or amounts at a predetermined rate of interest. In pension plan valuations, actuaries often combine arithmetic factors representing probability (e.g., mortality, withdrawal, future compensation levels) with arithmetic factors representing discount (interest). Consequently, to actuaries, determining the present value of future pension benefits may mean applying factors of both types.

.34 **Prior Service Cost.** Pension cost assigned, under the actuarial cost method in use, to years prior to the date of a particular actuarial valuation. *Prior service cost* includes any remaining past service cost. See *normal cost, past service cost.*

.35 **Projected Benefit Cost Method.** A type of *actuarial cost method.* See section 4063A.

.36 **Provision (Provide).** An accounting term meaning a charge against income for an estimated expense, such as pension cost.

.37 **Service.** Employment taken into consideration under a pension plan. Years of employment before the inception of a plan constitute an employee's past service; years thereafter are classified in relation to the particular actuarial valuation being made or discussed. Years of employment (including past service) prior to the date of a particular valuation constitute prior service; years of employment following the date of the valuation constitute future service.

.38 **Terminal Funding.** An *actuarial cost method.* See section 4063A. (Note—This is not an acceptable *actuarial cost method* for accounting purposes under section 4063.)

.39 **Trust Fund Plan.** A pension plan for which the funding instrument is a trust agreement.

.40 **Turnover.** Termination of employment for a reason other than death or retirement. See *withdrawal,* section 4063A.

.41 Unit Credit Method. An *actuarial cost method.* See section 4063A.

.42 Valuation. See *actuarial valuation,* section 4063A.

.43 Vested Benefits. Benefits that are not contingent on the employee's continuing in the service of the employer. In some plans the payment of the benefits will begin only when the employee reaches the normal retirement date; in other plans the payment of the benefits will begin when the employee retires (which may be before or after the normal retirement date). The *actuarially computed value of vested benefits,* as used in section 4063, represents the present value, at the date of determination, of the sum of (a) the benefits expected to become payable to former employees who have retired, or who have terminated service with vested rights, at the date of determination; and (b) the benefits, based on service rendered prior to the date of determination, expected to become payable at future dates to present employees, taking into account the probable time that employees will retire, at the vesting percentages applicable at the date of determination. The determination of vested benefits is not affected by other conditions, such as inadequacy of the pension fund, which may prevent the employee from receiving the vested benefits.

.44 Withdrawal. The removal of an employee from coverage under a pension plan for a reason other than death or retirement. See *turnover.*

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AC Section 4063-1

Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974: An Interpretation of Section 4063

[Source: FASB Interpretation No. 3.]

December 1974

INTRODUCTION

.01 The Employee Retirement Income Security Act of 1974 (commonly referred to as the Pension Reform Act) became law on September 2, 1974. It is principally concerned with the funding of pension plans, the conditions for employee participation and for vesting of benefits, and the safeguarding of employees' pension rights. Pension plans adopted after January 1, 1974 are subject to the participation, vesting, and funding requirements of the Act for plan years beginning after September 2, 1974. Pension plans in existence on January 1, 1974 are not subject to those requirements until plan years beginning after December 31, 1975, unless earlier compliance is elected.

.02 The Financial Accounting Standards Board has analyzed the Act to determine whether there is a need to reconsider *APB Opinion No. 8* [section 4063] "Accounting for the Cost of Pension Plans." As a result of that analysis, the Board has placed the overall subject of pension accounting, including accounting and reporting by pension trusts, on its technical agenda. Pending completion of that project, the Board is issuing this Interpretation to clarify the accounting for the cost of pension plans covered by the Act.

INTERPRETATION

.03 A fundamental concept of *APB Opinion No. 8* [section 4063] is that the annual pension cost to be charged to expense for financial accounting purposes is not necessarily determined by the funding of a pension plan. Therefore, no change in the minimum and maximum limits for the annual provision for pension cost set forth in paragraph 17 of *APB Opinion No. 8* [section 4063.17] is required as a result of the Act. Compliance with the Act's participation, vesting, or funding requirements may result, however, in a change in the amount of pension cost to be charged to expense periodically for financial accounting

purposes even though no change in accounting methods is made. Paragraph 17 of *APB Opinion No. 8* [section 4063.17] requires that "the entire cost of benefit payments ultimately to be made should be charged against income subsequent to the adoption or amendment of a plan." Consistent with that requirement and within the minimum and maximum limits of paragraph 17 of *APB Opinion No. 8* [section 4063.17], any change in pension cost resulting from compliance with the Act shall enter into the determination of periodic provisions for pension expense *subsequent* to the date a plan becomes subject to the Act's participation, vesting, and funding requirements. That date will be determined either by the effective dates prescribed by the Act or by an election of earlier compliance with the requirements of the Act.

.04 If, *prior* to the date a plan becomes subject to the Act's participation, vesting, and funding requirements, it appears likely that compliance will have a significant effect in the future on the amount of an enterprise's (a) periodic provision for pension expense, (b) periodic funding of pension costs, or (c) unfunded vested benefits, this fact and an estimate of the effect shall be disclosed in the notes to the financial statements.[1]

.05 Based on an analysis of information presently available, the Board does not believe that the Act creates a legal obligation for unfunded pension costs that warrants accounting recognition as a liability pursuant to paragraph 18 of *APB Opinion No. 8* [section 4063.18] except in the following two respects. First, an enterprise with a plan subject to the Act must fund a minimum amount annually unless a waiver is obtained from the Secretary of the Treasury. If a waiver is not obtained, the amount currently required to be funded shall be recognized as a liability by a charge to pension expense for the period, by a deferred charge, or by a combination of both, whatever is appropriate under *APB Opinion No. 8* [section 4063]. Second, in the event of the termination of a pension plan, the Act imposes a liability on an enterprise. When there is convincing evidence that a pension plan will be terminated, evidenced perhaps by a formal commitment by management to terminate the plan, and the liability on termination will exceed fund assets and related prior accruals, the excess liability shall be accrued. If the amount of the excess liability cannot be reasonably determined, disclosure of the circumstances shall be made in the notes to the financial statements, including an estimate of the possible range of the liability.

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[1] The Board recognizes that actuarial computations or other information may not be available in time to permit disclosure of an estimate of the effect in notes to financial statements for fiscal periods ending in 1974 or early in 1975. If an estimate cannot be furnished, an explanation shall be provided.

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EFFECTIVE DATE

.06 This Interpretation shall be effective on December 31, 1974.

The next page is 8601.

AC Section 4064

Deferred Compensation Contracts

[Source: APB Opinion No. 12, Pars. 6-8.]

Effective for fiscal periods beginning after December 31, 1967, unless otherwise indicated

.01 Section 4063, *Accounting for the Cost of Pension Plans,* applies to deferred compensation contracts with individual employees if such contracts, taken together, are equivalent to a pension plan. The Board believes that other deferred compensation contracts should be accounted for individually on an accrual basis. Such contracts customarily include certain requirements such as continued employment for a specified period and availability for consulting services and agreements not to compete after retirement, which, if not complied with, remove the employer's obligations for future payments. The estimated amounts[1] to be paid under each contract should be accrued in a systematic and rational manner over the period of active employment from the time the contract is entered into, unless it is evident that future services expected to be received by the employer are commensurate with the payments or a portion of the payments to be made. If elements of both current and future services are present, only the portion applicable to the current services should be accrued.

.02 Some deferred compensation contracts provide for periodic payments to employees or their surviving spouses for life with provisions for a minimum lump-sum settlement in the event of the early death of one or all of the beneficiaries. The estimated amount[1] of future payments to be made under such contracts should be accrued over the period of active employment from the time the contract is entered into. Such estimates should be based on the life expectancy of each individual concerned (based on the most

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[1] The amounts to be accrued periodically should result in an accrued amount at the end of the term of active employment which is not less than the then present value of the estimated payments to be made.

recent mortality tables available) or on the estimated cost of an annuity contract rather than on the minimum payable in the event of early death.

.03 At the effective date of this section, amounts[2] pertaining to deferred compensation contracts with employees actively employed, which amounts have not been accrued in a manner consistent with the provisions of the section, should be accrued over the employee's remaining term of active employment. For purposes of transition, these amounts may be accrued over a period of up to ten years if the remaining term of active employment is less than ten years.

The next page is 8651.

[2] See footnote 1.

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AC Section 4071

Depreciation and High Costs[1]

[Source: ARB No. 43, Chap. 9A.]

Issue date, unless otherwise indicated: June, 1953

.01 In December, 1947, the committee issued Accounting Research Bulletin No. 33, dealing with the subject of depreciation and high costs. In October, 1948, it published a letter to the membership reaffirming the opinion expressed in the bulletin.

.02 The subject is one of continuing importance. The committee once more expresses its approval of the basic conclusions asserted in both publications, but in view of the many requests received for further consideration of various aspects of the problem has placed the subject on its agenda for further study.

.03 Accounting Research Bulletin No. 33 read as follows:

.04 "The American Institute of Accountants committee on accounting procedure has given extensive consideration to the problem of making adequate provision for the replacement of plant facilities in view of recent sharp increases in the price level. The problem requires consideration of charges against current income for depreciation of facilities acquired at lower price levels.

.05 "The committee recognizes that business management has the responsibility of providing for replacement of plant and machinery. It also recognizes that, in reporting profits today, the cost of material and labor is reflected in terms of 'inflated' dollars while the cost of productive facilities in which capital was invested at a lower price level is reflected in terms of dollars whose purchasing power was much greater. There is no doubt that in considering depreciation in connection with product costs, prices, and business policies, management must take into consideration the probability that plant and machinery will have to be

[1] See section 1071, *Financial Statements Restated for General Price-Level Changes.*

replaced at costs much greater than those of the facilities now in use.

.06 "When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels.

.07 "It has been suggested in some quarters that the problem be met by increasing depreciation charges against current income. The committee does not believe that this is a satisfactory solution at this time. It believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level. An attempt to recognize current prices in providing depreciation, to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps, there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.

.08 "It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time.

.09 "The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels. However, the committee calls attention to the fact that plants expected to have less than normal useful life can properly be depreciated on a systematic basis related to economic usefulness."

.10 The letter of October 14, 1948, was addressed to the members of the Institute and read as follows:

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.11 "The committee on accounting procedure has reached the conclusion that no basic change in the accounting treatment of depreciation of plant and equipment is practicable or desirable under present conditions to meet the problem created by the decline in the purchasing power of the dollar.

.12 "The committee has given intensive study to this problem and has examined and discussed various suggestions which have been made to meet it. It has solicited and considered hundreds of opinions on this subject expressed by businessmen, bankers, economists, labor leaders, and others. While there are differences of opinion, the prevailing sentiment in these groups is against any basic change in present accounting procedures. The committee believes that such a change would confuse readers of financial statements and nullify many of the gains that have been made toward clearer presentation of corporate finances.

.13 "Should inflation proceed so far that original dollar costs lose their practical significance, it might become necessary to restate all assets in terms of the depreciated currency, as has been done in some countries. But it does not seem to the committee that such action should be recommended now if financial statements are to have maximum usefulness to the greatest number of users.

.14 "The committee, therefore, reaffirms the opinion it expressed in Accounting Research Bulletin No. 33, December, 1947.

.15 "Any basic change in the accounting treatment of depreciation should await further study of the nature and concept of business income.

.16 "The immediate problem can and should be met by financial management. The committee recognizes that the common forms of financial statements may permit misunderstanding as to the amount which a corporation has available for distribution in the form of dividends, higher wages, or lower prices for the company's products. When prices have risen appreciably since original investments in plant and facilities were made, a substantial proportion of net income as currently reported must be reinvested in the business in order to maintain assets at the same level of productivity at the end of a year as at the beginning.

.17 "Stockholders, employees, and the general public should be informed that a business must be able to retain out of profits amounts sufficient to replace productive facilities at current prices if it is to stay in business. The committee therefore gives its full support to the use of supplementary financial schedules, explanations or footnotes by which management may explain the need for retention of earnings."

→ *The next page is 8671.* ←

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AC Section 4072

Depreciation on Appreciation

[Source: APB Opinion No. 6, Par. 17.]

Effective for fiscal periods beginning after December 31, 1965, unless otherwise indicated

.01 The Board is of the opinion that property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity. This statement is not intended to change accounting practices followed in connection with quasi-reorganizations [1] or reorganizations. This statement may not apply to foreign operations under unusual conditions such as serious inflation or currency devaluation. However, when the accounts of a company with foreign operations are translated into United States currency for consolidation, such write-ups normally are eliminated. Whenever appreciation has been recorded on the books, income should be charged with depreciation computed on the written up amounts.

The next page is 8681.

[1] See section 5581, Quasi-Reorganization or Corporate Readjustment.

AC Section 4073

Emergency Facilities— Depreciation and Amortization

[Source: ARB No. 43, Chap. 9C, as amended.]

Issue date, unless otherwise indicated: June, 1953 [1]

CERTIFICATES OF NECESSITY

.01 Section 124A of the Internal Revenue Code, which was added by the Revenue Act of 1950, provides for the issuance of certificates of necessity under which all or part of the cost of so-called *emergency facilities* may be amortized over a period of 60 months for income tax purposes. In many cases, the amounts involved are material, and companies are faced with the problem of deciding whether to adopt the 60-month period over which the portions of the cost of the facilities covered by certificates of necessity may be amortized for income tax purposes as the period over which they are to be depreciated in the accounts.

.02 Thinking on this question apparently has become confused because many so-called *percentage certificates* have been issued covering less than the entire cost of the facility. This fact, together with the fact that the probable economic usefulness of the facility after the close of the five-year amortization period is considered by the certifying authority in determining the percentage covered by these certificates, has led many to believe that the percentage used represents the government's conclusion as to the proportion of the cost of the facility that is not expected to have usefulness at the end of five years.

.03 In some cases, it is apparent that the probable lack of economic usefulness of the facility after the close of the amortization period must constitute the principal if not the sole basis for determining the percentage to be

[1] The material included in this section is from ARB 43, Chapter 9, Section C. Paragraphs 11-13 of that Bulletin were superseded by APB Opinion No. 11, effective for fiscal periods beginning after December 31, 1967.

included in the certificate. However, it must be recognized that the certifying authority has acted under orders to give consideration also to a variety of other factors to the end that the amount certified may be the minimum amount necessary to secure expansion of industrial capacity in the interest of national defense during the emergency period. Among the factors required to be considered in the issuance of these certificates, in addition to loss of useful value, are (a) character of business, (b) extent of risk assumed (including the amount and source of capital employed, and the potentiality of recovering capital or retiring debt through tax savings or pricing), (c) assistance to small business and promotion of competition, (d) compliance with government policies (e.g., dispersal for security), and (e) other types of incentives provided by government, such as direct government loans, guaranties, and contractual arrangements.

DEPRECIATION CONSIDERATIONS

.04 The argument has been advanced from time to time that, since the portion of the cost of properties covered by certificates of necessity is amortized over a five-year period for income tax purposes, it is necessary to follow the same procedure in the accounts. Sound financial accounting procedures do not necessarily coincide with the rules as to what shall be included in "gross income," or allowed as a deduction therefrom, in arriving at taxable net income. It is well recognized that such rules should not be followed for financial accounting purposes if they do not conform to generally accepted accounting principles. However, where the results obtained from following income tax procedures do not materially differ from those obtained where generally accepted accounting principles are followed, there are practical advantages in keeping the accounts in agreement with the income tax returns.

.05 The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute

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the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.

.06 The committee is of the opinion that from an accounting standpoint there is nothing inherent in the nature of emergency facilities which requires the depreciation or amortization of their cost for financial accounting purposes over either a shorter or a longer period than would be proper if no certificate of necessity had been issued. Estimates of the probable useful life of a facility by those best informed in the matter may indicate either a shorter or a longer life than the statutory 60-month period over which the certified portion of its cost is deductible for income tax purposes.

.07 In determining the proper amount of annual depreciation with respect to emergency facilities for financial accounting purposes, it must be recognized that a great many of these facilities are being acquired primarily for what they can produce during the emergency period. To whatever extent it is reasonable to expect the useful economic life of a facility to end with the close of the amortization period, the cost of the facility is a proper cost of operation during that period.

.08 In determining the prospective usefulness of such facilities it will be necessary to consider their adaptability to post-emergency use, the effect of their use upon economic utilization of other facilities, the possibility of excessive costs due to expedited construction or emergency conditions, and the fact that no deductions for depreciation of the certified portion will be allowable for income tax purposes in the post-amortization years if the company elects to claim the amortization deduction. The purposes for which emergency facilities are acquired in a great many cases are such as to leave major uncertainties as to the extent of their use during the amortization period and as to their subsequent usefulness—uncertainties which are not normally encountered in the acquisition and use of operating facilities.

.09 Consideration of these factors, the committee believes, will in many cases result in the determination of de-

preciation charges during the amortization period in excess of the depreciation that would be appropriate if these factors were not involved. Frequently they will be so compelling as to indicate the need for recording depreciation of the cost of emergency facilities in the accounts in conformity with the amortization deductions allowable for income tax purposes. However, the committee believes that when the amount allowed as amortization for income tax purposes is materially different from the amount of the estimated depreciation, the latter should be used for financial accounting purposes.[2]

.10 In some cases, certificates of necessity cover facilities which the owner expects to use after the emergency period in lieu of older facilities. As a result the older facilities may become unproductive and obsolete before they are fully depreciated on the basis of their previously expected life. In such situations, the committee believes depreciation charges to income should be determined in relation to the total properties, to the end that sound depreciation accounting may be applied to the property accounts as a whole.

The next page is 8691.

[2] See section 4091.

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AC Section 4074

Declining-Balance Depreciation

[Source: ARB No. 44 (Revised), as amended.]

Issue date, unless otherwise indicated: July, 1958[1]

.01 The declining-balance method of estimating periodic depreciation has a long history of use in England and in other countries including, to a limited extent, the United States. Interest in this method has been increased by its specific recognition for income tax purposes in the Internal Revenue Code of 1954.

.02 The declining-balance method is one of those which meets the requirements of being "systematic and rational."[2] In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance method may well provide the most satisfactory allocation of cost. The conclusions of this section also apply to other methods, including the "sum-of-the-years-digits" method, which produce substantially similar results.

.03 When a change to the declining-balance method is made for general accounting purposes, and depreciation is a significant factor in the determination of net income, the change in method, including the effect thereof, should be disclosed in accordance with section 1051, *Accounting Changes*. [As amended, effective for fiscal periods beginning after July 31, 1971 by APB Opinion No. 20.]

.04 There may be situations in which the declining-balance method is adopted for income tax purposes but other appropriate methods are used for financial accounting purposes. In such cases, accounting recognition should be given to deferred income taxes (see definition in section

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[1] The material included in this section is partially from ARB 44 (Revised). Paragraphs 7 and 10 of that Bulletin were superseded by APB Opinion No. 11, effective for fiscal periods beginning after December 31, 1967.

[2] Accounting Terminology Bulletin No. 1, paragraph 56.

4091.34), if the amounts thereof are material, except in the cases mentioned in paragraph .07, where there are special circumstances which may make such procedure inappropriate. The foregoing provision as to accounting recognition of deferred income taxes applies to a single asset, or to a group of assets which are expected to be retired from service at about the same time; in this case an excess of depreciation taken for income tax purposes during the earlier years would be followed by the opposite condition in later years, and there would be a tax deferment for a definite period. It applies also to a group of assets consisting of numerous units which may be of differing lengths of life and which are expected to be continually replaced; in this case an excess of depreciation taken for income tax purposes during the earlier years would be followed in later years by substantial equality between the annual depreciation for income tax purposes and that for accounting purposes, and a tax deferment would be built up during the earlier years which would tend to remain relatively constant thereafter. It applies further to a gradually expanding plant; in this case an excess of depreciation taken for income tax purposes may exist each year during the period of expansion in which event there would be a tax deferment which might increase as long as the period of expansion continued. [As amended, effective for fiscal periods beginning after December 31, 1967, by APB Opinion No. 11.]

.05 Where it may reasonably be presumed that the accumulative difference between taxable income and financial income will continue for a long or indefinite period, it is not appropriate to recognize the related tax effect as additional amortization or depreciation applicable to such assets in recognition of the loss of future deductibility for income tax purposes. [As amended, effective for fiscal periods beginning after December 31, 1967, by APB Opinion No. 11.]

DISCUSSION

.06 Following the passage of the Internal Revenue Act of 1954 in August of that year, permitting the use of declining-balance and similar accelerated depreciation methods for federal income tax purposes, the committee anticipated that many companies would be considering whether such methods should be adopted for general ac-

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counting purposes. In October of that year, Accounting Research Bulletin No. 44 was issued in which the committee stated that such accelerated methods met the requirement of being "systematic and rational." The committee also stated that when such methods were adopted for general accounting purposes, appropriate disclosure of the change should be made whenever depreciation was a significant factor in the determination of net income. (Refer to section 1051, *Accounting Changes.*)

.07 Many regulatory authorities permit recognition of deferred income taxes for accounting and/or rate-making purposes, whereas some do not. The committee believes that they should permit the recognition of deferred income taxes for both purposes. However, where charges for deferred income taxes are not allowed for rate-making purposes, accounting recognition need not be given to the deferment of taxes if it may reasonably be expected that increased future income taxes, resulting from the earlier deduction of declining-balance depreciation for income tax purposes only, will be allowed in future rate determinations.

.08 When a company subject to rate-making processes adopts the declining-balance method of depreciation for income tax purposes but adopts other appropriate methods for financial accounting purposes in the circumstances described in paragraph .07, and does not give accounting recognition to deferred income taxes, disclosure should be made of this fact. [As amended, effective for fiscal periods beginning after December 31, 1965, by APB Opinion No. 6.]

The next page is 8751.

AC Section 4081

Accounting for Real and Personal Property Taxes

[Source: ARB No. 43, Chap. 10A, as amended.]

Issue date, unless otherwise indicated: June, 1953

.01 The purpose of this section is to draw attention to the problems involved in accounting for real and personal property taxes and to present some of the considerations which enter into a determination of their accounting treatment.

LEGAL LIABILITY FOR PROPERTY TAXES AND TREATMENT FOR INCOME TAX PURPOSES

.02 Unlike excise, income, and social security taxes, which are directly related to particular business events, real and personal property taxes are based upon the assessed valuation of property (tangible and intangible) as of a given date, as determined by the laws of a state or other taxing authority. For this reason the legal liability for such taxes is generally considered as accruing at the moment of occurrence of some specific event, rather than over a period of time. Whether such legal accrual should determine the accounting treatment is a question to be discussed later. Tax laws, opinions of attorneys, income tax regulations, and court decisions have mentioned various dates on which certain property taxes are said to accrue legally. Among them are the following:

(a) Assessment date,
(b) Beginning of taxing authority's fiscal year,
(c) End of taxing authority's fiscal year,
(d) Date on which tax becomes a lien on the property,
(e) Date tax is levied,
(f) Date or dates tax is payable,
(g) Date tax becomes delinquent,
(h) Tax period appearing on tax bill.

.03 Most of the foregoing dates are mentioned in tax laws. In a given case several of these dates may coincide.

.04 The date to be applied in a particular case necessarily requires reference to the law and court decisions of the state concerned. Where the matter has been litigated, it has often been held that property taxes become a liability at the point of time when they become a lien. The general rule, however, is that such taxes accrue as of the date on which they are assessed. The position of the Bureau of Internal Revenue is that generally property taxes accrue on the assessment date, even if the amount of the tax is not determined until later.

.05 A practical aspect of the legal liability for property taxes must be considered when title to property is transferred during the taxable year. As stated above, the assessment date generally determines accrual. But as between vendor and vendee, the Supreme Court[1] has laid down the rule that the lien date, or the date of personal obligation, controls and that where a transfer occurs after either of those dates, the purchaser is not entitled to deduct the taxes for income-tax purposes.

.06 Adjustments on account of property taxes paid or accrued are frequently incorporated in agreements covering the sale of real estate, which determine the question for the individual case as between the buyer and seller, though they are not necessarily controlling for income tax purposes.

.07 Although pro-rata accrual of property taxes has been permitted by some courts, the generally accepted rule seems to be that such taxes accrue in a lump sum on one date and not ratably over the year.

ACCOUNTING FOR PROPERTY TAXES

Accrual Accounting

.08 Accounting questions arise as to (1) when the liability for real and personal property taxes should be recorded on the books of a taxpayer keeping his accounts on the accrual basis and (2) the amounts to be charged against the income of respective periods. Here again, the decision is influenced by the particular circumstances of each tax. Such terms as *assessment date* and *levy date* vary in meaning in the different jurisdictions; and while there is sufficient agreement about assessment date to furn-

[1] Magruder v. Supplee, 316 U. S. 394 (1942). [Ed. Note: Subsequent changes in tax law are not indicated in this Reporter.]

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ish a basis for the general legal rule already mentioned, it does not necessarily follow that the legal rule should determine the accounting treatment.

.09 Determination of the liability for the tax often proceeds by degrees, the several steps being taken at appreciable intervals of time. For example, while it is known that the owner of real property is liable, with respect to each tax period, for a tax on property owned on the assessment date, the amount of the tax may not be fixed until much later. There is sometimes reluctance toward recording liabilities of indeterminate amount, especially such items as property taxes, and a preference for recording them when the amount can be computed with certainty. While this consideration is one which occasionally leads to the mention of taxes in footnotes as contingent liabilities, the inability to determine the exact amount of taxes is in itself no justification for failure to recognize an existing tax liability.

.10 In practice, real and personal property taxes have been charged against the income of various periods, as indicated below:

(a) Year in which paid (cash basis),
(b) Year ending on assessment (or lien) date,
(c) Year beginning on assessment (or lien) date,
(d) Calendar or fiscal year of taxpayer prior to assessment (or lien) date,
(e) Calendar or fiscal year of taxpayer including assessment (or lien) date,
(f) Calendar or fiscal year of taxpayer prior to payment date,
(g) Fiscal year of governing body levying the tax,
(h) Year appearing on tax bill.

.11 Some of these periods may coincide, as when the fiscal year of the taxing body and that of the taxpayer are the same. The charge to income is sometimes made in full at one time, sometimes ratably on a monthly basis, sometimes on the basis of prior estimates, adjusted during or after the period.

.12 The various periods mentioned represent varying degrees of conservatism in accrual accounting. Some jus-

tification may be found for each usage, but all the circumstances relating to a particular tax must be considered before a satisfactory conclusion is reached.

.13 Consistency of application from year to year is the important consideration and selection of any of the periods mentioned is a matter for individual judgment.

Basis Considered Most Acceptable

.14 Generally, the most acceptable basis of providing for property taxes is monthly accrual on the taxpayer's books during the fiscal period of the taxing authority for which the taxes are levied. The books will then show, at any closing date, the appropriate accrual or prepayment.

.15 It may be argued that the entire amount of tax should logically be accrued by the lien date. Advocates of this procedure vary from those who would accrue the tax by charges to income during the year ending on the lien date, to those who urge setting up the full tax liability on the lien date and charging the amount thereof to income during the subsequent year. However, the basis described in the preceding paragraph is held by the majority of accountants to be practical and satisfactory so long as it is consistently followed.

TREATMENT IN FINANCIAL STATEMENTS

Balance Sheet

.16 An accrued liability for real and personal property taxes, whether estimated or definitely known, should be included among the current liabilities. Where estimates are subject to a substantial measure of uncertainty the liability should be described as estimated.

Income Statement

.17 While it is sometimes proper to capitalize in property accounts the amount of real estate taxes applicable to property which is being developed for use or sale, these taxes are generally regarded as an expense of doing business. They may be (a) charged to operating expenses; (b) shown as a separate deduction from income; or (c) distributed among the several accounts to which they are deemed to apply, such as factory overhead, rent income, and selling or general expenses.

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.18 In condensed income statements appearing in published reports, the amounts of real and personal property taxes, however charged in the accounts, are rarely shown separately. They are frequently combined with other taxes but not with taxes on income.

.19 Since the liability for property taxes must frequently be estimated at the balance-sheet date, it is often necessary to adjust the provision for taxes of a prior year when their amount has been ascertained. These adjustments should be made through the income statement, either in combination with the current year's provision or as a separate item. [As amended, effective for fiscal periods beginning after December 31, 1966, by APB Opinion No. 9.] [As amended, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.]

The next page is 8791.

AC Section 4091

Accounting for Income Taxes

[Source: APB Opinion No. 11, as amended.]

Effective for fiscal periods beginning after December 31, 1967, unless otherwise indicated

INTRODUCTION

.01 This section sets forth the Board's conclusions on some aspects of accounting for income taxes. These conclusions include significant modifications of views previously expressed by the Committee on Accounting Procedure and by the Board.

.02 *Discounting.* The Board's Opinion on "Tax Allocation Accounts—Discounting," as expressed in section 4092, continues in effect pending further study of the broader aspects of discounting as it is related to financial accounting in general.

.03 *Investment Credits.* The Board is continuing its study on accounting for "Investment Credits" and intends to issue a new Opinion on the subject as soon as possible. In the meantime section 4094, *Accounting for the Investment Credit,* remains in effect.

.04 Certain aspects of tax allocation, including illustrations of procedures and an extended discussion of alternative approaches to allocation, are presented in Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes,* by Homer A. Black, published by the American Institute of Certified Public Accountants in 1966.[1] The Board has considered the Study and the comments received on it. The conclusions in this section vary in some important respects from those reached in the Study.

APPLICABILITY

.05 This section applies to financial statements which purport to present financial position and results of operations in conformity with generally accepted accounting

[1] Accounting Research Studies are not statements of this Board, or of the Institute, but are published for the purpose of stimulating discussion on important accounting issues.

principles. It does not apply (a) to regulated industries in those circumstances where the standards described in section 6011 (which remains in effect) are met and (b) to special areas requiring further study as specifically indicated in paragraphs .37-.40 of this section. The Board has deferred consideration of the special problems of allocation among components of a business enterprise pending further study and the issuance of Opinions on the applicability of generally accepted accounting principles to these statements. (As amended, effective after December 31, 1973, by APB Opinion No. 28.) (See section 2071.)

.06 The Board emphasizes that this section, as in the case of all other sections, is not intended to apply to immaterial items.

SUMMARY OF PROBLEMS

.07 The principal problems in accounting for income taxes arise from the fact that some transactions [2] affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income and income taxes payable in a different reporting period. The amount of income taxes determined to be payable for a period does not, therefore, necessarily represent the appropriate income tax expense applicable to transactions recognized for financial accounting purposes in that period. A major problem is, therefore, the measurement of the tax effects of such transactions and the extent to which the tax effects should be included in income tax expense in the same periods in which the transactions affect pretax accounting income.

.08 The United States Internal Revenue Code permits a "net operating loss" of one period to be deducted in determining taxable income of other periods. This leads to the question of whether the tax effects of an operating loss should be recognized for financial accounting purposes in the period of loss or in the periods of reduction of taxable income.

.09 Certain items includable in taxable income receive special treatment for financial accounting purposes, even though the items are reported in the same period in which

[2] The term *transactions* refers to all transactions and other events requiring accounting recognition. As used in this section, it relates either to individual events or to groups of similar events.

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they are reported for tax purposes. A question exists, therefore, as to whether the tax effects attributable to extraordinary items, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other stockholders' equity accounts should be associated with the particular items for financial reporting purposes.[3]

.10 Guidelines are needed for balance sheet and income statement presentation of the tax effects of timing differences, operating losses and similar items.

SUMMARY OF CONCLUSIONS

.11 The Board's conclusions on some of the problems in accounting for income taxes are summarized as follows:

a. Interperiod tax allocation is an integral part of the determination of income tax expense, and income tax expense should include the tax effects of revenue and expense transactions included in the determination of pretax accounting income.

b. Interperiod tax allocation procedures should follow the deferred method,[4] both in the manner in which tax effects are initially recognized and in the manner in which deferred taxes are amortized in future periods.

c. The tax effects of operating loss carry*backs* should be allocated to the loss periods. The tax effects of operating loss carry*forwards* [5] usually should not be recognized until the periods of realization.

d. Tax allocation within a period should be applied to obtain fair presentation of the various components of results of operations.

e. Financial statement presentations of income tax expense and related deferred taxes should disclose (1) the composition of income tax expense as between amounts currently payable and amounts representing tax effects allocable to the period and (2) the classification of deferred taxes into a net current amount and a net noncurrent amount.

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[3] See sections 2010, 2012 and 2014.

[4] See paragraph .18.

[5] The term "loss carry*forwards*" is used in this section to mean "loss carryovers" as referred to in the United States Internal Revenue Code.

DEFINITIONS AND CONCEPTS

.12 Terminology relating to the accounting for income taxes is varied; some terms have been used with different meanings. Definitions of certain terms used in this section are therefore necessary.

a. *Income taxes.* Taxes based on income determined under provisions of the United States Internal Revenue Code and foreign, state and other taxes (including franchise taxes) based on income.

b. *Income tax expense.* The amount of income taxes (whether or not currently payable or refundable) allocable to a period in the determination of net income.

c. *Pretax accounting income.* Income or loss for a period, exclusive of related income tax expense.

d. *Taxable income.* The excess of revenues over deductions or the excess of deductions over revenues to be reported for income tax purposes for a period.[6]

e. *Timing differences.* Differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or "turn around" in one or more subsequent periods. Some timing differences reduce income taxes that would otherwise be payable currently; others increase income taxes that would otherwise be payable currently.

f. *Permanent differences.* Differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or "turn around" in other periods.[7]

g. *Tax effects.* Differentials in income taxes of a period attributable to (1) revenue or expense transactions which enter into the determination of pretax accounting income in one period and into the deter-

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[6] For the purposes of this definition "deductions" do not include reductions in taxable income arising from net operating loss carry*backs* or carry*forwards*.

[7] See paragraph .32.

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mination of taxable income in another period, (2) deductions or credits that may be carried backward or forward for income tax purposes and (3) adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts which enter into the determination of taxable income in a period but which do not enter into the determination of pretax accounting income of that period. A permanent difference does not result in a "tax effect" as that term is used in this Opinion.

h. *Deferred taxes.* Tax effects which are deferred for allocation to income tax expense of future periods.

i. *Interperiod tax allocation.* The process of apportioning income taxes among periods.

j. *Tax allocation within a period.* The process of apportioning income tax expense applicable to a given period between income before extraordinary items and extraordinary items, and of associating the income tax effects of adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts with these items.

.13 Certain general concepts and assumptions are recognized by the Board to be relevant in considering the problems of accounting for income taxes.

a. The operations of an entity subject to income taxes are expected to continue on a going concern basis, in the absence of evidence to the contrary, and income taxes are expected to continue to be assessed in the future.

b. Income taxes are an expense of business enterprises earning income subject to tax.

c. Accounting for income tax expense requires measurement and identification with the appropriate time period and therefore involves accrual, deferral and estimation concepts in the same manner as these concepts are applied in the measurement and time period identification of other expenses.

d. Matching is one of the basic processes of income determination; essentially it is a process of deter-

mining relationships between costs (including reductions of costs) and (1) specific revenues or (2) specific accounting periods. Expenses of the current period consist of those costs which are identified with the revenues of the current period and those costs which are identified with the current period on some basis other than revenue. Costs identifiable with future revenues or otherwise identifiable with future periods should be deferred to those future periods. When a cost cannot be related to future revenues or to future periods on some basis other than revenues, or it cannot reasonably be expected to be recovered from future revenues, it becomes, by necessity, an expense of the current period (or of a prior period).

TIMING DIFFERENCES

Discussion

Nature of Timing Differences

.14 Four types of transactions are identifiable which give rise to timing differences; that is, differences between the periods in which the transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income.[8] Each timing difference originates in one period and reverses in one or more subsequent periods.

a. Revenues or gains are included in taxable income later than they are included in pretax accounting income. For example, gross profits on installment sales are recognized for accounting purposes in the period of sale but are reported for tax purposes in the period the installments are collected.

b. Expenses or losses are deducted in determining taxable income later than they are deducted in determining pretax accounting income. For example, estimated costs of guarantees and of product warranty contracts are recognized for accounting purposes in the current period but are reported for tax purposes in the period paid or in which the liability becomes fixed.

[8] Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes,* pages 2-3 and 8-10.

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c. Revenues or gains are included in taxable income earlier than they are included in pretax accounting income. For example, rents collected in advance are reported for tax purposes in the period in which they are received but are deferred for accounting purposes until later periods when they are earned.

d. Expenses or losses are deducted in determining taxable income earlier than they are deducted in determining pretax accounting income. For example, depreciation is reported on an accelerated basis for tax purposes but is reported on a straight-line basis for accounting purposes.

Additional examples of each type of timing difference are presented in Appendix A to this section (section 4091A).

.15 The timing differences of revenue and expense transactions entering into the determination of pretax accounting income create problems in the measurement of income tax expense for a period, since the income taxes payable for a period are not always determined by the same revenue and expense transactions used to determine pretax accounting income for the period. The amount of income taxes determined to be payable for a period does not, therefore, necessarily represent the appropriate income tax expense applicable to transactions recognized for financial accounting purposes in that period.

.16 Interperiod tax allocation procedures have been developed to account for the tax effects of transactions which involve timing differences. Interperiod allocation of income taxes results in the recognition of tax effects in the same periods in which the related transactions are recognized in the determination of pretax accounting income.

Differing Viewpoints

.17 Interpretations of the nature of timing differences are diverse, with the result that three basic methods of interperiod allocation of income taxes have developed and been adopted in practice. The three concepts and their applications are described and evaluated in Chapters 2, 3 and 4 of *Accounting Research Study No. 9*. A brief description of each method follows.

.18 Interperiod tax allocation under the *deferred method* is a procedure whereby the tax effects of current

timing differences are deferred currently and allocated to income tax expense of future periods when the timing differences reverse. The deferred method emphasizes the tax effects of timing differences on income of the period in which the differences originate. The deferred taxes are determined on the basis of the tax rates in effect at the time the timing differences originate and are not adjusted for subsequent changes in tax rates or to reflect the imposition of new taxes. The tax effects of transactions which reduce taxes currently payable are treated as deferred credits; the tax effects of transactions which increase taxes currently payable are treated as deferred charges. Amortization of these deferred taxes to income tax expense in future periods is based upon the nature of the transactions producing the tax effects and upon the manner in which these transactions enter into the determination of pretax accounting income in relation to taxable income.

.19 Interperiod tax allocation under the *liability method* is a procedure whereby the income taxes expected to be paid on pretax accounting income are accrued currently. The taxes on components of pretax accounting income may be computed at different rates, depending upon the period in which the components were, or are expected to be, included in taxable income. The differences between income tax expense and income taxes payable in the periods in which the timing differences originate are either liabilities for taxes payable in the future or assets for prepaid taxes. The estimated amounts of future tax liabilities and prepaid taxes are computed at the tax rates expected to be in effect in the periods in which the timing differences reverse. Under the liability method the initial computations are considered to be tentative and are subject to future adjustment if tax rates change or new taxes are imposed.

.20 Interperiod tax allocation under the *net of tax method* is a procedure whereby the tax effects (determined by either the deferred or liability methods) of timing differences are recognized in the valuation of assets and liabilities and the related revenues and expenses. The tax effects are applied to reduce specific assets or liabilities on the basis that tax deductibility or taxability are factors in their valuation.

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.21 In addition to the different methods of applying interperiod tax allocation, differing views exist as to the extent to which interperiod tax allocation should be applied in practice.

.22 Some transactions result in differences between pretax accounting income and taxable income which are permanent[9] because under applicable tax laws and regulations the current differences will not be offset by corresponding differences in later periods. Other transactions, however, result in differences between pretax accounting income and taxable income which reverse or turn around in later periods; these differences are classified broadly as timing differences. The tax effects of certain timing differences often are offset in the reversal or turnaround period by the tax effects of similar differences originating in that period. Some view these differences as essentially the same as permanent differences because, in effect, the periods of reversal are indefinitely postponed. Others believe that differences which originate in a period and differences which reverse in the same period are distinguishable phases of separate timing differences and should be considered separately.

.23 In determining the accounting recognition of the tax effects of timing differences, the first question is whether there should be any tax allocation. One view holds that interperiod tax allocation is never appropriate. Under this concept, income tax expense of a period equals income taxes payable for that period. This concept is based on the presumption that income tax expense of a period should be measured by the amount determined to be payable for that period by applying the laws and regulations of the governmental unit, and that the amount requires no adjustment or allocation. This concept has not been used widely in practice and is not supported presently to any significant extent.

.24 The predominant view holds that interperiod tax allocation is appropriate. However, two alternative concepts exist as to the extent to which it should be applied: partial allocation and comprehensive allocation.

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[9] See paragraph .32.

Partial Allocation

.25 Under partial allocation the general presumption is that income tax expense of a period for financial accounting purposes should be the tax payable for the period. Holders of this view believe that when recurring differences between taxable income and pretax accounting income give rise to an indefinite postponement of an amount of tax payments or to continuing tax reductions, tax allocation is not required for these differences. They believe that amounts not reasonably expected to be payable to, or recoverable from, a government as taxes should not affect net income. They point out in particular that the application of tax allocation procedures to tax payments or recoveries which are postponed indefinitely involves contingencies which are at best remote and thus, in their opinion, may result in an overstatement or understatement of expenses with consequent effects on net income. An example of a recurring difference not requiring tax allocation under this view is the difference that arises when a company having a relatively stable or growing investment in depreciable assets uses straight-line depreciation in determining pretax accounting income but an accelerated method in determining taxable income. If tax allocation is applied by a company with large capital investments coupled with growth in depreciable assets (accentuated in periods of inflation) the resulting understatement of net income from using tax allocation is magnified.

.26 Holders of the view expressed in paragraph .25 believe that the only exceptions to the general presumption stated therein should be those instances in which specific nonrecurring differences between taxable income and pretax accounting income would lead to a material misstatement of income tax expense and net income. If such nonrecurring differences occur, income tax expense of a period for financial accounting purposes should be increased (or decreased) by income tax on differences between taxable income and pretax accounting income provided the amount of the increase (or decrease) can be reasonably expected to be paid as income tax (or recovered as a reduction of income taxes) within a relatively short period not exceeding, say, five years. An example would be an isolated install-

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ment sale of a productive facility in which the gross profit is reported for financial accounting purposes at the date of sale and for tax purposes when later collected. Thus, tax allocation is applicable only when the amounts are reasonably certain to affect the flow of resources used to pay taxes in the near future.

.27 Holders of this view state that comprehensive tax allocation, as opposed to partial allocation, relies on the so-called "revolving" account approach which seems to suggest that there is a similarity between deferred tax accruals and other balance sheet items, like accounts payable, where the individual items within an account turn over regularly although the account balance remains constant or grows. For these other items, the turnover reflects actual, specific transactions—goods are received, liabilities are recorded and payments are subsequently made. For deferred tax accruals on the other hand, no such transactions occur—the amounts are not owed to anyone; there is no specific date on which they become payable, if ever; and the amounts are at best vague estimates depending on future tax rates and many other uncertain factors. Those who favor partial allocation suggest that accounting deals with actual events, and that those who would depart from the fact of the tax payment should show that the modification will increase the usefulness of the reports to management, investors or other users. To do this requires a demonstration that the current lower (or higher) tax payments will result in higher (or lower) cash outflows for taxes within a span of time that is of significant interest to readers of the financial statements.

Comprehensive Allocation

.28 Under comprehensive allocation, income tax expense for a period includes the tax effects of transactions entering into the determination of pretax accounting income for the period even though some transactions may affect the determination of taxes payable in a different period. This view recognizes that the amount of income taxes payable for a given period does not necessarily measure the appropriate income tax expense related to transactions for that period. Under this view, income tax expense encompasses any accrual, deferral or estimation

necessary to adjust the amount of income taxes payable for the period to measure the tax effects of those transactions included in pretax accounting income for that period. Those supporting comprehensive allocation believe that the tax effects of initial timing differences should be recognized and that the tax effects should be matched with or allocated to those periods in which the initial differences reverse. The fact that when the initial differences reverse other initial differences may offset any effect on the amount of taxable income does not, in their opinion, nullify the fact of the reversal. The offsetting relationships do not mean that the tax effects of the differences cannot be recognized and measured. Those supporting comprehensive allocation state that the makeup of the balances of certain deferred tax amounts "revolve" as the related differences reverse and are replaced by similar differences. These initial differences do reverse, and the tax effects thereof can be identified as readily as can those of other timing differences. While new differences may have an offsetting effect, this does not alter the fact of the reversal; without the reversal there would be different tax consequences. Accounting principles cannot be predicated on reliance that offsets will continue. Those supporting comprehensive allocation conclude that the fact that the tax effects of two transactions happen to go in opposite directions does not invalidate the necessity of recognizing separately the tax effects of the transactions as they occur.

.29 Under comprehensive allocation, material tax effects are given recognition in the determination of income tax expense, and the tax effects are related to the periods in which the transactions enter into the determination of pretax accounting income. The tax effects so determined are allocated to the future periods in which the differences between pretax accounting income and taxable income reverse. Those supporting this view believe that comprehensive allocation is necessary in order to associate the tax effects with the related transactions. Only by the timely recognition of such tax effects is it possible to associate the tax effects of transactions with those transactions as they enter into the determination of net income. The need exists to recognize the tax effects of initial differences because only by doing so will the income tax expense in

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the periods of initial differences include the tax effects of transactions of those periods.

.30 Those who support comprehensive allocation believe that the partial allocation concept in stressing cash outlays represents a departure from the accrual basis of accounting. Comprehensive allocation, in their view, results in a more thorough and consistent association in the matching of revenues and expenses, one of the basic processes of income determination.

.31 These differences in viewpoint become most significant with respect to the tax effects of transactions of a recurring nature—for example, depreciation of machinery and equipment using the straight-line method for financial accounting purposes and an accelerated method for income tax purposes. Under partial allocation the tax effects of these timing differences would not be recognized under many circumstances; under comprehensive allocation the tax effects would be recognized beginning in the periods of the initial timing differences. Under partial allocation, the tax effects of these timing differences would not be recognized so long as it is assumed that similar timing differences would arise in the future creating tax effects at least equal to the reversing tax effects of the previous timing differences. Thus, under partial allocation, so long as the amount of deferred taxes is estimated to remain fixed or to increase, no need exists to recognize the tax effects of the initial differences because they probably will not "reverse" in the foreseeable future. Under comprehensive allocation tax effects are recognized as they occur.

Permanent Differences

.32 Some differences between taxable income and pretax accounting income are generally referred to as permanent differences. Permanent differences arise from statutory provisions under which specified revenues are exempt from taxation and specified expenses are not allowable as deductions in determining taxable income. (Examples are interest received on municipal obligations and premiums paid on officers' life insurance.) Other permanent differences arise from items entering into the determination of taxable income which are not components of pretax accounting income

in any period. (Examples are the special deduction for certain dividends received and the excess of statutory depletion over cost depletion.)

Opinion

.33 The Board has considered the various concepts of accounting for income taxes and has concluded that comprehensive interperiod tax allocation is an integral part of the determination of income tax expense. Therefore, income tax expense should include the tax effects of revenue and expense transactions included in the determination of pretax accounting income. The tax effects of those transactions which enter into the determination of pretax accounting income either earlier or later than they become determinants of taxable income should be recognized in the periods in which the differences between pretax accounting income and taxable income arise and in the periods in which the differences reverse. Since permanent differences do not affect other periods, interperiod tax allocation is not appropriate to account for such differences.

.34 The Board has concluded that the deferred method[10] of tax allocation should be followed since it provides the most useful and practical approach to interperiod tax allocation and the presentation of income taxes in financial statements.

.35 The tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income. The resulting income tax expense for the period includes the tax effects of transactions entering into the determination of results of operations for the period. The resulting deferred tax amounts reflect the tax effects which will reverse in future periods. The measurement of income tax expense becomes thereby a consistent and integral part of the process of matching revenues and expenses in the determination of results of operations.

.36 In computing the tax effects referred to in paragraph .35 timing differences may be considered individually or similar timing differences may be grouped. The net

[10] See paragraph .18.

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change in deferred taxes for a period for a group of similar timing differences may be determined on the basis of either (a) a combination of amounts representing the tax effects arising from timing differences originating in the period at the current tax rates and reversals of tax effects arising from timing differences originating in prior periods at the applicable tax rates reflected in the accounts as of the beginning of the period; or (b) if the applicable deferred taxes have been provided in accordance with this section on the cumulative timing differences as of the beginning of the period, the amount representing the tax effects at the current tax rates of the net change during the period in the cumulative timing differences. If timing differences are considered individually, or if similar timing differences are grouped, no recognition should be given to the reversal of tax effects arising from timing differences originating prior to the effective date of this section unless the applicable deferred taxes have been provided for in accordance with this section, either during the periods in which the timing differences originated or, retroactively, as of the effective date of this section. The method or methods adopted should be consistently applied.

Special Areas Requiring Further Study

[.37] [Superseded, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 23.] (See section 4095.)

[.38] [Superseded, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 23.] (See section 4095.)

[.39] [Superseded, effective for financial statements issued on or after December 1, 1975, by FASB Statement No. 9.] (See section 4097.)

[.40] [Superseded, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 23.] (See section 4095.)

OPERATING LOSSES

Discussion

.41 An operating loss arises when, in the determination of taxable income, deductions exceed revenues. Under

applicable tax laws and regulations, operating losses of a period may be carried backward or forward for a definite period of time to be applied as a reduction in computing taxable income, if any, in those periods. When an operating loss is so applied, pretax accounting income and taxable income (after deducting the operating loss carry*back* or carry*forward*) will differ for the period to which the loss is applied.

.42 If operating losses are carried backward to earlier periods under provisions of the tax law, the tax effects of the loss carry*backs* are included in the results of operations of the loss period, since realization is assured. If operating losses are carried forward under provisions of the tax law, the tax effects usually are not recognized in the accounts until the periods of realization, since realization of the benefits of the loss carry*forwards* generally is not assured in the loss periods. The only exception to that practice occurs in unusual circumstances when realization is assured beyond any reasonable doubt in the loss periods. Under an alternative view, however, the tax effects of loss carry*forwards* would be recognized in the loss periods unless specific reasons exist to question their realization.

Opinion

.43 The tax effects of any realizable loss carry*backs* should be recognized in the determination of net income (loss) of the loss periods. The tax loss gives rise to a refund (or claim for refund) of past taxes, which is both measurable and currently realizable; therefore the tax effect of

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the loss is properly recognizable in the determination of net income (loss) for the loss period. Appropriate adjustments of existing net deferred tax credits may also be necessary in the loss period.

.44 The tax effects of loss carry*forwards* also relate to the determination of net income (loss) of the loss periods. However, a significant question generally exists as to realization of the tax effects of the carry*forwards,* since realization is dependent upon future taxable income. Accordingly, the Board has concluded that the tax benefits of loss carry*forwards* should not be recognized until they are actually realized, except in unusual circumstances when realization is *assured beyond any reasonable doubt* at the time the loss carry*forwards* arise. When the tax benefits of loss carry*forwards* are not recognized until realized in full or in part in subsequent periods, the tax benefits should be reported in the results of operations of those periods as extraordinary items.[11]

.45 In those rare cases in which realization of the tax benefits of loss carry*forwards* is assured beyond any reasonable doubt, the potential benefits should be associated with the periods of loss and should be recognized in the determination of results of operations for those periods. Realization is considered to be assured beyond any reasonable doubt when conditions such as those set forth in paragraph .46 are present. (Also see paragraph .47.) The amount of the asset (and the tax effect on results of operations) recognized in the loss period should be computed at the rates expected [12] to be in effect at the time of realization. If the applicable tax rates change from those used to measure the tax effect at the time of recognition, the effect of the rate change should be accounted for in the period of the change as an adjustment of the asset account and of income tax expense.

[11] See section 2012.07, *Reporting the Results of Operations.*

[12] The rates referred to here are those rates which, at the time the loss carry *forward* benefit is recognized for financial accounting purposes, have been enacted to apply to appropriate future periods.

.46 Realization of the tax benefit of a loss carry*forward* would appear to be assured beyond any reasonable doubt when both of the following conditions exist: (a) the loss results from an identifiable, isolated and nonrecurring cause and the company either has been continuously profitable over a long period or has suffered occasional losses which were more than offset by taxable income in subsequent years, and (b) future taxable income is virtually certain to be large enough to offset the loss carry*forward* and will occur soon enough to provide realization during the carry*forward* period.

.47 Net deferred tax credits arising from timing differences may exist at the time loss carry*forwards* arise. In the usual case when the tax effect of a loss carry*forward* is not recognized in the loss period, adjustments of the existing net deferred tax credits may be necessary in that period or in subsequent periods. In this situation net deferred tax credits should be eliminated to the extent of the lower of (a) the tax effect of the loss carry*forward,* or (b) the amortization of the net deferred tax credits that would otherwise have occurred during the carry*forward* period. If the loss carry*forward* is realized in whole or in part in periods subsequent to the loss period, the amounts eliminated from the deferred tax credit accounts should be reinstated (at the then current tax rates) on a cumulative basis as, and to the extent that, the tax benefit of the loss carry*forward* is realized. In the unusual situation in which the tax effect of a loss carry*forward* is recognized as an asset in the loss year,[13] the deferred tax credit accounts would be amortized in future periods as indicated in paragraph .18.

.48 The tax effects of loss carry*forwards* of purchased subsidiaries (if not recognized by the subsidiary prior to purchase) should be recognized as assets at the date of purchase only if realization is assured beyond any reasonable doubt. Otherwise they should be recognized only when the tax benefits are actually realized and should be re-

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[13] See paragraph .45.

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corded as retroactive adjustments[14] of the purchase transactions and treated in accordance with the procedures described in section 1091.88. Retroactive adjustments of results of operations for the periods subsequent to purchase may also be necessary if the balance sheet items affected have been subject to amortization in those periods.

.49 Tax effects of loss carry*forwards* arising prior to a quasi-reorganization (including for this purpose the application of a deficit in retained earnings to contributed capital) should, if not previously recognized, be recorded as assets at the date of the quasi-reorganization only if realization is assured beyond any reasonable doubt. If not previously recognized and the benefits are actually realized at a later date, the tax effects should be added to contributed capital because the benefits are attributable to the loss periods prior to the quasi-reorganization.

TAX ALLOCATION WITHIN A PERIOD

Discussion

.50 The need for tax allocation within a period arises because items included in the determination of taxable income may be presented for accounting purposes as (a) extraordinary items, (b) adjustments of prior periods (or of the opening balance of retained earnings) or (c) as direct entries to other stockholders' equity accounts.

Opinion

.51 The Board has concluded that tax allocation within a period should be applied to obtain an appropriate relationship between income tax expense and (a) income before extraordinary items, (b) extraordinary items, (c) adjustments of prior periods (or of the opening balance of retained earnings) and (d) direct entries to other stockholders' equity accounts. The income tax expense attributable to income before extraordinary items is computed by determining the income tax expense related to revenue and expense transactions entering into the determination of such income, without giving effect to the tax consequences of the items excluded from the determination of income before extraordinary items. The income tax ex-

[14] See section 2010, *Reporting the Results of Operations.*

pense attributable to other items is determined by the tax consequences of transactions involving these items. If an operating loss exists before extraordinary items, the tax consequences of such loss should be associated with the loss.

OTHER UNUSED DEDUCTIONS AND CREDITS

Opinion

.52 The conclusions of this section, including particularly the matters discussed in paragraphs .41-.49 on tax reductions resulting from operating losses, also apply to other unused deductions and credits for tax purposes that may be carried backward or forward in determining taxable income (for example, capital losses, contribution carryovers, and foreign tax credits).

FINANCIAL REPORTING

Discussion

Balance Sheet

.53 Interperiod tax allocation procedures result in the recognition of several deferred tax accounts. Classification of deferred taxes in the balance sheet has varied in practice, with the accounts reported, alternatively, as follows:

a. *Separate current and noncurrent amounts.* In this form of presentation all balance sheet accounts resulting from income tax allocation are classified into four separate categories—current assets, noncurrent assets, current liabilities and noncurrent liabilities.

b. *Net current and net noncurrent amounts.* In this form of presentation all balance sheet accounts resulting from income tax allocation are classified into two categories—net current amount and net noncurrent amount.

c. *Single amount.* In this form of presentation all balance sheet accounts resulting from income tax allocation are combined in a single amount.

d. *Net of tax presentation.* Under this approach each balance sheet tax allocation account (or portions thereof) is reported as an offset to, or a valuation of, the asset or liability that gave rise to the tax effect. Net of tax presentation is an extension of a valuation concept and treats the tax effects as valu-

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ation adjustments of the related assets and liabilities.

Income Statement

.54 Interperiod tax allocation procedures result in income tax expense generally different from the amount of income tax payable for a period. Three alternative approaches have developed for reporting income tax expense:

a. *Combined amount.* In this presentation income tax expense for the period is reported as a single amount, after adjustment of the amount of income taxes payable for the period for the tax effects of those transactions which had different effects on pretax accounting income and on taxable income. This form of presentation emphasizes that income tax expense for the period is related to those transactions entering into the determination of pretax accounting income.

b. *Combined amount plus disclosure (or two or more separate amounts).* In this presentation the amount of income taxes reported on the tax return is considered significant additional information for users of financial statements. The amount of taxes payable (or the effect of tax allocation for the period) is, therefore, disclosed parenthetically or in a note to the financial statements. Alternatively, income tax expense may be disclosed in the income statement by presenting separate amounts—the taxes payable and the effects of tax allocation.

c. *''Net of tax'' presentation.* Under the ''net of tax'' concept the tax effects recognized under interperiod tax allocation are considered to be valuation adjustments to the assets or liabilities giving rise to the adjustments. For example, depreciation deducted for tax purposes in excess of that recognized for financial accounting purposes is held to reduce the future utility of the related asset because of a loss of a portion of future tax deductibility. Thus, depreciation expense, rather than income tax expense, is adjusted for the tax effect of the difference between the depreciation amount used in the determination of taxable income and

that used in the determination of pretax accounting income.

Opinion

Balance Sheet

.55 Balance sheet accounts related to tax allocation are of two types:

a. Deferred charges and deferred credits relating to timing differences; and

b. Refunds of past taxes or offsets to future taxes arising from the recognition of tax effects of carry*backs* and carry*forwards* of operating losses and similar items.

.56 Deferred charges and deferred credits relating to timing differences represent the cumulative recognition given to their tax effects and as such do not represent receivables or payables in the usual sense. They should be classified in two categories—one for the net current amount and the other for the net noncurrent amount. This presentation is consistent with the customary distinction between current and noncurrent categories and also recognizes the close relationship among the various deferred tax accounts, all of which bear on the determination of income tax expense. The current portions of such deferred charges and credits should be those amounts which relate to assets and liabilities classified as current. Thus, if installment receivables are a current asset, the deferred credits representing the tax effects of uncollected installment sales should be a current item; if an estimated provision for warranties is a current liability, the deferred charge representing the tax effect of such provision should be a current item.

.57 Refunds of past taxes or offsets to future taxes arising from recognition of the tax effects of operating loss carry*backs* or carry*forwards* should be classified either as current or noncurrent. The current portion should be determined by the extent to which realization is expected to occur during the current operating cycle as defined in section 2031.

.58 Deferred taxes represent tax effects recognized in the determination of income tax expense in current and

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prior periods, and they should, therefore, be excluded from retained earnings or from any other account in the stockholders' equity section of the balance sheet.

Income Statement

.59 In reporting the results of operations the components of income tax expense for the period should be disclosed, for example:

a. Taxes estimated to be payable

b. Tax effects of timing differences

c. Tax effects of operating losses.

These amounts should be allocated to (a) income before extraordinary items and (b) extraordinary items and may be presented as separate items in the income statement or, alternatively, as combined amounts with disclosure of the components parenthetically or in a note to the financial statements.

.60 When the tax benefit of an operating loss carry*forward* is realized in full or in part in a subsequent period, and has not been previously recognized in the loss period, the tax benefit should be reported as an extraordinary item [15] in the results of operations of the period in which realized.

.61 Tax effects attributable to adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts should be presented as adjustments of such items with disclosure of the amounts of the tax effects.[15]

General

.62 Certain other disclosures should be made in addition to those set forth in paragraphs .55-.61:

a. Amounts of any operating loss carry*forwards* not recognized in the loss period, together with expiration dates (indicating separately amounts which, upon recognition, would be credited to deferred tax accounts);

b. Significant amounts of any other unused deductions or credits, together with expiration dates; and

c. Reasons for significant variations in the customary relationships between income tax expense and pre-

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[15] See section 2012.07, *Reporting the Results of Operations.*

tax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

The Board recommends that the nature of significant differences between pretax accounting income and taxable income be disclosed.

.63 The "net of tax" form of presentation of the tax effects of timing differences should not be used for financial reporting. The tax effects of transactions entering into the determination of pretax accounting income for one period but affecting the determination of taxable income in a different period should be reported in the income statement as elements of income tax expense and in the balance sheet as deferred taxes and not as elements of valuation of assets or liabilities.

EFFECTIVE DATE

.64 This section shall be effective for all fiscal periods that begin after December 31, 1967. However, the Board encourages earlier application of the provisions of this section.

.65 Accordingly, the tax allocation procedures set forth in this section should be applied to timing differences occurring after the effective date. (See paragraph .36 for treatment of timing differences originating prior to the effective date.) Balance sheet accounts which arose from interperiod tax allocation and accounts stated on a net of tax basis prior to the effective date of this section should be presented in the manner set forth in this section.

.66 The Board recognizes that companies may apply this section retroactively to periods prior to the effective date to obtain comparability in financial presentations for the current and future periods. If the procedures are applied retroactively, they should be applied to all material items of those periods insofar as the recognition of prior period tax effects of timing differences, operating losses and other deductions or credits is concerned. Any adjustments made to give retroactive effect to the conclusions stated in this section should be considered adjustments of prior periods and treated accordingly.[16]

→ *The next page is 8831.* ←

[16] See section 2010, *Reporting the Results of Operations.*

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AC Section 4091 A

Accounting for Income Taxes— Appendix A

EXAMPLES OF TIMING DIFFERENCES

.01 The following examples of timing differences are taken from Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes,* by Homer A. Black, pages 8-10. They are furnished for illustrative purposes only without implying approval by the Board of the accounting practices described.

.02 (A) *Revenues or gains are taxed after accrued for accounting purposes:*

Profits on installment sales are recorded in accounts at date of sale and reported in tax returns when later collected.

Revenues on long-term contracts are recorded in accounts on percentage-of-completion basis and reported in tax returns on a completed-contract basis.

Revenue from leasing activities is recorded in a lessor's accounts based on the financing method of accounting and exceeds rent less depreciation reported in tax returns in the early years of a lease.

Earnings of foreign subsidiary companies are recognized in accounts currently and included in tax returns when later remitted.

.03 (B) *Expenses or losses are deducted for tax purposes after accrued for accounting purposes:*

Estimated costs of guarantees and product warranty contracts are recorded in accounts at date of sale and deducted in tax returns when later paid.

Expenses for deferred compensation, profit-sharing, bonuses, and vacation

and severance pay are recorded in accounts when accrued for the applicable period and deducted in tax returns when later paid.

Expenses for pension costs are recorded in accounts when accrued for the applicable period and deducted in tax returns for later periods when contributed to the pension plan.

Current expenses for self-insurance are recorded in accounts based on consistent computations for the plan and deducted in tax returns when losses are later incurred.

Estimated losses on inventories and purchase commitments are recorded in accounts when reasonably anticipated and deducted in tax returns when later realized.

Estimated losses on disposal of facilities and discontinuing or relocating operations are recorded in accounts when anticipated and determinable and deducted in tax returns when losses or costs are later incurred.

Estimated expenses of settling pending lawsuits and claims are recorded in accounts when reasonably ascertainable and deducted in tax returns when later paid.

Provisions for major repairs and maintenance are accrued in accounts on a systematic basis and deducted in tax returns when later paid.

Depreciation recorded in accounts exceeds that deducted in tax returns in early years because of:

accelerated method of computation for accounting purposes

shorter lives for accounting purposes

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Organization costs are written off in accounts as incurred and amortized in tax returns.

.04 (C) *Revenues or gains are taxed before accrued for accounting purposes:*

Rent and royalties are taxed when collected and deferred in accounts to later periods when earned.

Fees, dues, and service contracts are taxed when collected and deferred in accounts to later periods when earned.

Profits on intercompany transactions are taxed when reported in separate returns, and those on assets remaining within the group are eliminated in consolidated financial statements.

Gains on sales of property leased back are taxed at date of sale and deferred in accounts and amortized during the term of lease.

Proceeds of sales of oil payments or ore payments are taxed at date of sale and deferred in accounts and recorded as revenue when produced.

.05 (D) *Expenses or losses are deducted for tax purposes before accrued for accounting purposes:*

Depreciation deducted in tax returns exceeds that recorded in accounts in early years because of:

accelerated method of computation for tax purposes

shorter guideline lives for tax purposes

amortization of emergency facilities under certificates of necessity

Unamortized discount, issue cost and redemption premium on bonds refunded are deducted in tax returns and deferred and amortized in accounts.

Research and developments costs are deducted in tax returns when incurred and deferred and amortized in accounts.

Interest and taxes during construction are deducted in tax returns when incurred and included in the cost of assets in accounts.

Preoperating expenses are deducted in tax returns when incurred and deferred and amortized in accounts.

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AC Section 4091-1

Applicability of Indefinite Reversal Criteria to Timing Differences: An Interpretation of Sections 4091 and 4095

[Source: FASB Interpretation No. 22.]

April 1978

INTRODUCTION AND BACKGROUND INFORMATION

.01 The FASB has been asked to clarify whether the indefinite reversal criteria described in *APB Opinion No. 23* [section 4095], "Accounting for Income Taxes—Special Areas," are applicable beyond the four special areas addressed by that Opinion, for example, in connection with the costs of railroad gradings and tunnel bores that are reported differently for financial statement purposes and income tax purposes.

.02 Paragraph 13 of *APB Opinion No. 11* [section 4091.12], "Accounting for Income Taxes," defines differences between taxable income and pretax accounting income as either timing differences or permanent differences and provides criteria for distinguishing between the differences. Timing differences are "differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or 'turn around' in one or more subsequent periods." Permanent differences are "differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or 'turn around' in other periods." Opinion No. 11 [section 4091] recognizes five special areas with unique aspects in which reversal of the tax consequences of some timing differences may be indefinite and defers any conclusion as to whether interperiod tax allocation should be required in those areas. The five special areas are:

a. Undistributed earnings of subsidiaries.
b. Intangible development costs in the oil and gas industry.
c. "General reserves" of stock savings and loan associations.
d. Amounts designated as "policyholders' surplus" by stock life insurance companies.
e. Deposits in statutory reserve funds by United States steamship companies.

Except for those special areas, Opinion No. 11 [section 4091] requires interperiod income tax allocation under the comprehensive allocation view adopted in the Opinion for timing differences.

.03 *APB Opinion No. 23* [section 4095] addresses three of the special areas identified in *APB Opinion No. 11* [section 4091]: undistributed earnings of subsidiaries,[1] "general reserves" of stock savings and loan associations, and amounts designated as "policyholders' surplus" by stock life insurance companies and also addresses undistributed earnings of corporate joint ventures. Opinion No. 23 [section 4095] concludes that because of special provisions of the United States Internal Revenue Code that are unique to the four special areas addressed, an enterprise might postpone indefinitely the payment of income taxes on certain differences between pretax accounting income and taxable income that would otherwise require tax allocation for financial reporting purposes. The Opinion further indicates that an enterprise must take specific action for income tax purposes before taxes on those timing differences become payable and the taxes may never become payable unless the enterprise takes those actions. However, if circumstances indicate that the enterprise is likely to pay taxes on those differences, either currently or in later years because of known or expected actions, income taxes should be accrued as tax expense of the current period. Further, the Opinion indicates that there is a presumption that interperiod income tax allocation applies to timing differences in the four special areas addressed even though the presumption may be overcome in each case.

.04 Paragraphs 5 and 6 of *APB Opinion No. 23* [section 4095.05-.06] discuss permanent and timing differences. Paragraph 6 [section 4095.06] states:

> A timing difference arises when the initial difference between taxable income and pretax accounting income originates in one period and predictably reverses or turns around in one or more subsequent periods. The reversal of a timing difference at some future date is definite and the period of reversal is generally predictable within reasonable limits. Sometimes, however, reversal of a difference cannot be predicted because the events that create the tax consequences are controlled by the taxpayer and frequently require that the taxpayer take specific action before the initial difference reverses.

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[1] Footnote 2 of Opinion No. 23 [section 4095.09] states that the conclusions on undistributed earnings of a subsidiary also apply to the portion of the earnings of a Domestic International Sales Corporation (DISC) that is eligible for tax deferral.

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Some have suggested that the discussion of timing differences in Opinion No. 23 [section 4095] amends the definition of timing differences in *APB Opinion No. 11* [section 4091] (see paragraph .02 above).

.05 *APB Opinion No. 24* [section 4096], "Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)," which was issued concurrently with *APB Opinion No. 23* [section 4095], requires tax allocation for an investor's equity in the undistributed earnings of an investee other than a subsidiary or corporate joint venture, both of which are addressed by Opinion No. 23 [section 4095].

.06 *FASB Statement No. 19* [section 6021], "Financial Accounting and Reporting by Oil and Gas Producing Companies," which supersedes *FASB Statement No. 9* [section 4097], "Accounting for Income Taxes—Oil and Gas Producing Companies," addresses income tax allocation for intangible development costs in the oil and gas industry. Statement No. 19 [section 6021] requires comprehensive interperiod income tax allocation by oil and gas producing companies and prohibits "interaction" of book/tax timing differences (see paragraphs 60-62 and 260-264 of that Statement [sections 6021.060-.062 and 6021.260-.264]).

.07 This Interpretation does not modify *APB Opinion No. 17* [section 5141], "Intangible Assets," or the AICPA Industry Audit Guide, "Audits of Stock Life Insurance Companies." This Interpretation does not apply to deposits in capital construction funds or statutory reserve funds by United States steamship companies, for which *APB Opinions No. 11* [section 4091] and *23* [section 4095] did not reach a conclusion as to whether interperiod tax allocation should be required.

.08 The Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit'," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process" and discusses the application of generally accepted accounting principles to regulated industries. Accordingly, the provisions of the Addendum shall govern the application of this Interpretation to those operations of a company that are regulated for rate-making purposes on an individual-company-cost-of-service basis.

.09 Although *APB Opinion No. 23* [section 4095] discusses criteria for identifying a special category of timing differences

involving indefinite reversal, it carefully limited the application of those criteria to specified transactions and only under certain circumstances. The Board believes that Opinion No. 23 [section 4095] was not intended to establish general criteria applicable beyond the specified areas. The Board recognizes that the income tax benefits resulting from amortization and depreciation of railroad gradings and tunnel bores, and possibly other transactions, have characteristics that might be considered similar in some respects to the four special areas addressed in Opinion No. 23 [section 4095]. However, the Board is engaged in other studies which may lead to a comprehensive reexamination of tax allocation concepts and believes that it should not reopen the matter of tax allocation at this time or extend the range of exceptions to *APB Opinion No. 11* [section 4091]. Accordingly, the Board reaffirms the applicability of Opinion No. 11 [section 4091], which requires comprehensive interperiod tax allocation for timing differences unless specifically exempted by other APB Opinions or FASB Statements.

INTERPRETATION

.10 *APB Opinion No. 23* [section 4095] acknowledges that reversal of some timing differences cannot be predicted because of special provisions in the tax law that allow a taxpayer to control the events that control the tax consequences in certain areas. Opinion No. 23 [section 4095] does not require interperiod tax allocation for timing differences in the four special areas addressed in that Opinion except in specified circumstances, and the indefinite reversal criteria of that Opinion apply only to the four special areas addressed. *APB Opinion No. 11* [section 4091] as amended to date requires interperiod tax allocation under the comprehensive allocation view adopted in that Opinion except for the four special areas addressed in Opinion No. 23 [section 4095] and for the areas described in paragraph .07 of this Interpretation.

.11 The income tax benefits resulting from amortization and depreciation of railroad gradings and tunnel bores for income tax reporting purposes are timing differences for which comprehensive interperiod income tax allocation is required. The provisions of *APB Opinion No. 23* [section 4095] do not apply to those timing differences.

EFFECTIVE DATE AND TRANSITION

.12 The provisions of this Interpretation shall be applied prospectively for timing differences occurring in fiscal years beginning after June 15, 1978. Timing differences that result

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from depreciation or amortization reported in fiscal years beginning after June 15, 1978, shall be subject to the provisions of this Interpretation. Earlier application is encouraged in financial statements for fiscal years beginning before June 16, 1978, that have not been previously issued.

.13 If early application is adopted in financial reports for interim periods of a fiscal year beginning before June 16, 1978, previously issued financial information for any interim periods of that fiscal year that precede the period of adoption shall be restated to give effect to the provisions of this Interpretation and any subsequent presentation of that information shall be on the restated basis.

The next page is 8861.

AC Section 4092

Tax Allocation Accounts—Discounting

[Source: APB Opinion No. 10, Par. 6.]

Effective for fiscal periods beginning after December 31, 1966, unless otherwise indicated

.01 Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes,*[1] deals with the allocation of income taxes among accounting periods when revenues and expenses are reported for financial accounting purposes in different periods than they are for income tax purposes. The Board is presently giving attention to this general subject with a view to issuing an Opinion on it.[2] One of the questions now being considered is whether certain long-term tax allocation accounts should be determined on a discounted basis as recommended in the Study. Pending further consideration of this subject and the broader aspects of discounting as it is related to financial accounting in general and until the Board reaches a conclusion on this subject, it is the Board's opinion that, except for applications existing on the exposure date of this section (September 26, 1966) with respect to transactions consummated prior to that date, deferred taxes should not be accounted for on a discounted basis.

The next page is 8881.

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[1] Accounting Research Studies are not statements of this Board or of the American Institute of Certified Public Accountants, but are published for the purpose of stimulating discussion on important accounting issues.

[2] APB Opinion No. 11 was issued effective for fiscal periods beginning after December 31, 1967. See section 4091.

AC Section 4093

New Depreciation Guidelines and Rules

[Source: APB Opinion No. 1, as amended.]

Issue date, unless otherwise indicated: November, 1962

.01 Accounting problems may arise in connection with the Depreciation Guidelines and Rules issued by the United States Treasury Department Internal Revenue Service as Revenue Procedure 62-21, effective July 12, 1962. [As amended, effective for fiscal periods beginning after December 31, 1967, by APB Opinion No. 11.]

.02 The service lives suggested in the Guidelines for broad classes of depreciable assets are, in general, appreciably shorter than the individual lives given in Bulletin "F," which was previously used as a guide in the determination of deductible depreciation for income tax purposes. The Guidelines purport to bring the lives used for income tax purposes into line with the actual experience of taxpayers, and thereby reduce the areas of controversy as to the amount of deductible depreciation, but not to provide another type of accelerated depreciation.

.03 For the first three years, either the new Guideline lives, or lives longer than the Guideline lives, may be used for income tax purposes without challenge. Lives shorter than those found in the Guidelines may be used if they have previously been established or are justifiable as reflecting the taxpayer's existing or intended retirement and replacement practices. If the "reserve ratio" tests provided in the Procedure subsequently indicate that the lives used for income tax purposes are not in accordance with actual retirement and replacement practices, the lives may be lengthened in accordance with the "life adjustment" tables provided in the Procedure. If the adjustment is not sufficient to bring tax and actual lives into line, the adjusted lives will then be replaced by lives determined in accordance with all of the facts and circumstances.

.04 A taxpayer should carefully review the estimates of useful life of depreciable property adopted for financial accounting purposes, with the objective of conforming them with Guideline lives to the extent that the latter fall within a reasonable range of estimated useful lives applicable in his business.

.05 With exceptions such as those discussed in paragraphs .06 and .07, net income for the period should not be *increased* as the result of the adoption of Guideline lives for income tax purposes only. Accordingly, where Guideline lives shorter than the lives used for financial accounting purposes are adopted for income tax purposes, provision for deferred income taxes should be made in the manner provided by section 4091. [As amended effective for fiscal periods beginning after December 31, 1967, by APB Opinion No. 11.]

.06 It may happen that a company has used shorter lives for accounting purposes than for tax purposes in the past, and now finds that these lives are longer than the new Guideline lives. If the lives previously used for accounting purposes are still considered reasonable, they presumably will be continued, but Guideline lives might be adopted for tax purposes. Tax-effect accounting should be introduced in this type of case in conformity with section 4091. [As amended, effective for fiscal periods beginning after December 31, 1967, by APB Opinion No. 11.]

.07 It may develop that some regulatory authorities having jurisdiction over regulated businesses will prescribe the manner in which the tax effect of the adoption of Guideline lives for income tax purposes only is to be dealt with for rate-making purposes. Where this is done, the principles set forth in section 4074.07-.08 are applicable.

The next page is 8901.

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AC Section 4094

Accounting for the Investment Credit

[Source: APB Opinion Nos. 2 and 4, as amended.]

This is a combination of APB Opinion No. 2, issued December, 1962, and APB Opinion No. 4 (Amending No. 2), issued March, 1964, unless otherwise indicated

.01 The Internal Revenue Code of 1954, as amended, provides for an "investment credit" which, in general, is equal to a specified percentage of the cost of certain depreciable assets acquired and placed in service after 1961. It is subject to certain statutory limitations and the amount available in any one year is used to reduce the amount of income tax payable for that year. An investment credit once allowed is subject to recapture under certain circumstances set forth in the statute.

.02 Some decision as to the nature of the investment credit, i.e., as to the *substance* of its essential characteristics, if not indispensable, is of great significance in a determination of its accounting treatment.

.03 Three concepts as to the substance of the investment credit have been considered by the Board: (a) subsidy by way of a contribution to capital; (b) reduction in taxes otherwise applicable to the income of the year in which the credit arises; and (c) reduction in a cost otherwise chargeable in a greater amount to future accounting periods.

.04 There is no significant disagreement with the view that the investment credit is a factor which influences the determination of net income. The basic accounting issue before us therefore is not whether the investment credit increases net income but, rather, the accounting period(s) during which it should be reflected in the operating statement. Resolution of the accounting issue, in large part, rests upon the accounting principles relative to the realiza-

tion of income. This is true for both regulated and non-regulated companies. (See paragraph .22 of this section.)

.05 **Subsidy by way of a contribution to capital.** This concept, in our opinion, is the least rational because it runs counter to the conclusion that the investment credit increases the net income of some accounting period(s).

.06 **Tax reduction.** The argument for this concept essentially is that since the investment credit is made available by the Internal Revenue Code of 1954, as amended, it is in substance a selective reduction in taxes related to the taxable income of the year in which the credit arises.

.07 The General Rule of Section 38(a) of the Internal Revenue Code of 1954, as amended, provides that:

> There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under sub-part B of this part.

The tax code has traditionally distinguished between exclusions from taxable income (which affect the computation of taxes payable on taxable income of the period) and credits to be applied to reduce taxes otherwise applicable to such taxable income (which do not enter into such computation). In our view the relevant materials support the interpretation that the investment credit is an administrative procedure to permit the taxpayer to withhold the cash equivalent of the credit from taxes otherwise payable and that it is not an element entering into the computation of taxes related to income of the period.

.08 **Cost reduction.** We believe that the interpretation of the investment credit as a reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods is supported by the weight of the pertinent factors and is based upon existing accounting principles.

.09 In reaching this conclusion we have evaluated the pertinent portions of the legislative history of the investment credit, which we regard as significant but not decisive. We also evaluated the pertinent provisions of the tax code which contain recapture and other provisions the effect of which is to make realization of the credit dependent to some degree on future events.

.10 In concluding that the cost reduction concept is based upon existing accounting principles we attach sub-

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stantial weight to two points in particular. First, in our opinion, earnings arise from the use of facilities, not from their acquisition. Second, the ultimate realization of the credit is contingent to some degree on future developments. Where the incidence of realization of income is uncertain, as in the present circumstances, we believe the record does not support the treatment of the investment credit as income at the earliest possible point of time. In our opinion the alternative choice of spreading the income in some rational manner over a series of future accounting periods is more logical and supportable.

.11 In December 1962 the Board stated (in APB Opinion No. 2):

> ". . . the allowable investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service."

.12 In January 1963 the Securities and Exchange Commission issued Accounting Series Release No. 96 in which it reported that in recognition of the substantial diversity of opinion among responsible persons in the matter of accounting for the investment credit the Commission would accept statements in which the credit was accounted for either as this Board concluded in Opinion No. 2 or as a reduction in taxes otherwise applicable to the year in which the credit arises. The Commission has recently reconsidered and reaffirmed that position.

.13 The Board's review of experience since the issuance of Opinion No. 2 shows that the investment credit has been treated by a significant number of companies as an increase in net income of the year in which the credit arose.

.14 The Revenue Act of 1964 eliminates the requirement imposed by the Revenue Act of 1962 that the investment credit be treated for income tax purposes as a reduction in the basis of the property to which the credit relates.

CONCLUSIONS

.15 It is the conclusion of this Board that the Revenue Act of 1964 does not change the essential nature of the investment credit and, hence, of itself affords no basis

for revising our Opinion as to the method of accounting for the investment credit.

.16 However, the authority of Opinions of this Board rests upon their general acceptability. The Board, in the light of events and developments occurring since the issuance of Opinion No. 2, has determined that its conclusions as there expressed have not attained the degree of acceptability which it believes is necessary to make the Opinion effective.

.17 In the circumstances the Board believes that, while the method of accounting for the investment credit recommended in paragraph .11 should be considered to be preferable, the alternative method of treating the credit as a reduction of Federal income taxes of the year in which the credit arises is also acceptable.

.18 The Board emphasizes that whichever method of accounting for the investment credit is adopted, it is essential that full disclosure be made of the method followed and amounts involved, when material.

.19 A number of alternative choices for recording the credit on the balance sheet has been considered. While we believe the reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account) may be preferable in many cases, we recognize as equally appropriate the treatment of the credit as deferred income, provided it is amortized over the productive life of the acquired property.

.20 We believe it preferable that the statement of income in the year in which the allowable investment credit arises should be affected only by the results which flow from the accounting for the credit set forth in paragraph .11. Nevertheless, reflection of income tax provisions, in the income statement, in the amount payable (that is, after deduction of the allowable investment credit) is appropriate provided that a corresponding charge is made to an appropriate cost or expense (for example, to the provision for depreciation) and the treatment is adequately disclosed in the financial statements of the first year of its adoption.

.21 An investment credit should be reflected in the financial statements only to the extent that it has been

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used as an offset against income tax liability. Under the statute, unused investment credits may be carried backward or forward to other years. The amount of a carry*back* of unused investment credit may be set up as an asset (a claim for refund of income taxes) and be added to the allowable investment credit in accounting for the effect of the credit in the year in which the property is placed in service. A carry*forward* of unused investment credit should ordinarily be reflected only in the year in which the amount becomes "allowable," in which case the unused amount would not appear as an asset. Either of two treatments is acceptable in the preparation of income statements for the year in which these carry*backs* or carry*forwards* are recognized: (a) the amount of taxes estimated to be actually payable for such year may be shown in the income statement, with the amount of the tax reduction attributable to the amounts carried backward or forward indicated either in a footnote or parenthetically in the body of the income statement; or (b) the income statement may indicate the tax expense for the period without inclusion of such reduction, which reduction should be shown as a separate item in the statement of income. Material amounts of unused investment credits should be disclosed. [As amended, effective for fiscal periods beginning after December 31, 1966, by APB Opinion No. 9.]

The next page is 8921.

AC Section 4095

Accounting for Income Taxes—Special Areas

[Source: APB Opinion No. 23, as amended.]

Effective for fiscal periods beginning after December 31, 1971, unless otherwise indicated

INTRODUCTION

.01 In December 1967 the Accounting Principles Board issued section 4091, *Income Taxes,* but deferred modifying the practices of accounting for income taxes in five special areas identified in paragraphs .37 through .40 of that section as requiring further study:

a. Undistributed earnings of subsidiaries
b. Intangible development costs in the oil and gas industry *
c. "General reserves" of stock savings and loan associations
d. Amounts designated as "policyholders' surplus" by stock life insurance companies
e. Deposits in statutory reserve funds by United States steamship companies.

.02 The Board has examined the characteristics of the tax consequences of transactions in the three special areas designated (a), (c), and (d) above and sets forth in this section its conclusions on appropriate accounting treatments. The Board defers conclusions on deposits in capital construction funds or statutory reserve funds by United States steamship companies until regulations covering the provisions of the Merchant Marine Act of 1970 are available; experience under the 1970 Act, which substantially modified the Merchant Marine Act of 1936, is now limited. The Board also expresses in this section its conclusions on accounting for taxes on income from investments in corporate joint ventures accounted for by the equity method in accordance with section 5131, *The Equity Method of Accounting for Investments in Common Stock.* Section 4096 covers accounting for taxes on income from invest-

* See section 4097, *Accounting for Income Taxes—Oil and Gas Producing Companies.*

ments in common stock accounted for by the equity method (other than subsidiaries and corporate joint ventures). [Amended, effective for financial statements issued on or after December 1, 1975, by FASB Statement No. 9.] (See section 4097.)

.03 This section supersedes section 2051.15, *Consolidated Financial Statements,* sections 4091.37-.38 and 4091.40, and section 5131.19j. Except as stated in the preceding sentence this section does not modify section 4091.

.04 This section applies to financial statements which purport to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. It does not apply to regulated industries in those circumstances meeting the standards described in section 6011.

Discussion

.05 In section 4091 the Board defined differences between taxable income and pretax accounting income as either timing differences or permanent differences and provided criteria for distinguishing between the differences. Timing differences are "Differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or 'turn around' in one or more subsequent periods." Permanent differences are "Differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or 'turn around' in other periods." The Board also recognized that the tax consequences of a number of other transactions are somewhat similar to those of timing differences; however, the initial differences between taxable income and pretax accounting income related to the transactions may not reverse until indefinite future periods or may never reverse.

.06 A timing difference arises when the initial difference between taxable income and pretax accounting income originates in one period and predictably reverses or turns around in one or more subsequent periods. The reversal of a timing difference at some future date is definite and the

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period of reversal is generally predictable within reasonable limits. Sometimes, however, reversal of a difference cannot be predicted because the events that create the tax consequences are controlled by the taxpayer and frequently require that the taxpayer take specific action before the initial difference reverses.

UNDISTRIBUTED EARNINGS OF SUBSIDIARIES

Discussion

.07 Section 2051.15, *Consolidated Financial Statements,* which is superseded by this section, provided guides for interperiod allocation of income taxes that will be incurred at the date that previously undistributed earnings of subsidiaries are remitted to the parent company.[1] The concept of accruing income taxes for earnings included in consolidated income in accordance with section 2051 has been applied inconsistently. Some believe that the only appropriate method is to accrue related deferred taxes substantially in accordance with sections 4091.35-.36 while others believe that under the criteria set forth in section 2051 a parent company need accrue related deferred taxes only if the transfer of earnings to the parent company in a taxable distribution is imminent or relatively certain. Disclosure of the accounting for income taxes on undistributed earnings of subsidiaries has often been inadequate. Some believe that the contingent liability for taxes that would be payable if the undistributed earnings of subsidiaries were remitted should be disclosed. In their view changing circumstances, often beyond the control of the parent company, may accelerate distribution of earnings of a subsidiary so that the parent company will incur a tax for which no provision has been made. They believe an inability to determine the exact amount of the tax that might be payable is in itself no justification for not accruing the best current

[1] Section 2051.15 stated: "When separate income tax returns are filed, income taxes usually are incurred when earnings of subsidiaries are transferred to the parent. Where it is reasonable to assume that a part or all of the undistributed earnings of a subsidiary will be transferred to the parent in a taxable distribution, provision for related income taxes should be made on an estimated basis at the time the earnings are included in consolidated income, unless these taxes are immaterial in amount when effect is given, for example, to dividend-received deductions or foreign-tax credits. There is no need to provide for income tax to the parent company in cases where the income has been, or there is evidence that it will be, permanently invested by the subsidiaries, or where the only likely distribution would be in the form of a tax-free liquidation."

estimate of the contingent liability. Others believe that instead the amount of undistributed earnings of subsidiaries for which a parent company has not accrued income taxes should be disclosed in notes to financial statements. In their view disclosure of a hypothetical tax which would be payable, assuming those earnings were distributed currently, implies a contradiction of the decision that it is not necessary to provide for income taxes on the earnings in the financial statements. They do not believe that such a hypothetical tax is normally a realistic quantification of the contingent taxes that would be incurred even if some portion of the undistributed earnings were remitted.

.08 A domestic or foreign subsidiary remits earnings to a parent company after the parties consider numerous factors, including the following:

a. Financial requirements of the parent company
b. Financial requirements of the subsidiary
c. Operational and fiscal objectives of the parent company, both long-term and short-term
d. Remittance restrictions imposed by governments
e. Remittance restrictions imposed by lease or financing agreements of the subsidiary
f. Tax consequences of the remittance.

Remittance of earnings of a subsidiary may sometimes be indefinite because of the specific long-term investment plans and objectives of the parent company. Even in the absence of long-term investment plans, the flexibility inherent in the United States Internal Revenue Code may permit a parent company to postpone income taxes on the earnings of a subsidiary for an extended period or may permit the ultimate distribution to be taxed at special rates applicable to the nature of the distribution. Other circumstances may indicate that the earnings will probably be remitted in the foreseeable future. However, the parent company may control the events that create the tax consequences in either circumstance.

Opinion

.09 The Board concludes that including undistributed earnings of a subsidiary[2] in the pretax accounting income

[2] The conclusions of the Board on undistributed earnings of a subsidiary also apply to the portion of the earnings of a Domestic International Sales Corporation (DISC) that is eligible for tax deferral.

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of a parent company, either through consolidation or accounting for the investment by the equity method, may result in a timing difference, in a difference that may not reverse until indefinite future periods, or in a combination of both types of differences, depending on the intent and actions of the parent company.

.10 *Timing difference.* The Board believes it should be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. Accordingly, the undistributed earnings of a subsidiary included in consolidated income (or in income of the parent company [3]) should be accounted for as a timing difference, except to the extent that some or all of the undistributed earnings meet the criteria in paragraph .12. Income taxes attributable to a timing difference in reporting undistributed earnings of a subsidiary should be accounted for in accordance with the provisions of section 4091 for interperiod allocation of taxes. Problems in measuring and recognizing the tax effect of a timing difference do not justify ignoring income taxes related to the timing difference. Income taxes of the parent company applicable to a timing difference in undistributed earnings of a subsidiary are necessarily based on estimates and assumptions. For example, the tax effect may be determined by assuming that unremitted earnings were distributed in the current period and that the parent company received the benefit of all available tax-planning alternatives and available tax credits and deductions.[4] The income tax expense of the parent company should also include taxes that would have been withheld if the undistributed earnings had been remitted as dividends.

.11 The tax effect of a difference between taxable income and pretax accounting income attributable to losses of a subsidiary should be accounted for in accordance with the Board's conclusions on operating losses in sections 4091.43-.49.

.12 *Indefinite reversal criteria.* The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and no income taxes should be

[3] Section 5131.14.

[4] As the unused tax credits that are recognized by the parent in determining deferred income taxes on undistributed earnings of a subsidiary are subsequently realized, the initial reduction in deferred taxes should be reinstated at the then current rates in accordance with the provisions of section 4091.

accrued by the parent company, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. A parent company should have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. Experience of the companies and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent company's representation of indefinite postponement of remittances from a subsidiary. If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent company, it should accrue as an expense of the current period income taxes attributable to that remittance; income tax expense for such undistributed earnings should not be accounted for as an extraordinary item. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent company should adjust income tax expense of the current period; such adjustment of income tax expense should not be accounted for as an extraordinary item.

.13 *Change in investment.* An investment in common stock of a subsidiary may change so that it is no longer a subsidiary because the parent company sells a portion of the investment, the subsidiary sells additional stock, or other transactions affect the investment. If the remaining investment in common stock should be accounted for by the equity method, the investor should recognize income taxes on its share of current earnings of the investee company in accordance with the provisions of section 4096. If a parent company did not recognize income taxes on its equity in undistributed earnings of a subsidiary for the reasons cited in paragraph .12 (and the company in which the investment is held ceases to be a subsidiary), it should accrue as a current period expense income taxes on undistributed earnings in the period that it becomes apparent[5] that any

[5] The change in the status of an investment would not by itself mean that remittance of these undistributed earnings should be considered apparent.

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of those undistributed earnings (prior to the change in status) will be remitted; the accrual of those income taxes should not be accounted for as an extraordinary item. If a parent company recognized income taxes on its equity in undistributed earnings of a subsidiary, the amount of deferred income taxes of the parent attributable to undistributed earnings of the subsidiary should be considered in accounting for a disposition through sale or other transaction which reduces the investment.

.14 *Disclosure.* Information concerning undistributed earnings of a subsidiary for which income taxes have not been accrued that should be disclosed in notes to financial statements includes:

a. A declaration of an intention to reinvest undistributed earnings of a subsidiary to support the conclusion that remittance of those earnings has been indefinitely postponed, or a declaration that the undistributed earnings will be remitted in the form of a tax-free liquidation, and

b. The cumulative amount of undistributed earnings on which the parent company has not recognized income taxes.[6]

INVESTMENTS IN CORPORATE JOINT VENTURES

Discussion

.15 Corporate joint ventures, as defined in section 5131 are of two kinds: (1) those essentially permanent in duration and (2) those that have a life limited by the nature of the venture or other business activity. In section 5131 the Board concluded that the equity method of accounting best enables an investor in a corporate joint venture to recognize the underlying nature of the investment regardless of duration.

.16 Unless characteristics indicate a limited life, a corporate joint venture has many of the characteristics of a subsidiary. The investors usually participate in the management of the joint venture, consider the factors set forth in paragraph .08 above, and agree (frequently before form-

[6] Other disclosure requirements in sections 4091.55-.63 may also apply. Disclosure of other matters such as available tax credits and deductions may be desirable.

ing the venture) as to plans for long-term investment, for utilizing the flexibility inherent in the United States Internal Revenue Code, and for planned remittances.

Opinion

.17 The Board concludes that the principles applicable to undistributed earnings of subsidiaries (paragraphs .09, .10, .11, .12 and .13) also apply to tax effects of differences between taxable income and pretax accounting income attributable to earnings of corporate joint ventures that are essentially permanent in duration and are accounted for by the equity method.[7]

.18 *Disclosure.* The disclosure requirements set forth in paragraph .14 also apply to earnings of corporate joint ventures.

"BAD DEBT RESERVES" OF SAVINGS AND LOAN ASSOCIATIONS

Discussion

.19 Regulatory authorities require both stock and mutual savings and loan associations to appropriate a portion of earnings to general reserves[8] and to retain the reserves as a protection for depositors. Provisions of the United States Internal Revenue Code permit a savings and loan association to deduct an annual addition to a reserve for bad debts[8] in determining taxable income, subject to certain limitations. This annual addition permitted by the Code generally differs significantly from the bad debt experience upon which determination of pretax accounting income is based. Thus, taxable income and pretax accounting income of an association usually differ.

.20 Although a general reserve determined according to requirements of the regulatory authorities is not directly related to a reserve for bad debts computed according to provisions of the United States Internal Revenue Code, the purposes and restrictions of each reserve are similar.

[7] Certain corporate joint ventures have a life limited by the nature of the venture, project, or other business activity. Therefore, a reasonable assumption is that a part or all of the undistributed earnings of the venture will be transferred to the investor in a taxable distribution. Deferred taxes should be recorded, in accordance with the concepts of section 4091 at the time the earnings (or losses) are included in the investor's income.

[8] The terms *general reserves* and *reserve for bad debts* are used in the context of the special meaning these terms have in regulatory pronouncements and in the United States Internal Revenue Code.

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Amounts of bad debt deductions for income tax purposes are includable in taxable income of later years only if the bad debt reserves are used subsequently for purposes other than to absorb bad debt losses.

.21 The term *pretax accounting income,* as used in this section, represents income or loss for a period, exclusive of related income tax expense, determined in conformity with generally accepted accounting principles. The term *taxable income,* as used in this section, represents pretax accounting income (a) adjusted for reversal of provisions for estimated losses on loans and property acquired in settlement of loans, and gains or losses on the sales of such property, and adjusted for permanent differences, and (b) after giving effect to the bad debt deduction allowable by the United States Internal Revenue Code assuming the applicable tax return were to be prepared based on such adjusted pretax accounting income.

.22 Some believe that a difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserve and undivided profits of a savings and loan association has attributes of a permanent or indefinite deferral of tax payments. In their view, a savings and loan association should not accrue income taxes on such differences. Others believe that this difference has the principal attributes of a timing difference as described in sections 4091.35-.36. In effect, they believe that this difference is a Government-sponsored deferral of tax, that the Government has an equity in the savings and loan association to the extent of the deferred tax, and that it is inappropriate to include earnings in stockholders' equity without accruing income taxes which the the association would incur if the earnings were distributed to stockholders or otherwise became subject to tax. In their view the savings and loan association should recognize deferred taxes on the difference.

Opinion

.23 The Board concludes that a difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserves and undivided profits of a savings and

loan association[9] may not reverse until indefinite future periods or may never reverse. The association controls the events that create the tax consequence, and the association is required to take specific action before the initial difference reverses. Therefore, a savings and loan association should not provide income taxes on this difference. However, if circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction should be accrued as tax expense of the current period; the accrual of those income taxes should not be accounted for as an extraordinary item.

.24 *Disclosure.* Information that should be disclosed in notes to financial statements of a savings and loan association concerning bad debt reserves that are accounted for as part of the general reserves and undivided profits includes:

a. The purposes for which the reserves are provided under the applicable rules and regulations and the fact that income taxes may be payable if the reserves are used for other purposes, and

b. The accumulated amount of the reserves for which income taxes have not been accrued.[10]

.25 The disclosure requirements set forth in paragraph .24 also apply to a parent company of a savings and loan association accounting for that investment either through consolidation or by the equity method.

"POLICYHOLDERS' SURPLUS" OF STOCK LIFE INSURANCE COMPANIES

Discussion

.26 The provisions of the United States Internal Revenue Code provide for the exclusion from taxable income of a stock life insurance company of amounts determined under a formula and the allocation of those amounts to

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[9] Section 4091.37 indicated that the "general reserves" of stock savings and loan associations was a special area requiring further study. In practice the statement also has been applied to mutual savings and loan associations and mutual savings banks. The Board affirms that its conclusions in this section apply to stock and mutual savings and loan associations and mutual savings banks.

[10] Other disclosure requirements in sections 4091.55-.63 may also apply.

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policyholders' surplus until the total policyholders' surplus equals a specified maximum. The amounts excluded from taxable income and designated as policyholders' surplus are includable in taxable income of later years if the company elects to (a) distribute policyholders' surplus to stockholders as dividends, (b) transfer amounts from policyholders' surplus to shareholders' surplus designated for tax purposes as available for any business purpose, or (c) take, or if it fails to take, certain other specified actions (none of which usually occur).

.27 Some believe that a difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus of a stock life insurance company has attributes of a permanent or indefinite deferral of tax payments. In their view, a stock life insurance company should not accrue income taxes on the difference between taxable income and pretax accounting income related to amounts designated as policyholders' surplus unless circumstances indicate that the insurance company is likely to pay income taxes, either currently or in future years, because of known or expected reductions in policyholders' surplus. Others believe that the difference has the principal attributes of a timing difference as described in sections 4091.35-.36. In effect, they believe that the difference is a Government-sponsored deferral of tax, that the Government has an equity in the stock life insurance company to the extent of the deferred tax, and that it is inappropriate to include earnings in stockholders' equity without accruing income taxes which would be incurred by the stock life insurance company if those earnings were distributed to stockholders or otherwise became subject to tax. In their view the stock life insurance company should accrue deferred taxes on the difference.

Opinion

.28 The Board concludes that a difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus of a stock life insurance company may not reverse until indefinite future periods or may never reverse. The insurance company controls the events that create the tax consequences and the company is generally required to take specific ac-

tion before the initial difference reverses. Therefore, a stock life insurance company should not accrue income taxes on the difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus. However, if circumstances indicate that the insurance company is likely to pay income taxes, either currently or in later years, because of known or expected reductions in policyholders' surplus, income taxes attributable to that reduction should be accrued as a tax expense of the current period; the accrual of those income taxes should not be accounted for as an extraordinary item.

.29 *Disclosure.* Information concerning amounts designated as policyholders' surplus of a stock life insurance company that should be disclosed in notes to financial statements includes:

a. The treatment of policyholders' surplus under the United States Internal Revenue Code and the fact that income taxes may be payable if the company takes certain specified actions, which should be appropriately described, and

b. The accumulated amount of the policyholders' surplus for which income taxes have not been accrued.[11]

.30 The disclosure requirements set forth in paragraph .29 also apply to a parent company of a stock life insurance company accounting for that investment either through consolidation or by the equity method.

EFFECTIVE DATE

.31 This section shall be effective for all fiscal periods beginning after December 31, 1971. However, the Board encourages earlier application of the provisions of this section.

.32 The conclusions of the Board on accounting for income taxes on undistributed earnings of subsidiaries and corporate joint ventures represent a clarification of current practice. Accordingly, this section should be applied retroactively to undistributed earnings of subsidiaries included in consolidated financial statements and to undistributed earnings applicable to unconsolidated subsidiaries and investments in corporate joint ventures accounted for by the

[11] Other disclosure requirements in sections 4091.55-.63 may also apply.

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equity method in accordance with section 5131. An adjustment resulting from a change in accounting method to comply with this section should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated.

.33 The conclusions of the Board on "bad debt reserves" of savings and loan associations and amounts designated as "policyholders' surplus" by stock life insurance companies agree generally with current practice. If application of this section should result in a change in accounting principle, the adjustment should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated.

The next page is 8941.

AC Section 4096

Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (other than Subsidiaries and Corporate Joint Ventures)

[Source: APB Opinion No. 24.]

Effective for fiscal periods beginning after December 31, 1971, unless otherwise indicated

INTRODUCTION

.01 In March 1971 the Accounting Principles Board issued section 5131, *The Equity Method of Accounting for Investments in Common Stock,* and stated that the guides in section 2051.15, *Consolidated Financial Statements,* should apply in accounting for income taxes on income recognized by an investor in common stock of an investee company until the APB issued an Opinion on the special areas referred to in sections 4091.37-.40, *Income Taxes.* (See section 4095, *Accounting for Income Taxes — Special Areas.*)

.02 The Board has examined the characteristics of the tax consequences of transactions in this area and sets forth in this section its conclusion on appropriate accounting for taxes on income from investments in common stock accounted for by the equity method (other than subsidiaries and corporate joint ventures) in accordance with section 5131.

.03 This section applies to financial statements which purport to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. It does not apply to regulated industries in those circumstances meeting the standards described in section 6011.

DISCUSSION

.04 The Board concluded in section 5131 that an investor should follow the equity method of accounting for

an investment in common stock if the investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock.

.05 Under the equity method of accounting for investments, an investor recognizes its share of the earnings or losses of an investee in the periods for which they are reported by the investee in its financial statements rather than in the period in which an investee declares a dividend or the period in which an investor liquidates its investment. A reasonable assumption is that a part or all of the earnings of an investee ultimately transferred to the investor or realized through the sale or liquidation of the investment will be taxable to the investor. Some believe that the assumed eventual tax consequences have the essential characteristics of a timing difference, and accordingly they would require interperiod tax allocation under the provisions of section 4091.

.06 Others believe that the principles applicable to undistributed earnings of subsidiaries (paragraphs .09, .10, .11, .12, and .13) of section 4095 are equally applicable to undistributed earnings of investees (other than subsidiaries and corporate joint ventures) accounted for by the equity method and that income taxes should be provided only on the portion of undistributed earnings of an investee that represents a timing difference and not on the portion that available evidence indicates will be invested permanently or for an indefinite period. They emphasize that application of section 5131 is based on the presumption that the investor has the ability to exercise significant influence over the operating and financial policies of the investee, and accordingly they believe that the investor must necessarily be presumed to have the ability to exercise significant influence on the extent to which and manner in which the earnings of an investee will be remitted or invested. Under such circumstances, they believe that the investor is in a position to determine and substantiate the effect of probable future remittances which may require an accrual of income tax.

OPINION

.07 The Board concludes that the tax effects of differences between taxable income and pretax accounting in-

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come attributable to an investor's share of earnings of investee companies (other than subsidiaries and corporate joint ventures) accounted for by the equity method in accordance with section 5131 are related either to probable future distributions of dividends or to anticipated realization on disposal of the investment and therefore have the essential characteristics of timing differences. The Board believes that the ability of an investor to exercise significant influence over an investee differs significantly from the ability of a parent company to control investment policies of a subsidiary and that only control can justify the conclusion that undistributed earnings may be invested for indefinite periods.

.08 The Board believes that the determination of whether an investor's equity in undistributed earnings of an investee will be realized in the form of dividends, will be realized by ultimate disposition of the investment, or a combination of both must be based on all facts and circumstances. If evidence indicates that an investor's equity in undistributed earnings of an investee will be realized in the form of dividends, an investor should recognize income taxes attributable to the timing difference as if the equity in earnings of the investee that the investor included in income were remitted as a dividend during the period, recognizing available dividend-received deductions and foreign tax credits. Income taxes of the investor company should also include taxes that would have been withheld if the undistributed earnings had been remitted as dividends. If evidence indicates that an investor's equity in undistributed earnings of an investee will be realized by ultimate disposition of the investment, an investor should accrue income taxes attributable to the timing difference at capital gains or other appropriate rates, recognizing all available deductions and credits.

.09 The tax effect of a difference between taxable income and pretax accounting income attributable to losses of an investee should be accounted for in accordance with the Board's conclusions on operating losses in sections 4091.43-.49.

.10 *Change in Investment.* An investment in common stock of an investee (other than a subsidiary or corporate

joint venture) may change so that the investee becomes a subsidiary because the investor acquires additional common stock, the investee acquires or retires common stock or other transactions affect the investment. Or, an investment in common stock of an investee may fall below the level of ownership necessary for the investor to have the ability to exercise significant influence over operating and financial policies of the investee because the investor sells a portion of the investment, the investee sells additional stock or other transactions affect the investment. If an investment in an investee increases so that it becomes a subsidiary, the deferred income taxes previously accrued by the investor in accordance with paragraphs .07 through .09 should be included in the income of the parent company only as dividends from the subsidiary are received in amounts which exceed the parent company's share of the earnings of the subsidiary subsequent to the date it became a subsidiary. Similarly, if an investment in the investee falls below the level of ownership necessary to enable the investor to follow the equity method of accounting, the deferred income taxes previously accrued by the investor should be included in the income of the former investor only as dividends from the former investee are received in amounts which exceed the former investor's allocable share of earnings of the former investee subsequent to the date it ceased to qualify as an investee. The amount of deferred income taxes of the investor attributable to its share of the equity in earnings of the investee company should be considered in accounting for a disposition through sale or other transaction that reduces the investment.

EFFECTIVE DATE

.11 This section shall be effective for all fiscal periods beginning after December 31, 1971. However, the Board encourages earlier application of the provisions of this section.

.12 The conclusions of the Board on accounting for income taxes on investments in common stock (other than subsidiaries and corporate joint ventures) represent a clarification of current practice. Accordingly, this section should be applied retroactively to undistributed earnings applicable to investments (other than subsidiaries and cor-

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porate joint ventures) accounted for by the equity method in accordance with section 5131. Adjustments resulting from a change in accounting method to comply with this section should be treated as adjustments of prior periods, and financial statements presented for the periods affected should be restated.

The next page is 8951.

AC Section 4097

*Accounting for Income Taxes— Oil and Gas Producing Companies**

an amendment of sections 4091 and 4095
[Source: FASB Statement No. 9.]

October 1975

INTRODUCTION AND BACKGROUND INFORMATION

.01 *APB Opinion No. 11* [section 4091], "Accounting for Income Taxes," issued in 1967, has not required interperiod income tax allocation with respect to "intangible development costs" incurred by oil and gas producing companies. Paragraph 40 of the Opinion [section 4091.39] states:

> Intangible development costs in the oil and gas industry are commonly deducted in the determination of taxable income in the period in which the costs are incurred. Usually the costs are capitalized for financial accounting purposes and are amortized over the productive periods of the related wells. A question exists as to whether the tax effects of the current deduction of these costs for tax purposes should be deferred and amortized over the productive periods of the wells to which the costs relate. Other items have a similar, or opposite, effect because of the interaction with "percentage" depletion for income tax purposes. The Board [APB] has decided to defer any conclusion on these questions until the accounting research study on extractive industries is completed and an Opinion is issued on that subject.

.02 Paragraph 33 of *APB Opinion No. 11* [section 4091.32] cites as an example of a permanent difference (defined in paragraph 13(f) [section 4091.12(f)] of that Opinion) "the excess of statutory depletion over cost depletion."

.03 *APB Opinion No. 23* [section 4095], "Accounting for Income Taxes—Special Areas," issued in 1972, amended *APB Opinion No. 11* [section 4091] in certain respects but did not modify paragraph 40 of *APB Opinion No. 11* [section 4091.39]. Paragraph 2 of *APB Opinion No. 23* [section 4095.02] states: "The Board [APB] continues to defer conclusions on intangible development costs in the oil and gas industry pending the issuance of an Opinion on extractive industries."

.04 Prior to the effective date of *APB Opinion No. 11* [section 4091], some oil and gas producing companies had allocated income taxes with respect to intangible drilling and development costs and some other costs associated with the exploration for and

* This section has been superseded, effective for financial statements for fiscal years beginning after December 15, 1978 by FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*. (See section 6021.)

development of oil and gas reserves that entered into the determination of taxable income and pretax accounting income in different periods. Those companies generally have continued that practice since the issuance of *APB Opinion No. 11* [section 4091].

.05 On the other hand, both before and after the effective date of *APB Opinion No. 11* [section 4091] many oil and gas producing companies have not allocated income taxes with respect to those costs. The fact that percentage depletion over the life of oil and gas properties was expected to exceed costs of that type that are capitalized and amortized in the determination of pretax accounting income (i. e., the interaction with percentage depletion described in the citation in paragraph .01 of this Statement) has generally been cited as the conceptual basis for not allocating income taxes.

.06 The Tax Reduction Act of 1975 (hereinafter sometimes referred to as the *Act*) substantially reduced or eliminated percentage depletion as a Federal income tax deduction for many oil and gas producing companies as of January 1, 1975.

.07 The Board has, among other things, (a) examined the provisions of the Act relating to percentage depletion for oil and gas production, (b) reviewed a report dated April 11, 1975 of an American Petroleum Institute survey of 25 oil and gas producing companies on interperiod tax allocation relating to the elimination of percentage depletion, and (c) reviewed the financial statements of a number of oil and gas producing companies.

.08 The Board originally concluded not to hold a public hearing on the specific issue of interperiod tax allocation related to intangible drilling and development costs and other costs associated with the exploration for and development of oil and gas reserves. An Exposure Draft of a proposed Statement on "Accounting for Income Taxes—Oil and Gas Producing Companies" was issued on April 25, 1975. Ninety-eight letters were received in response to the request for comments. Most of the respondents objected to the method of transition set forth in paragraph 15 of the Exposure Draft, but they held widely divergent views about other methods of transition. On June 26, 1975 the Board announced that it would hold a public hearing. A Notice of Public Hearing was issued on July 10, 1975 stating that the purpose of the public hearing was to provide an opportunity for the Board to receive additional information from, and to hear the views of, interested persons and groups with respect to the accounting problems and issues associated with this matter, in particular those issues discussed in paragraphs 11-17 and Appendix A of the Exposure Draft and those issues and questions set forth in Appendix 1 of the Notice of Public Hearing. The Board received 54 position papers,

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letters of comment, and outlines of oral presentation in response to the Notice of Public Hearing. Twenty-seven presentations were made at the public hearing.

.09 The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in Appendix A to this Statement.

.10 This Statement applies to regulated enterprises in accordance with the provisions of the Addendum to *APB Opinion No. 2* [section 6011] "Accounting for the 'Investment Credit.'"

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Interperiod Tax Allocation

.11 Commencing January 1, 1975, interperiod tax allocation is required [1] for intangible drilling and development costs [2] and other costs [3] associated with the exploration for and development of oil and gas reserves that enter into the determination of taxable income and pretax accounting income in different periods (hereinafter referred to as *IDC financial accounting/tax differences*) pursuant to the provisions of *APB Opinion No. 11* [section 4091].

.12 An oil or gas producing company that heretofore has not allocated income taxes related to IDC financial accounting/tax differences shall, as of January 1, 1975, begin allocating income taxes on the difference (hereinafter referred to as the *net change*) between (i) IDC financial accounting/tax differences originating in the period and (ii) the reversal of similar differences during the period. *APB Opinion No. 11* [section 4091], particularly paragraphs 36-37 [section 4091.35-.36] thereof, specifies the method for computing the income tax effect [4] relating to the net change. In any period during which reversals exceed originating timing differences, the resulting income tax effect shall reduce previously deferred income taxes attributable only to the costs described in paragraph .11 and footnotes 2 and 3. If deferred income taxes have not been provided or if previously deferred income taxes are eliminated, deferred tax credits attributable to other items shall not be reduced, and the excess income tax effect shall be charged to income tax expense in the period in which the excess arises.

[1] See the exception provided by paragraph .13, however.

[2] Intangible drilling and development costs include costs incurred with respect to both producing and nonproducing wells or properties.

[3] These other costs include costs such as geological and geophysical costs, leasehold costs, delay rentals, advance or shut-in royalties, and ad valorem taxes, some of which may be charged to expense for financial accounting purposes before they are deducted for income tax purposes.

[4] The income tax effect referred to in this Statement is determined in the same manner as if income taxes had been allocated on IDC financial accounting/tax differences in the periods of their origination using the net change method as set forth in *APB Opinion No. 11* [section 4091].

.13 In making the computation of deferred income tax expense as set forth in the first sentence of paragraph .12, an oil or gas producing company with excess statutory depletion [5] may elect, but is not required, to recognize interaction with percentage depletion. If this election is made, income taxes shall be deferred on the amount by which originating timing differences exceed reversals during the period, except that the amount on which income taxes are deferred in that period shall be limited to the excess of cumulative IDC financial accounting/tax differences at the end of the period over the sum of (a) excess statutory depletion and (b) cumulative IDC financial accounting/tax differences with respect to which income taxes have been allocated. In periods in which reversals exceed originating timing differences, previously deferred income taxes attributable only to the costs described in paragraph .11 and footnotes 2 and 3 shall be reduced.[6] If at the end of the period the sum of (a) excess statutory depletion and (b) cumulative IDC financial accounting/tax differences with respect to which income taxes have been allocated is equal to or greater than cumulative IDC financial accounting/tax differences, income taxes shall not be allocated on the amount by which originating timing differences exceed reversals during the period. Previously deferred income taxes attributable to the costs described in paragraph .11 and footnotes 2 and 3 shall not be reduced unless reversals exceed originating timing differences during the period.[7] See Appendix B for examples of the application of this paragraph.

.14 Prior to January 1, 1975, certain oil and gas producing companies allocated income taxes in accordance with the provisions of *APB Opinion No. 11* [section 4091] with respect to IDC financial accounting/tax differences without recognizing interaction with percentage depletion. This method of income tax allocation shall continue as an accepted method. Accordingly, an oil or gas producing company may change to that method of accounting and, if it does, shall apply the method retroactively by restating financial statements and financial summaries or other data derived therefrom presented for prior periods (see paragraphs 18, 26, and 27 of *APB Opinion No. 9* [sections 2010.17, 2010.25, and 2010.26], "Reporting the Results of Operations"). If records are not available to make the detailed year-by-year

[5] *Excess statutory depletion* is the excess of estimated statutory depletion allowable as an income tax deduction in future years over the amount of cost depletion otherwise allowable as a tax deduction, determined on a total enterprise basis.

[6] If deferred income taxes have not been provided or if previously deferred income taxes are eliminated, deferred tax credits attributable to other items shall not be reduced, and any excess income tax effect shall be charged to income tax expense in the period in which the excess arises.

[7] See footnote 6.

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"with and without" computations under this method (see paragraph 36 of *APB Opinion No. 11* [section 4091.35]), reasonable approximations shall be made. Considering the unique circumstance of the question at hand, the requirement of paragraphs 15-17 of *APB Opinion No. 20* [section 1051.15-.17], "Accounting Changes," for justification of a change in accounting principle need not be met in connection with a change made in accordance with this paragraph.

Disclosure

.15 Because different methods of accounting are permitted in paragraphs .12-.14 of this Statement and because of the uncertainties involved in estimating future statutory depletion, a company that allocates income taxes in accordance with paragraph .12 or .13 shall disclose in its financial statements the amount of cumulative IDC financial accounting/tax differences at the end of the period with respect to which income taxes have not been allocated. In addition, when it becomes probable that future reversals of IDC financial accounting/tax differences will exceed future originating differences of a similar nature and that the excess income tax effect (referred to in paragraphs .12 and .13) will be charged to income tax expense, the company shall disclose that probability.

Amendments to Existing Pronouncements

.16 *APB Opinion No. 11* [section 4091] exempted "intangible development costs" from the requirement for interperiod tax allocation pending further study of the question of interaction with percentage depletion, and that exemption was continued in *APB Opinion No. 23* [section 4095]. The Board has not considered, and therefore does not in this Statement address, the question of whether interperiod tax allocation should or should not be affected by that interaction. In light of the substantial reduction in or elimination of percentage depletion for many companies resulting from the Tax Reduction Act of 1975, however, the exemption in *APB Opinions No. 11* [section 4091] and *23* [section 4095] of intangible development costs from the requirement for interperiod tax allocation is removed by this Statement. Accordingly, this Statement supersedes paragraph 40 of *APB Opinion No. 11* [section 4091.39] and the second sentence of paragraph 2 of *APB Opinion No. 23* [section 4095.02].

Effective Date

.17 This Statement shall be effective with respect to financial statements issued on or after December 1, 1975, although earlier application is encouraged.

.18 If financial statements for the fiscal year that includes January 1, 1975 have been issued prior to December 1, 1975, when those financial statements or financial summaries or other data derived therefrom are subsequently presented, they shall be restated to reflect the requirements of this Statement. Interim financial reports issued prior to December 1, 1975 that include results of operations subsequent to December 31, 1974 also shall be restated to reflect the requirements of this Statement.

The provisions of this Statement need not be applied to immaterial items.

Appendix A

BASIS FOR CONCLUSIONS

.19 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others.

.20 The scope of this Statement is limited to the question of whether, in light of the Tax Reduction Act of 1975, interperiod tax allocation is now required for IDC financial accounting/tax differences. Although the Board has not considered the question of whether interperiod tax allocation should or should not be affected by interaction with percentage depletion, it has set forth in paragraph .13 the method of computing deferred income taxes when interaction with percentage depletion is recognized.

.21 Allocation of income taxes on timing differences is the basic concept of *APB Opinion No. 11* [section 4091]. That Opinion had allowed an exemption for "intangible development costs," however, pending further study of the question of interaction with percentage depletion. Because the Tax Reduction Act of 1975 substantially reduced or eliminated percentage depletion for many companies as of January 1, 1975, the Board concluded that the exemption of intangible drilling and development costs and other costs from the provisions of *APB Opinion No. 11* [section 4091] is no longer appropriate. Accordingly, paragraph .11 of this Statement requires that beginning January 1, 1975 income taxes be deferred on IDC financial accounting/tax differences. Because the Board has not considered whether interperiod tax allocation should or should not be affected by interaction with percentage depletion, paragraph .13 permits, but does not require, companies to recognize interaction with percentage depletion.

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.22 In the Exposure Draft, the Board set forth five methods of transition that had been considered:

a) *Retroactive restatement.* Record the cumulative income tax effect that had not been deferred prior to January 1, 1975 by restating the financial statements for prior periods. Thereafter, allocate income taxes in accordance with *APB Opinion No. 11* [section 4091].

b) *Direct charge to retained earnings without restatement.* Record the cumulative income tax effect that had not been deferred prior to January 1, 1975 by a direct charge to retained earnings as of that date, with no restatement of financial statements for prior periods. Thereafter, allocate income taxes in accordance with *APB Opinion No. 11* [section 4091].

c) *Allocate taxes prospectively—gross method.* Allocate income taxes only with respect to IDC financial accounting/tax differences arising after December 31, 1974.

d) *Allocate taxes prospectively—net method.* Allocate income taxes on the net change in (i) IDC financial accounting/tax differences originating in the period and (ii) the reversal of similar differences during the period.

e) *Charge in the income statement.* Record the cumulative income tax effect that had not been deferred prior to January 1, 1975 by a charge in the income statement, with no restatement of financial statements for prior periods. Thereafter, allocate income taxes in accordance with *APB Opinion No. 11* [section 4091].

Charge in the Income Statement

.23 The method proposed in the Exposure Draft would have required an income statement charge as of January 1, 1975 for the cumulative income tax effect that had not been deferred prior to that date; the charge in the income statement would have been reported between the captions "extraordinary items" and "net income." The Board reasoned that reporting the charge separately between the captions "extraordinary items" and "net income" would have highlighted the fact that passage of the Act was a unique event of considerable impact on oil and gas producing companies and would have segregated the charge in the presentation of results of current operations. Respondents to the Exposure Draft and the Notice of Public Hearing argued that users of financial statements in general would not understand the charge in the income statement. They reasoned that, as a result of the emphasis users place on net income, comparability of financial statements would be weakened since net income for

none of the years 1974, 1975, and 1976 would be comparable. They also reasoned that to require a charge now based on a 1975 event, viz., passage of the Act, would be inconsistent with the fact that the effect of the Act is prospective in nature and that the accounting should reflect that fact. The Board took these arguments into consideration in concluding that this method of transition should not be adopted.

Allocate Taxes Prospectively—Net Method

.24 The Board originally rejected the prospective net method because it appeared inconsistent with the rationale underlying paragraph 37 of *APB Opinion No. 11* [section 4091.36]. That paragraph states that the net change method is permitted only "if the applicable deferred taxes have been provided in accordance with this Opinion on the cumulative timing differences as of the beginning of the period." Certain respondents to the Exposure Draft and the Notice of Public Hearing argued that they had provided *applicable* deferred income taxes in prior years with respect to IDC financial accounting/tax differences in accordance with *APB Opinion No. 11* [section 4091], either on the basis of interaction with percentage depletion or because of the exemption referred to in paragraph 40 [section 4091.39] of that Opinion, and that, therefore, use of the net change method on a prospective basis is appropriate and consistent with prior accounting. In addition, certain of those respondents suggested that the prospective net method would result in income statement presentations after 1974 that would facilitate comparisons of results of operations of oil and gas producing companies. Other respondents pointed out that considering the unique circumstance of the question at hand existing accounting pronouncements are ambiguous with respect to the proper method of transition and that conceptual support is not limited to any one method of transition. They concluded that the prospective net method represents a practical solution to a unique and complex problem. The Board took these arguments into consideration in concluding that the prospective net method together with the disclosures required by paragraph .15 represent a practical and reasonable solution to the problem.

Retroactive Restatement

.25 One question that arises in connection with retroactive restatement of prior year financial statements concerns the feasibility of making the computations for individual prior years, because of the detailed information that might be required in making the year-by-year "with and without" computations under paragraph 36 of *APB Opinion No. 11* [section 4091.35]. Some respond-

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ents indicated that the computations would be impossible or extremely difficult because, in certain cases, records are not available or were not kept on a basis suitable for that purpose. Other respondents indicated, however, that the retroactive restatement could be computed on a reasonable basis. The Board notes that some oil and gas producing companies have been allocating income taxes on IDC financial accounting/tax differences, and have been doing so without recognizing interaction with percentage depletion. Some respondents reasoned that this method would result in greater comparability of financial statements of an individual company among years, as well as among oil and gas producing companies in general, than would any of the other methods considered. After considering all of the circumstances, the Board decided that retroactive restatement should not be required but should be permitted. The Board concluded, therefore, that it would be appropriate for a company to change its method of accounting to that of allocating income taxes without recognizing interaction with percentage depletion and, if it does, financial statements presented for prior periods should be restated.

Direct Charge to Retained Earnings without Restatement

.26 Direct charges or credits to retained earnings without restatement of prior period financial statements are prohibited by *APB Opinion No. 9* [section 2010]. Consequently, the Board concluded that it would be inappropriate to record the cumulative income tax effect at January 1, 1975 by a direct charge to retained earnings as of that date. To do so would be in conflict with the basic concepts underlying *APB Opinion No. 9* [section 2010].

Allocate Taxes Prospectively—Gross Method

.27 Allocation of income taxes only with respect to IDC financial accounting/tax differences arising after December 31, 1974 would result in substantial variations in the ratio of income tax expense to pretax accounting income reported in financial statements for periods ending after that date. Costs unamortized for financial accounting purposes as of January 1, 1975 but previously deducted for income tax purposes would be amortized in determination of pretax accounting income after December 31, 1974 with no corresponding reversal of deferred income taxes because none would have been recorded. As a result, a company's effective income tax rate might appear to be abnormally high. Moreover, the degree of "abnormality" could vary significantly among companies depending on the extent of IDC financial accounting/tax differences at January 1, 1975. Further, practical difficulties exist in applying this method because of the need to identify separately

certain pre-1975 and post-1974 information. Accordingly, the Board rejected this method.

Other Matters

.28 The Exposure Draft proposed disclosure of the amount of additional income taxes paid or payable for the first full fiscal year beginning on or after January 1, 1975 as a result of the reduction or elimination of percentage depletion. Certain respondents argued that this would be a burdensome, hypothetical calculation and that the disclosures required by paragraph 63(c) of *APB Opinion No. 11* [section 4091.62(c)] will reflect the result of the reduction or elimination of percentage depletion caused by the Act. The Board found merit in these arguments and as a result concluded that this additional disclosure should not be required.

.29 The Notice of Public Hearing included a question concerning what difficulties, if any, exist with respect to net operating loss carryforwards, investment tax credit carryforwards, and foreign tax credit carryforwards in the application of the transition method(s) preferred. Those respondents who addressed this point indicated that accounting for those carryforwards could be accommodated by the provisions of *APB Opinion No. 11* [section 4091].

.30 Several respondents commented that the recognition of interaction with percentage depletion should not be permitted. The Board concluded that interaction with percentage depletion should continue to be permitted as set forth by paragraph .13 of this Statement because to do otherwise would require examination of the conceptual basis of interaction. As stated in paragraph .16 of this Statement, the Board has not considered the question of whether interperiod tax allocation should or should not be affected by that interaction.

.31 The Board has concluded it advisable that this Statement be effective as set forth in paragraph .17.

Appendix B

EXAMPLES OF APPLICATION OF PARAGRAPH .13

.32 The following examples illustrate the computation of deferred income taxes under the election permitted by paragraph .13 of this Statement. It should be recognized that these examples do not comprehend all possible circumstances and do not include the disclosures required by paragraph .15.

General Assumptions

.33 The assumptions on which the examples are based are as follows:

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a) The company's fiscal year-end is December 31.

b) The rate for deferring income taxes resulting from applying the computation required by paragraph .12 is 48 percent.

c) Excess statutory depletion:

January 1, 1975	$ 505,000
December 31, 1975	400,000
December 31, 1976	650,000
December 31, 1977	860,000
December 31,1978	1,020,000
December 31, 1979	1,000,000
December 31, 1980	800,000

d) Cumulative IDC financial accounting/tax differences:

January 1, 1975	$ 500,000
December 31, 1975	600,000
December 31, 1976	760,000
December 31, 1977	930,000
December 31, 1978	1,010,000
December 31, 1979	990,000
December 31, 1980	960,000

December 31, 1975

.34 At December 31, 1975 cumulative IDC financial accounting/tax differences ($600,000) exceeds by $200,000 the sum of (a) excess statutory depletion ($400,000) and (b) cumulative IDC financial accounting/tax differences with respect to which taxes had been allocated (zero). Therefore, income taxes of $48,000 would be deferred with respect to the $100,000 increase in IDC financial accounting/tax differences during the year.

December 31, 1976

.35 At December 31, 1976 cumulative IDC financial accounting/tax differences ($760,000) exceeds by $10,000 the sum of (a) excess statutory depletion ($650,000) and (b) cumulative IDC financial accounting/tax differences with respect to which income taxes had been allocated ($100,000). Although IDC financial accounting/tax differences increased $160,000 during the year, the amount on which income taxes would be deferred is limited to $10,000. Therefore, income taxes of $4,800 would be deferred in the current year.

December 31, 1977

.36 At December 31, 1977 the sum of (a) excess statutory depletion ($860,000) and (b) cumulative IDC financial accounting/tax differences with respect to which income taxes had been allocated ($110,000) exceeds cumulative IDC financial accounting/

tax differences ($930,000). Therefore, no income taxes would be deferred in the current year. Previously deferred income taxes would not be reduced.

December 31, 1978

.37 At December 31, 1978 the sum of (a) excess statutory depletion ($1,020,000) and (b) cumulative IDC financial accounting/tax differences with respect to which income taxes had been allocated ($110,000) exceeds cumulative IDC financial accounting/tax differences ($1,010,000). Therefore, no income taxes would be deferred in the current year. Previously deferred income taxes would not be reduced.

December 31, 1979

.38 Reversals exceed originating IDC financial accounting/tax differences during the year by $20,000. Therefore, previously deferred income taxes would be reduced by $9,600 in the current year.

December 31, 1980

.39 Reversals exceed originating IDC financial accounting/tax differences during the year by $30,000. Therefore, previously deferred income taxes would be reduced by $14,400 in the current year.

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.40 The following summarizes the examples in paragraphs .33-.39:

	1	2	3	4	5	6	7
		IDC Financial Accounting/Tax Differences					
	Excess Statutory Depletion	Cumulative	Net Change	Memo Amounts*	Portion of Net Change on which Deferred Tax is Computed	Deferred Tax Expense Dr. (Cr.)	Cumulative Deferred Tax
1/01/75	$ 505,000	$ 500,000	$ N/A	$ 505,000	$ -0-	$ -0-	$ -0-
12/31/75	400,000	600,000	100,000	400,000	100,000	48,000	48,000
12/31/76	650,000	760,000	160,000	750,000	10,000	4,800	52,800
12/31/77	860,000	930,000	170,000	970,000	-0-	-0-	52,800
12/31/78	1,020,000	1,010,000	80,000	1,130,000	-0-	-0-	52,800
12/31/79	1,000,000	990,000	(20,000)	1,110,000	(20,000)	(9,600)	43,200
12/31/80	800,000	960,000	(30,000)	890,000	(30,000)	(14,400)	28,800

*Memo amounts represent the sum of (a) excess statutory depletion and (b) cumulative IDC financial accounting/tax differences with respect to which income taxes have been allocated (column 1 plus the cumulative amount in column 5 at the beginning of the period).

The next page is 8991.

AC Section 4111

Interest on Receivables and Payables

[Source: APB Opinion No. 21.]

Effective for transactions entered into on or after October 1, 1971 unless otherwise indicated [1]

INTRODUCTION

.01 *Problem.* Business transactions often involve the exchange of cash or property, goods, or service for a note or similar instrument. The use of an interest rate that varies from prevailing interest rates warrants evaluation of whether the face amount and the stated interest rate of a note or obligation provide reliable evidence for properly recording the exchange and subsequent related interest. This section sets forth the Board's views regarding the appropriate accounting when the face amount of a note does not reasonably represent the present value [2] of the consideration given or received in the exchange. This circumstance may arise if the note is noninterest bearing or has a stated interest rate which is different from the rate of interest appropriate for the debt at the date of the transaction. Unless the note is recorded at its present value in this circumstance the sales price and profit to a seller in the year of the transaction and the purchase price and cost to the buyer are misstated, and interest income and interest expense in subsequent periods are also misstated. The primary objective of this section is to refine the manner of applying existing accounting principles in this circumstance. Thus, it is not intended to create a new accounting principle.

.02 *Applicability.* The principles discussed in this section are applicable to receivables and payables which represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest, except as stated in paragraphs .03 and .04. Such receivables and payables are collectively referred to in this section as

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[1] See Paragraph .16.

[2] *Present value* is the sum of the future payments discounted to the present date at an appropriate rate of interest. Section 4111A contains a description of the valuation process.

"notes." Examples are secured and unsecured notes, debentures, bonds, mortgage notes, equipment obligations, and some accounts receivable and payable.

.03 Except that paragraph .15 covering statement presentation of discount and premium is applicable in all circumstances, this section is not intended to apply to:

(a) receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year;

(b) amounts which do not require repayment in the future, but rather will be applied to the purchase price of the property, goods, or service involved (e. g., deposits or progress payments on construction contracts, advance payments for acquisition of resources and raw materials, advances to encourage exploration in the extractive industries);

(c) amounts intended to provide security for one party to an agreement (e. g., security deposits, retainages on contracts);

(d) the customary cash lending activities and demand or savings deposit activities of financial institutions whose primary business is lending money;

(e) transactions where interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (e. g., industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlements); and

(f) transactions between parent and subsidiary companies and between subsidiaries of a common parent.[3]

.04 This section is also not intended to apply to, and the Board is not presently taking a position[4] as to, the application of the present value measurement (valuation) technique to estimates of contractual or other obligations assumed in connection with sales of property, goods, or

[3] The Board has deferred consideration of the treatment of transactions between such companies pending consideration of the subject of reporting on components of a business enterprise and completion of the Accounting Research Study on intercorporate investments.

[4] In section 4092, the Board concluded that deferred income taxes should not be accounted for on a discounted (present value) basis. That conclusion is not modified by this section.

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service, for example, a warranty for product performance. This section does not alter the accounting for convertible debt securities described in section 5516, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants.*

DISCUSSION

.05 *Note received or issued for cash.* The total amount of interest during the entire period of a cash loan is generally measured by the difference between the actual amount of cash received by the borrower and the total amount agreed to be repaid to the lender. Frequently, the stated or coupon interest rate differs from the prevailing rate applicable to similar notes, and the proceeds of the note differ from its face amount. As section 4111A demonstrates, such differences are related to differences between the present value upon issuance and the face amount of the note. The difference between the face amount and the proceeds upon issuance is shown as either discount or premium, which is amortized over the life of the note.[5]

.06 *Unstated rights or privileges.* A note issued solely for cash equal to its face amount is presumed to earn the stated rate of interest. However, in some cases the parties may also exchange unstated (or stated) rights or privileges, which are given accounting recognition by establishing a note discount or premium account. In such instances, the effective interest rate differs from the stated rate. For example, a corporation may lend a supplier cash which is to be repaid five years hence with no stated interest. Such a noninterest bearing loan may be partial consideration under a purchase contract for supplier products at lower than the prevailing market prices. In this circumstance, the difference between the present value of the receivable and the cash loaned to the supplier is appropriately regarded as an addition to the cost of products purchased during the con-

[5] For example, if a bond is issued at a discount or premium, such discount or premium is recognized in accounting for the original issue. The coupon or stated interest rate is not regarded as the effective yield or market rate. Moreover, if a long-term noninterest bearing note or bond is issued, its net proceeds are less than face amount and an effective interest rate is based on its market value upon issuance. As section 4111A illustrates, the coupon or stated rate of interest and the face amount of a note or bond may *not* be the appropriate bases for valuation. The presumption that market values provide the evidence for valuation must be overcome before using coupon or stated rates and face or maturity amounts as the bases for accounting.

tract term. The note discount is amortized as interest income over the five-year life of the note.

.07 *Note received or issued in a noncash transaction.* A note exchanged for property, goods, or service represents two elements, which may or may not be stipulated in the note: (1) the principal amount, equivalent to the bargained exchange price of the property, goods, or service as established between the supplier and the purchaser and (2) an interest factor to compensate the supplier over the life of the note for the use of funds he would have received in a cash transaction at the time of the exchange. Notes so exchanged are accordingly valued and accounted for at the present value of the consideration exchanged between the contracting parties at the date of the transaction in a manner similar to that followed for a cash transaction. The difference between the face amount and the present value upon issuance is shown as either discount or premium, which is amortized over the life of the note.

.08 *Determining present value.* If determinable, the established exchange price (which, presumably, is the same as the price for a cash sale) of property, goods, or service acquired or sold in consideration for a note may be used to establish the present value of the note. When notes are traded in an open market, the market rate of interest and market value of the notes provide the evidence of the present value. The above methods are preferable means of establishing the present value of the note.

.09 If an established exchange price is not determinable and if the note has no ready market, the problem of determining present value is more difficult. To estimate the present value of a note under such circumstances, an applicable interest rate is approximated which may differ from the stated or coupon rate. This process of approximation is frequently called imputation, and the resulting rate is often called an imputed interest rate. Nonrecognition of an apparently small difference between the stated rate of interest and the applicable current rate may have a material effect on the financial statements if the face amount of the note is large and its term is relatively long.

OPINION

.10 *Note exchanged for cash.* When a note[6] is re-

[6] Paragraphs .02, .03 and .04 describe the applicability of this section.

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ceived or issued solely for cash and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged. If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges should be given accounting recognition as described in paragraph .06.

.11 *Note exchanged for property, goods, or service.* When a note is exchanged for property, goods, or service in a bargained transaction entered into at arm's length, there should be a general presumption that the rate of interest stipulated by the parties to the transaction represents fair and adequate compensation to the supplier for the use of the related funds. That presumption, however, must not permit the form of the transaction to prevail over its economic substance and thus would not apply if (1) interest is not stated, or (2) the stated interest rate is unreasonable (paragraphs .12 and .13) or (3) the stated face amount of the note is materially different from the current cash sales price for the same or similar items or from the market value of the note at the date of the transaction. In these circumstances, the note, the sales price, and the cost of the property, goods, or service exchanged for the note should be recorded at the fair value of the property, goods, or service or at an amount that reasonably approximates the market value of the note, whichever is the more clearly determinable. That amount may or may not be the same as its face amount, and any resulting discount or premium should be accounted for as an element of interest over the life of the note (paragraph .14). In the absence of established exchange prices for the related property, goods, or service or evidence of the market value of the note (paragraph .08), the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable should be determined by discounting all future payments on the notes using an imputed rate of interest as described in paragraphs .12 and .13. This determination should be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates should be ignored.

.12 *Determining an appropriate interest rate.* The variety of transactions encountered precludes any specific interest rate from being applicable in all circumstances. However, some general guides may be stated. The choice

of a rate may be affected by the credit standing of the issuer, restrictive covenants, the collateral, payment and other terms pertaining to the debt, and, if appropriate, the tax consequences to the buyer and seller. The prevailing rates for similar instruments of issuers with similar credit ratings will normally help determine the appropriate interest rate for determining the present value of a specific note at its date of issuance. In any event, the rate used for valuation purposes will normally be at least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction. The objective is to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase which bears the prevailing rate of interest to maturity.

.13 The selection of a rate may be affected by many considerations. For instance, where applicable, the choice of a rate may be influenced by (a) an approximation of the prevailing market rates for the source of credit that would provide a market for sale or assignment of the note; (b) the prime or higher rate for notes which are discounted with banks, giving due weight to the credit standing of the maker; (c) published market rates for similar quality bonds; (d) current rates for debentures with substantially identical terms and risks that are traded in open markets; and (e) the current rate charged by investors for first or second mortgage loans on similar property.[7]

.14 *Amortization of discount and premium.* With respect to a note which by the provisions of this section requires the imputation of interest, the difference between the present value and the face amount should be treated as discount or premium[8] and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount

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[7] A theory has been advanced which states that no imputation of interest is necessary if the stated interest rate on a note receivable exceeds the interest cost on the borrowed funds used to finance such notes. The Board considers this theory unacceptable for reasons discussed in this section.

[8] Differences between the recognition for financial accounting purposes and income tax purposes of discount or premium resulting from determination of the present value of a note should be treated as timing differences in accordance with section 4091, *Income Taxes.*

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outstanding at the beginning of any given period. This is the "interest" method described in and supported by section 5361. However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the "interest" method.

.15 *Statement presentation of discount and premium.* The discount or premium resulting from the determination of present value in cash or non-cash transactions is not an asset or liability separable from the note which gives rise to it. Therefore, the discount or premium should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit. The description of the note should include the effective interest rate; the face amount should also be disclosed in the financial statements or in the notes to the statements.[9] Amortization of discount or premium should be reported as interest in the statement of income. Issue costs should be reported in the balance sheet as deferred charges.

EFFECTIVE DATE

.16 This section shall be effective for transactions entered into on or after October 1, 1971. The Board believes that the conclusions as to balance sheet presentation and disclosure in paragraph .15 should apply to transactions made prior as well as subsequent to the issuance of this section. However, this section is not intended to require the discounting of notes existing on September 30, 1971 which were not previously discounted. Notes that were previously recorded in fiscal years ending before October 1, 1971 should not be adjusted. However, notes that have previously been recorded in the fiscal year in which October 1, 1971 occurs may be adjusted to comply with the provisions of this section.

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[9] Refer to section 4111A for illustrations of balance sheet presentation.

AC Section 4111A

Interest on Receivables and Payables—Appendix

.01 *Present value concepts.* Upon issuance of a note or bond, the issuer customarily records as a liability the face or principal amount of the obligation. Ordinarily, the recorded liability also represents the amount which is to be repaid upon maturity of the obligation. The value recorded in the liability account, however, may be different from the proceeds received or the present value of the obligation at issuance if the market rate of interest differs from the coupon rate of interest. For example, consider the issuance of a $1,000, 20-year bond which bears interest at 10% annually. If we assume that 10% is an appropriate market rate of interest for such a bond the proceeds at issuance will be $1,000. The bond payable would be recorded at $1,000 which represents the amount repayable at maturity and also the present value at issuance which is equal to the proceeds. However, under similar circumstances, if the prevailing market rate were more (less) than 10%, a 20-year 10% bond with a face amount of $1,000 would usually have a value at issuance and provide cash proceeds of less (more) than $1,000. The significant point is that, upon issuance, a bond is valued at (1) the present value of the future coupon interest payments *plus* (2) the present value of the future principal payments (face amount). These two sets of future cash payments are discounted at the prevailing market rate of interest (for an equivalent security) at the date of issuance of the debt. As the 8% and 12% columns show, premium or discount arises when the prevailing market rate of interest differs from the coupon rate:

	Assume prevailing market rate of		
	10%	*8%*	*12%*
1. Present value of annual interest payments of $100 (the coupon rate of 10% of $1,000) for 20 years	$ 851	$ 982	$747
2. Present value of payment of the face amount of $1,000 at the end of year 20	149	215	104
Present value and proceeds at date of issuance	$1,000	$1,197	$851

.02 In the case of a $1,000 noninterest bearing 20-year note, where the prevailing market rate for comparable credit risks is 10%, the following valuation should be made:

1. Present value of no annual interest payments	$ 0
2. Present value of payment of the face amount of $1,000 at the end of year 20	149
Present value and proceeds at date of issuance	$149

Comparison of the results of the illustrations in paragraph .01 with the illustration above shows the significant impact of interest.

.03 *Illustrations of balance sheet presentation of notes which are discounted.*

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	December 31	
	1970	*1969*
Example 1—Discount presented in caption		
NOTE RECEIVABLE FROM SALE OF PROPERTY:		
$1,000,000 face amount, noninterest bearing, due December 31, 1975 (less unamortized discount based on imputed interest rate of 8% — 1970, $320,000; 1969, $370,000)	$ 680,000	$ 630,000
Example 2—Discount presented separately		
NOTE RECEIVABLE FROM SALE OF PROPERTY:		
Noninterest bearing note due December 31, 1975	$ 1,000,000	$ 1,000,000
Less unamortized discount based on imputed interest rate of 8%	320,000	370,000
Note receivable less unamortized discount	$ 680,000	$ 630,000
Example 3—Several notes involved		
LONG-TERM DEBT (Note 1):		
Principal amount	$24,000,000	$24,000,000
Less unamortized discount	2,070,000	2,192,000
Long-term debt less unamortized discount	$21,930,00	$21,808,000

Note 1—Long-Term Debt

Long-term debt at December 31, 1970 consisted of the following:

	Principal	*Unamortized Discount*
6% subordinated debentures, due 1984 (discount is based on imputed interest rate of 7%)	$20,000,000	$ 1,750,000
6½% bank loan, due 1973	3,000,000	—
Noninterest bearing note issued in connection with acquisition of property, due 1975 (discount is based on imputed interest rate of 8%)	1,000,000	320,000
Total	$24,000,000	$ 2,070,000

The next page is 9101.

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AC Section 4211

Accounting for Research and Development Costs

[Source: FASB Statement No. 2.]

INTRODUCTION

October 1974

.01 This Statement establishes standards of financial accounting and reporting for research and development costs with the objectives of reducing the number of alternative accounting and reporting practices presently followed and providing useful financial information about research and development costs. This Statement specifies:

a) Those activities that shall be identified as research and development for financial accounting and reporting purposes.

b) The elements of costs that shall be identified with research and development activities.

c) The accounting for research and development costs.

d) The financial statement disclosures related to research and development costs.

.02 Accounting for the costs of research and development activities conducted for others under a contractual arrangement is a part of accounting for contracts in general and is beyond the scope of this Statement. Indirect costs that are specifically reimbursable under the terms of a contract are also excluded from this Statement.

.03 This Statement does not apply to activities that are unique to enterprises in the extractive industries, such as prospecting, acquisition of mineral rights, exploration, drilling, mining, and related mineral development. It does apply, however, to research and development activities of enterprises in the extractive industries that are comparable in nature to research and development activities of other

enterprises, such as development or improvement of processes and techniques including those employed in exploration, drilling, and extraction.

.04 *APB Opinion No. 17* [section 5141], "Intangible Assets," is hereby amended to exclude from its scope those research and development costs encompassed by this Statement.

.05 Paragraph 13 of *APB Opinion No. 22* [section 2045.13], "Disclosure of Accounting Policies," is amended to delete "research and development costs (including basis for amortization)" as an example of disclosure "commonly required" with respect to accounting policies.

.06 Standards of financial accounting and reporting for research and development costs are set forth in paragraphs 7—16. The basis for the Board's conclusions, as well as alternatives considered by the Board and reasons for their rejection, are discussed in Appendix B to this Statement. Background information is presented in Appendix A.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Activities Constituting Research and Development

.07 Paragraphs 8—10 set forth broad guidelines as to the activities that shall be classified as research and development.

.08 For purposes of this Statement, research and development is defined as follows:

a) *Research* is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (hereinafter "product") or a new process or technique (hereinafter "process") or in bringing about a significant improvement to an existing product or process.

b) *Development* is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines,

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manufacturing processes, and other on-going operations even though those alterations may represent improvements and it does not include market research or market testing activities.

.09 The following are examples of activities that typically would be included in research and development in accordance with paragraph 8 (unless conducted for others under a contractual arrangement — see paragraph 2):

a) Laboratory research aimed at discovery of new knowledge.

b) Searching for applications of new research findings or other knowledge.

c) Conceptual formulation and design of possible product or process alternatives.

d) Testing in search for or evaluation of product or process alternatives.

e) Modification of the formulation or design of a product or process.

f) Design, construction, and testing of pre-production prototypes and models.

g) Design of tools, jigs, molds, and dies involving new technology.

h) Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the enterprise for commercial production.

i) Engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture.

.10 The following are examples of activities that typically would be excluded from research and development in accordance with paragraph 8:

a) Engineering follow-through in an early phase of commercial production.

b) Quality control during commercial production including routine testing of products.

c) Trouble-shooting in connection with break-downs during commercial production.

d) Routine, on-going efforts to refine, enrich, or otherwise improve upon the qualities of an existing product.

e) Adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity.

f) Seasonal or other periodic design changes to existing products.

g) Routine design of tools, jigs, molds, and dies.

h) Activity, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than (1) pilot plants (see paragraph 9(h)) and (2) facilities or equipment whose sole use is for a particular research and development project (see paragraph 11(a)).

i) Legal work in connection with patent applications or litigation, and the sale or licensing of patents.

Elements of Costs to Be Identified with Research and Development Activities

.11 Elements of costs shall be identified with research and development activities as follows:

a) *Materials, equipment, and facilities.* The costs of materials (whether from the enterprise's normal inventory or acquired specially for research and development activities) and equipment or facilities that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized as tangible assets when acquired or constructed. The cost of such materials consumed in research and development activities and the depreciation of such equipment or facilities used in those activities are research and development costs. However, the costs of materials,

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equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

b) *Personnel.* Salaries, wages, and other related costs of personnel engaged in research and development activities shall be included in research and development costs.

c) *Intangibles purchased from others.* The costs of intangibles that are purchased from others for use in research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized and amortized as intangible assets in accordance with *APB Opinion No. 17* [section 5141]. The amortization of those intangible assets used in research and development activities is a research and development cost. However, the costs of intangibles that are purchased from others for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

d) *Contract services.* The costs of services performed by others in connection with the research and development activities of an enterprise, including research and development conducted by others in behalf of the enterprise, shall be included in research and development costs.

e) *Indirect costs.* Research and development costs shall include a reasonable allocation of indirect costs. However, general and administrative costs that are not clearly related to research and development activities shall not be included as research and development costs.

Accounting for Research and Development Costs

.12 All research and development costs encompassed by this Statement shall be charged to expense when incurred.

Disclosure

.13 Disclosure shall be made in the financial statements of the total research and development costs charged to expense in each period for which an income statement is presented.

.14 A government-regulated enterprise that defers research and development costs for financial accounting purposes in accordance with the Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit,'" shall disclose the following additional information about its research and development costs:

a) Accounting policy, including basis for amortization.

b) Total research and development costs incurred in each period for which an income statement is presented and the amount of those costs that has been capitalized or deferred in each period.

Effective Date and Transition

.15 This Statement shall be effective for fiscal years beginning on or after January 1, 1975, although earlier application is encouraged. The requirement of paragraph 12 that research and development costs be charged to expense when incurred shall be applied retroactively by prior period adjustment (described in paragraphs 18 and 26 of *APB Opinion No. 9* [sections 2010.17 and 2010.25], "Reporting the Results of Operations"). When financial statements for periods before the effective date or financial summaries or other data derived therefrom are presented, they shall be restated to reflect the prior period adjustment. The prior period adjustment shall recognize any related income tax effect. The nature of a restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period presented shall be disclosed in the period of change.

.16 The disclosures specified in paragraphs 13—14 are encouraged but not required for fiscal periods prior to the effective date of this Statement. If disclosures for those earlier periods are made, amounts shall be based to the extent practicable on the guidelines in paragraphs 8—11 of this Statement for identifying research and development activities and costs.

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The provisions of this Statement need not be applied to immaterial items.

Appendix A
BACKGROUND INFORMATION

.17 Expenditures for research and development constitute a significant element of the United States economy and are vital for its growth. Based on statistics for research and development as defined by the National Science Foundation (see paragraph 25), total expenditures were over $30 billion in 1973, approximately two-thirds of which was spent for research and development conducted by business enterprises and the balance for research and development conducted by the government, universities and colleges, and other organizations.

.18 In recognition of the significance of research and development and the alternative accounting and reporting practices presently followed for research and development costs, in April 1973 the FASB placed on its technical agenda a project on "Accounting for Research and Development and Similar Costs." The scope of the project encompassed accounting and reporting by companies in the development stage.

.19 A task force of 16 persons from industry, government, public accounting, the financial community, and academe was appointed in July 1973 to provide counsel to the Board in preparing a Discussion Memorandum analyzing issues related to the project.

.20 In February 1973 the AICPA published *Accounting Research Study No. 14*, "Accounting for Research and Development Expenditures." In view of the availability of that study and other published research studies and articles, which are cited in Appendix B and in the Discussion Memorandum, the FASB did not undertake a major research effort for the project. The FASB staff interviewed a limited number of selected financial analysts and commercial bankers and reviewed a substantial number of published financial statements.

.21 The Board issued the Discussion Memorandum on December 28, 1973, and held a public hearing on the subject on March 15, 1974. The Board received 74 position papers, letters of comment, and outlines of oral presentations in

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connection with the public hearing and heard 14 oral presentations at the hearing.

.22 In its deliberations following the hearing, the Board concluded that the initial Statement of Financial Accounting Standards resulting from the project should address solely accounting for research and development costs. An Exposure Draft of a proposed Statement on "Accounting for Research and Development Costs" was issued on June 5, 1974. The Board received 168 letters of comment on the Exposure Draft.

Appendix B

BASIS FOR CONCLUSIONS

.23 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including the various alternatives considered and reasons for accepting some and rejecting others.

ACTIVITIES CONSTITUTING RESEARCH AND DEVELOPMENT

.24 The guidelines in paragraphs 8—10 for activities that should be identified as research and development are designed to accommodate a wide variety of research and development activities. Adherence to those guidelines should result in a reasonable degree of comparability. Differences among enterprises and among industries are so great that a detailed prescription of the activities and related costs includable in research and development, either for all companies or on an industry-by-industry basis, is not a realistic undertaking for the FASB.

.25 The Board began its consideration of a definition of research and development with the following definition by the National Science Foundation (NSF):[1]

> *Research and development* — Basic and applied research in the sciences and engineering and the design and development of prototypes and processes. This definition excludes quality control, routine product testing, market research, sales promotion, sales service, research in the social sciences or psychology, and other nontechnological activities or technical services.

.26 The NSF further classifies research and development activities by type, as follows:[2]

> *Basic research* — Original investigations for the advancement of scientific knowledge not having specific commercial objectives, although such investigations may be in fields of present or potential interest to the reporting company.

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[1]National Science Foundation, *Research and Development in Industry 1971* (Washington, D.C.: U.S. Government Printing Office, May 1973), p. 19.

[2]*Ibid.*

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> *Applied research* — Investigations directed to the discovery of new scientific knowledge having specific commercial objectives with respect to products or processes. This definition differs from that of basic research chiefly in terms of the objectives of the reporting company.
>
> *Development* — Technical activities of a nonroutine nature concerned with translating research findings or other scientific knowledge into products or processes. [Development] does not include routine technical services to customers or other activities excluded from . . . research and development.

.27 The NSF definition has the advantage of being relatively widely used and understood. However, it is oriented primarily to research in the physical and biological sciences and excludes research in the social sciences.

.28 Respondents to the Discussion Memorandum recommended modifications of the NSF definition as well as various other definitions which were generally similar to or broader than the NSF definition. The Board agreed that a broad definition including research and development activities in the social sciences such as those conducted by service-type business enterprises is appropriate for financial accounting and reporting purposes. Accordingly, the definition in paragraph 8 has been adopted.

.29 The Exposure Draft had included research and development activities conducted for others under a contractual arrangement within the definition of research and development and had proposed that all research and development costs not directly reimbursable by others be charged to expense when incurred. Some respondents to the Exposure Draft contended that costs incurred in research and development activities conducted for others under a contractual arrangement should continue to be accounted for in accordance with financial accounting standards for contracts in general rather than as research and development costs. The Board agrees with this view and the change is reflected in paragraph 2.

.30 The examples in paragraphs 9—10 incorporate certain changes, many of which were recommended by respondents to the Exposure Draft. The Board believes that those paragraphs as changed more clearly reflect its intent regarding the inclusion or exclusion of particular types of activities within the definition of research and development.

.31 Several respondents to the Exposure Draft raised questions about the inclusion or exclusion of the development of various types of computer software within the definition of research and development. Computer software is developed for many and diverse uses. Accordingly, in each case the nature of the activity for which the software is being developed should be considered in relation to the guidelines in paragraphs 8—10 to determine whether software costs should be included or excluded. For example, efforts to develop a new or higher level of computer software capability intended for sale (but not under a contractual arrangement) would be a research and development activity encompassed by this Statement.

ELEMENTS OF COSTS TO BE IDENTIFIED WITH RESEARCH AND DEVELOPMENT ACTIVITIES

.32 To achieve a reasonable degree of comparability among enterprises, the Board concluded that broad guidelines are appropriate to identify the elements of costs that should be included as research and development. Those guidelines are in paragraph 11.

.33 Consideration was given to the alternative that the costs of materials, equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) be apportioned over the life of the project rather than treated as research and development costs when incurred. The Board reasoned, however, that if materials, equipment, or facilities are of such a specialized nature that they have no alternative future uses, even in another research and development project, those materials, equipment, or facilities have no separate economic values to distinguish them from other types of costs such as salaries and wages incurred in a particular project. Accordingly, all costs of those materials, equipment, and facilities should be treated as research and development costs when incurred.

.34 Paragraph 11(c) reflects certain changes from the Exposure Draft to treat the costs of intangibles purchased from others in a manner similar to that in paragraph 11(a) for the costs of materials, equipment, or facilities. Paragraph 11(c) is not intended to alter the conclusions in paragraphs

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87-88 of *APB Opinion No. 16* [section 1091.87-.88], "Business Combinations," regarding allocation of cost to assets acquired in a business combination accounted for by the purchase method.

.35 The conclusion that general and administrative costs not be allocated to research and development activities (unless clearly related) conforms to present accounting practice, which generally treats such costs as expenses when incurred.

.36 One question in the Discussion Memorandum was whether interest or other cost of capital should be allocated to research and development activities. At present, interest or other cost of capital generally is not allocated to the cost of assets or specific activities for financial accounting purposes. The Board believes that allocation of interest or other cost of capital to research and development activities is part of a broader question beyond the scope of this Statement.

ACCOUNTING FOR RESEARCH AND DEVELOPMENT COSTS

.37 The Board considered four alternative methods of accounting at the time research and development costs are incurred:

a) Charge all costs to expense when incurred.

b) Capitalize all costs when incurred.

c) Capitalize costs when incurred if specified conditions are fulfilled and charge all other costs to expense.

d) Accumulate all costs in a special category until the existence of future benefits can be determined.

.38 In concluding that all research and development costs be charged to expense when incurred (see paragraph 12), Board members considered the factors discussed in paragraphs 39—59. Individual Board members gave greater weight to some factors than to others.

Uncertainty of Future Benefits

.39 There is normally a high degree of uncertainty about the future benefits of individual research and development projects, although the element of uncertainty may diminish

as a project progresses. Estimates of the rate of success of research and development projects vary markedly — depending in part on how narrowly one defines a "project" and how one defines "success" — but all such estimates indicate a high failure rate. For example, one study of a number of industries found that an average of less than 2 percent of new product ideas and less than 15 percent of product development projects were commercially successful.[3]

.40 Even after a project has passed beyond the research and development stage, and a new or improved product or process is being marketed or used, the failure rate is high. Estimates of new product failures range from 30 percent to 90 percent, depending on the definition of failure used.[4] One study concludes that "for about every three products emerging from research and development departments as technical successes, there is an average of only one commercial success."[5] That study goes on to say that "of all the dollars of new product expense, almost three-fourths go to unsuccessful products; about two-thirds of these . . . dollars are in the 'development stage.' "[6]

Lack of Causal Relationship Between Expenditures and Benefits

.41 A direct relationship between research and development costs and specific future revenue generally has not been demonstrated, even with the benefit of hindsight. For example, three empirical research studies, which focus on companies in industries intensively involved in research and development activities, generally failed to find a significant correlation between research and development expenditures and increased future benefits as measured by subsequent sales,[7] earnings,[8] or share of industry sales.[9]

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[3]Booz-Allen & Hamilton, Inc., *Management of New Products* (Chicago: Booz-Allen & Hamilton, Inc., 1968), p. 12.

[4]John T. Gerlach and Charles Anthony Wainwright, *Successful Management of New Products* (New York: Hastings House, Publishers, Inc., 1968), p. 126.

[5]Booz-Allen & Hamilton, Inc., *Management of New Products*, p. 2.

[6]*Ibid.*, p. 11.

[7]Maurice S. Newman, "Equating Return from R & D Expenditures," *Financial Executive*, April 1968, pp. 26-33.

[8]Orace Johnson, "A Consequential Approach to Accounting for R & D," *Journal of Accounting Research*, Autumn 1967, pp. 164-172.

[9]Alex J. Milburn, "An Empirical Study of the Relationship of Research and Development Expenditures to Subsequent Benefits," (Unpublished Research Study, Department of Accountancy of the University of Illinois, 1971).

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Accounting Recognition of Economic Resources

.42 In paragraph 57 of *APB Statement No. 4* [section 1023.18], "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," economic resources are defined as the scarce means for carrying on economic activities. The economic resources of a particular enterprise are generally regarded as those *scarce* resources for which there is an *expectation of future benefits to the enterprise* either through use or sale.

.43 Not all of the economic resources of an enterprise are recognized as assets for financial accounting purposes. However, criteria for identifying those economic resources that should be recognized as the assets of an enterprise for accounting purposes have not been specified in the official accounting literature. One criterion that has been suggested in published research studies and articles and in position papers, letters of comment, and oral presentations the Board received in connection with the public hearing is that of *measurability*.

.44 The criterion of measurability would require that a resource not be recognized as an asset for accounting purposes unless at the time it is acquired or developed its future economic benefits can be identified and objectively measured.

.45 Paragraphs 39—40 indicate that at the time most research and development costs are incurred the future benefits are at best uncertain. In other words, there is no indication that an economic resource has been created. Moreover, even if at some point in the progress of an individual research and development project the expectation of future benefits becomes sufficiently high to indicate that an economic resource has been created, the question remains whether that resource should be recognized as an asset for financial accounting purposes. Although future benefits from a particular research and development project may be foreseen, they generally cannot be measured with a reasonable degree of certainty. According to the research data cited in paragraph 41, there is normally little, if any, direct relationship between the amount of current research and development expenditures and the amount of resultant future benefits to the enterprise. Research and development costs therefore fail to satisfy the suggested measurability test for accounting recognition as an asset.

.46 The criterion of exchangeability, which was discussed in the Exposure Draft, was not considered a significant factor by the Board in reaching its final conclusion on accounting for research and development costs. The Board believes that exchangeability needs further study and at this time the Board neither accepts nor rejects exchangeability as a criterion for accounting recognition of an economic resource.

Expense Recognition and Matching

.47 *APB Statement No. 4* [section 1021—1029] explicitly avoids using the term "matching" because it has a variety of meanings in the accounting literature. In its broadest sense, matching refers to the entire process of income determination —described in paragraph 147 of *APB Statement No. 4* [section 1026.11] as "identifying, measuring, and relating revenues and expenses of an enterprise for an accounting period." Matching may also be used in a more limited sense to refer only to the process of expense recognition or in an even more limited sense to refer to the recognition of expenses by associating costs with revenue on a cause and effect basis. In the following discussion, matching is used in its most limited sense to refer to the process of recognizing costs as expenses on a cause and effect basis.

.48 Three pervasive principles for recognizing costs as expenses are set forth in paragraphs 156—160 of *APB Statement No. 4* [section 1026.20—.24], as follows:

> *Associating Cause and Effect.* Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. . . . recognizing them as expenses accompanies recognition of the revenue.
>
> *Systematic and Rational Allocation.* . . . If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect.
>
> *Immediate Recognition.* Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits, or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose. . . . The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense, for example, a patent that is determined to be worthless.

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.49 As noted in paragraph 41, evidence of a direct causal relationship between current research and development expenditures and subsequent future benefits generally has not been found. Also, there is often a high degree of uncertainty about whether research and development expenditures will provide any future benefits. Thus, even an indirect cause and effect relationship can seldom be demonstrated. Because there is generally no direct or even indirect basis for relating costs to revenues, the Board believes that the principles of "associating cause and effect" and "systematic and rational allocation" cannot be applied to recognize research and development costs as expenses. That is, the notion of "matching" — when used to refer to the process of recognizing costs as expenses on any sort of cause and effect basis — cannot be applied to research and development costs. Indeed, the general lack of discernible future benefits at the time the costs are incurred indicates that the "immediate recognition" principle of expense recognition should apply.

Usefulness of Resulting Information

.50 *APB Statement No. 4* [sections 1021—1029] indicates that certain costs are immediately recognized as expenses because allocating them to several accounting periods "is considered to serve no useful purpose." There is general agreement that two of the basic elements in the decision models of many financial statement users are (a) expected return—the predicted amount and timing of the return on an investment—and (b) risk—the variability of that expected return. The data cited in paragraphs 39—41, the views of security analysts and other professional investors submitted to the Board in connection with the public hearing, and FASB interviews with selected analysts and bankers suggest that the relationship between current research and development costs and the amount of resultant future benefits to an enterprise is so uncertain that capitalization of any research and development costs is not useful in assessing the earnings potential of the enterprise. Therefore, it is unlikely that one's ability to predict the return on an investment and the variability of that return would be enhanced by capitalization.

Capitalization of All Costs When Incurred

.51 Enterprises undertake research and development activities with the hope of future benefits. If there were no such hope, the activities would not be conducted. Some

persons take the position that the accounting treatment for research and development costs should be determined by considering in the aggregate all of the research and development activities of an enterprise. In their view, if there is a high probability of future benefits from an enterprise's total research and development program, the entire cost of those activities should be capitalized without regard to the certainty of future benefits from individual projects.

.52 The Board believes, however, that it is not appropriate to consider accounting for research and development activities on an aggregate or total-enterprise basis for several reasons. For accounting purposes the expectation of future benefits generally is not evaluated in relation to broad categories of expenditures on an enterprise-wide basis but rather in relation to individual or related transactions or projects. Also, an enterprise's total research and development program may consist of a number of projects at varying stages of completion and with varying degrees of uncertainty as to their ultimate success. If research and development costs were capitalized on an enterprise-wide basis, a meaningful method of amortization could not be developed because the period of benefit could not be determined. Moreover, over 90 percent of the respondents to a survey reported in AICPA *Accounting Research Study No. 14* indicated that their company's philosophy is that research and development expenditures are intended to be recovered by current revenues rather than by revenue from new products.[10]

Selective Capitalization

.53 Selective capitalization — capitalizing research and development costs when incurred if specified conditions are fulfilled and charging to expense all other research and development costs — requires establishment of conditions that must be fulfilled before research and development costs are capitalized. The Board considered a number of factors on which prerequisite conditions might be based, including the following:

a) *Definition of product or process.* The new or improved product or process must be defined.

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[10]Oscar S. Gellein and Maurice A. Newman, *Accounting Research Study No. 14*, "Accounting for Research and Development Expenditures," (New York: AICPA, 1973), p. 100.

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b) *Technological feasibility.* The new or improved product or process must be determined to be technologically feasible.

c) *Marketability/Usefulness.* The marketability of the product or process or, if it is to be used internally rather than sold, its usefulness to the enterprise must be substantially assured.

d) *Economic feasibility.* Probability of future economic benefits sufficient to recover all capitalized costs must be high. Encompassed by the notion of economic feasibility is measurability of future benefits. Also implicit is the ability to associate particular future benefits with particular costs.

e) *Management action.* Management must have definitely decided to produce and market or use the new product or process or to incorporate the significant improvement into an existing product or process.

f) *Distortion of net income comparisons.* Capitalization or immediate charging to expense of research and development costs must be determined on the basis of whether interperiod comparisons of net income would be materially distorted.

.54 None of those factors, however, lends itself to establishing a condition that could be objectively and comparably applied by all enterprises. Considerable judgment is required to identify the point in the progress of a research and development project at which a new or improved product or process is "defined" or is determined to be "technologically feasible," "marketable," or "useful." Nor can the "probability of future benefits" be readily assessed. A "management decision" to proceed with production does not necessarily assure future benefits. The Board does not believe that "distortion of net income comparisons," which a few respondents to the Discussion Memorandum suggested, is an operable criterion by which to decide whether research and development costs should be capitalized because the point at which net income comparisons might be "distorted" cannot be defined. Moreover, in assessing risk, financial statement users have indicated that they seek information about the variability of earnings.

.55 The Board has concluded that no set of conditions that might be established for capitalization of costs could achieve the comparability among enterprises that proponents of "selective capitalization" cite as a primary objective of that approach.

.56 If selective capitalization were applied only to costs incurred after fulfillment of the specified conditions, only a portion of the total costs of a particular research and development project would be capitalized and amortized. Thus, the capitalized amount would not indicate the total costs incurred to produce future benefits; nor would the amount of periodic amortization of capitalized costs represent a "matching" of costs and benefits.

.57 Selective capitalization might involve retroactive capitalization of previously incurred costs in addition to capitalization of costs incurred after fulfillment of the specified conditions. However, many research and development costs incurred before fulfillment of the conditions are not likely to be directly identifiable with the particular new or improved product or process for which costs would be capitalized. Moreover, retroactive capitalization of costs previously charged to expense is contrary to present accounting practice for other transactions whose initial accounting is not altered as a result of hindsight. The preparation of periodic financial statements requires many estimates and judgments for which restatements are not made in retrospect.

Accumulation of Costs in a Special Category

.58 The Board considered the proposal that all research and development costs be accumulated in a special category distinct from assets and expenses until a determination can be made about whether future benefits exist. That special category might be reported either below the asset section of the balance sheet (with segregation of a corresponding amount of stockholders' equity) or as a negative (contra) element of stockholders' equity. Ultimately, the accumulated costs would be transferred to assets (if future benefits become reasonably established) or written off (if it were reasonably established that no significant future benefits would ensue).

.59 A feature cited by proponents of this approach is that it draws attention to the uncertainty surrounding most research

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and development costs and it enables postponement of the capitalize vs. expense decision. This alternative was rejected, however, for the following reasons. First, financial analysts and others have indicated that costs accumulated in that special category would not be useful in assessing the earning power of an enterprise because of the uncertainties involved, and the research data cited earlier tend to support that view. Second, use of a special category would alter the nature of the basic financial statements and would complicate the computation of ratios and other financial data.

DISCLOSURE

.60 Regardless of their position on the accounting treatment for research and development costs, respondents to the Discussion Memorandum generally pointed out that current disclosure practices for research and development costs vary and that requirements for informative disclosure need to be established. The disclosures specified in paragraphs 13—14 reflect the Board's general agreement with that view.

.61 The Exposure Draft had proposed that disclosure also be required of (a) the accounting policy for research and development costs, (b) the amount of directly reimbursable research and development costs incurred, (c) the costs of research and development conducted in behalf of the enterprise by others, and (d) the amounts and classifications in the income statement of research and development costs charged to expense during the period. The Board has accepted the recommendation of some respondents to the Exposure Draft that disclosure of accounting policy not be required[11] because this Statement permits only one method of accounting for research and development costs. Some letters of comment on the Exposure Draft indicated that data related to items (b), (c), and (d) above are frequently difficult to obtain and that those disclosures generally would not be meaningful. The Board agrees with this view; this Statement does not require those disclosures.

.62 The Board recognizes that disclosure of additional information about an enterprise's research and development activities might be useful to some financial statement users. However, many respondents to the Discussion Memorandum

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[11]That disclosure is required by this Statement for certain government-regulated enterprises (see paragraph 14).

contended that certain kinds of information should not be required to be included in financial statements because the information is not sufficiently objective, is confidential in nature, or is beyond the scope of financial accounting information. For that reason, the Board concluded that disclosure of (a) the nature, status, and costs of individual research and development projects, (b) the nature and status of patents, (c) projections about new or improved products or processes, and (d) an enterprise's philosophy regarding research and development, all of which were included in the Discussion Memorandum as disclosure possibilities, should not be required. In addition, most respondents said that forecasts of research and development expenditures should not be considered in this project, and the Board agrees with that view. Disclosure of research and development costs by line of business was considered by the FASB in its project, "Financial Reporting for Segments of a Business Enterprise," but FASB Statement No. 14 [section 2081] does not require that disclosure. [As modified, effective for financial statements for fiscal years beginning after December 15, 1976, and for interim periods within those fiscal years, by FASB Statement No. 14.] (See section 2081.)

EFFECTIVE DATE AND TRANSITION

.63 The Board considered three alternative approaches to reporting a change in the method of accounting for research and development costs: (1) prior period adjustment, (2) the "cumulative effect" method described in *APB Opinion No. 20* [section 1051], "Accounting Changes," and (3) continued amortization of previously capitalized costs. The Board concluded that the prior period adjustment method will provide the most useful information about research and development costs for comparing financial data for periods after the effective date of this Statement with data presented for earlier periods.

.64 Upon consideration of all circumstances, the Board judged that the effective date specified in paragraph 15, which had been proposed in the Exposure Draft, is advisable.

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AC Section 4211-1

Applicability of Section 4211 to Business Combinations Accounted for by the Purchase Method: An Interpretation of Section 4211

[Source: FASB Interpretation No. 4.]

February 1975

INTRODUCTION

.01 The FASB has been asked to explain the applicability of *FASB Statement No. 2* [section 4211], "Accounting for Research and Development Costs," to the cost of tangible and intangible assets to be used in research and development activities of an enterprise when those assets are acquired in a business combination accounted for by the purchase method.

.02 Broad guidelines about the activities to be classified as research and development and the elements of costs to be identified with those activities are set forth in paragraphs 8-11 of *Statement No. 2* [section 4211.08-.11]. Paragraph 12 of that Statement [section 4211.12] provides that research and development costs shall be charged to expense when incurred. However, some costs associated with research and development activities shall be capitalized if the item has alternative future uses in research and development or otherwise (see paragraphs 11(a) and 11(c) of *Statement No. 2*). [Sections 4211.11(a) and 4211.11(c).] The cost of materials consumed, the depreciation of equipment and facilities used, and the amortization of intangibles used in research and development activities are research and development costs.

.03 *Statement No. 2* amends *APB Opinion No. 17* [section 5141], "Intangible Assets," to exclude from the scope of that Opinion those research and development costs encompassed by the Statement but does not amend *APB Opinion No. 16* [section 1091], "Business Combinations." Paragraph 34 of the Statement [section 4211.34] indicates that paragraph 11(c) [section 4211.11(c)] is not intended to alter the conclusions in paragraphs 87-88 of *APB Opinion No. 16* [section 1091.87-.88] regarding allocation of cost to assets acquired in a business combination accounted for by the purchase method.

INTERPRETATION

.04 The intent of paragraph 34 of *Statement No. 2* [section 4211.34] is that the allocation of cost to the identifiable assets of an acquired enterprise shall be made in accordance with the provisions

of *APB Opinion No. 16* [section 1091]. Therefore, costs shall be assigned to all identifiable tangible and intangible assets, including any *resulting from* research and development activities of the acquired enterprise or *to be used in* research and development activities of the combined enterprise. Identifiable assets *resulting from* research and development activities of the acquired enterprise might include, for example, patents received or applied for, blueprints, formulas, and specifications or designs for new products or processes. Identifiable assets *to be used in* research and development activities of the combined enterprise might include, for example, materials and supplies, equipment and facilities, and perhaps even a specific research project in process. In either case, the costs to be assigned under *APB Opinion No. 16* [section 1091] are determined from the amount paid by the acquiring enterprise and *not* from the original cost to the acquired enterprise.

.05 The subsequent accounting by the combined enterprise for the costs allocated to assets[1] *to be used in* research and development activities shall be determined by reference to *Statement No. 2* [section 4211]. Paragraph 12 of *Statement No. 2* [section 4211.12] requires that costs identified with research and development activities shall be charged to expense when incurred unless the test of alternative future use in paragraph 11(a) or 11(c) [sections 4211.11(a) or 4211.11(c)] is met. That requirement also applies in a business combination accounted for by the purchase method. Accordingly, costs assigned to assets to be used in a particular research and development project and that have no alternative future use shall be charged to expense at the date of consummation of the combination. Therefore, the accounting for the cost of an item to be used in research and development activities is the same under paragraphs 11 and 12 of *Statement No. 2* [sections 4211.11 and 4211.12], whether the item is purchased singly, or as part of a group of assets, or as part of an entire enterprise in a business combination accounted for by the purchase method.

EFFECTIVE DATE AND TRANSITION

.06 Because there have been varying interpretations of *Statement No. 2* [section 4211] with respect to the accounting for the cost of tangible and intangible assets covered by this Interpretation, the Board has concluded that it shall be effective as follows:

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[1] In this regard, paragraph 69 of *APB Opinion No. 16* [section 1091.69] states in part that: "The nature of an asset and not the manner of its acquisition determines an acquirer's subsequent accounting for the cost of that asset."

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(a) Application of this Interpretation to business combinations accounted for by the purchase method that are initiated[2] after March 31, 1975 is required.

(b) Application of this Interpretation to business combinations accounted for by the purchase method that are initiated prior to April 1, 1975 and consummated after March 31, 1975 is encouraged but is not required. It may be applied selectively to those combinations.

(c) Application of this Interpretation to business combinations accounted for by the purchase method that were initiated and consummated prior to April 1, 1975 is encouraged but is not required. If an enterprise chooses to apply this Interpretation to those combinations, it shall be applied retroactively as described in paragraphs 15 and 16 of *Statement No. 2* [sections 4211.15 and 4211.16] to *all* business combinations accounted for by the purchase method that were consummated prior to April 1, 1975.

.07 This Interpretation shall not be applied prior to the initial application of *Statement No. 2* [section 4211].

→ *The next page is 9131.* ←

[2] See paragraph .46(a) of *APB Opinion No. 16* [section 1091.46(a)] for the definition of "initiated."

AC Section 4211-3

Applicability of Section 4211 to Computer Software: An Interpretation of Section 4211

[Source: FASB Interpretation No. 6.]

February 1975

INTRODUCTION

.01 The FASB has been asked to explain the applicability of *FASB Statement No. 2* [section 4211], "Accounting for Research and Development Costs," to costs incurred to obtain or develop computer software.

.02 Broad guidelines about the activities to be classified as research and development and the elements of costs to be identified with those activities are set forth in paragraphs 8-11 of *Statement No. 2* [section 4211.08-.11]. Paragraph 12 of that Statement [section 4211.12] provides that research and development costs shall be charged to expense when incurred. However, some costs associated with research and development activities shall be capitalized if the item has alternative future uses in research and development or otherwise (see paragraphs 11(a) and 11(c) of *Statement No. 2*). [Sections 4211.11(a) and 4211.11(c).] The costs of materials consumed, the depreciation of equipment and facilities used, and the amortization of intangibles used in research and development activities are research and development costs.

.03 Paragraph 31 of *Statement No. 2* [section 4211.31] states the following about the activities for which computer software is developed:

> Computer software is developed for many and diverse uses. Accordingly, in each case the nature of the activity for which the software is being developed should be considered in relation to the guidelines in paragraphs 8-10 to determine whether software costs should be included or excluded [in research and development]. For example, efforts to develop a new or higher level of computer software capability intended for sale (but not under a contractual arrangement) would be a research and development activity encompassed by this Statement.

INTERPRETATION

.04 Paragraph 8 of *Statement No. 2* [section 4211.08] defines research and development to include those activities aimed at developing or significantly improving a product or service (hereinafter "product") or a process or technique (hereinafter "process") whether the product or process is intended for sale or use. A process may be a system whose output is to be sold, leased, or otherwise marketed to others. A process also may be used internally as a part of a manufacturing activity or a service

activity where the service itself is marketed. A process may be intended to achieve cost reductions as opposed to revenue generation. Paragraph 8(b) of *Statement No. 2* [section 4211.08(b)], however, specifically excludes from research and development activities "market research or market testing activities." Those activities were excluded because they relate to the selling function of an enterprise. Thus, while in the broadest sense of the word, a process may be used in all of an enterprise's activities, the Board's intent in *Statement No. 2* [section 4211] was that the acquisition, development, or improvement of a process by an enterprise for use in its selling or administrative activities be excluded from the definition of research and development activities.[1] To the extent, therefore, that the acquisition, development, or improvement of a process by an enterprise for use in its selling or administrative activities includes costs for computer software, those costs are not research and development costs. Examples of the excluded costs of software are those incurred for development by an airline of a computerized reservation system or for development of a general management information system.

Purchase or Lease of Software

.05 Costs incurred to purchase or lease computer software developed by others are not research and development costs under *Statement No. 2* [section 4211] unless the software is for use in research and development activities. When software for use in research and development activities is purchased or leased, its cost shall be accounted for as specified by paragraphs 11(c) and 12 of *Statement No. 2* [sections 4211.11(c) and 4211.12]. That is, the cost shall be charged to expense as incurred unless the software has alternative future uses (in research and development or otherwise).

Internal Development of Software

.06 An enterprise may undertake development of computer software internally for its own use or as a product or process to be sold, leased, or otherwise marketed to others for their use. If development is undertaken for the enterprise's own use, the software may be intended, for example, to be used in the research and development activities of the enterprise or as a part of a newly developed or significantly improved product or process.

.07 *Development of software as a product or process to be sold, leased, or otherwise marketed.* Accounting for the cost of developing software for others under a contractual arrangement is

[1] General and administrative costs are discussed in paragraphs 11(e) and 35 of *Statement No. 2* [sections 4211.11(e) and 4211.35].

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beyond the scope of *Statement No. 2* [section 4211], because paragraph 2 of the Statement [section 4211.02] indicates that this is part of accounting for contracts in general. On the other hand, if the development of software is undertaken to create a new or significantly improved product or process without any contractual arrangement, costs incurred for *conceptual formulation or the translation of knowledge into a design* would be research and development costs (see paragraph 8 of *Statement No. 2* [section 4211.08]). Other costs, including those incurred for programming and testing software, are research and development costs when incurred in the search for or the evaluation of product or process alternatives or in the design of a pre-production model. On the other hand, costs for programming and testing are *not* research and development costs when incurred, for example, in routine or other on-going efforts to improve an existing product or adapt a product to a particular requirement or customer's need. Because the term *product* also encompasses services that are sold, leased, or otherwise marketed to others, this paragraph applies, for example, to costs incurred in developing software to be used by a data processing service bureau or a computer time-sharing company.

.08 *Development of software to be used in research and development activities.* Developing or significantly improving a product or process that is intended to be sold, leased, or otherwise marketed to others is a research and development activity (see paragraph 8 of *Statement No. 2* [section 4211.08]). Similarly, developing or significantly improving a process whose output is a product that is intended to be sold, leased, or otherwise marketed to others is a research and development activity. Costs incurred by an enterprise in developing computer software internally for use in its research and development activities are research and development costs and, therefore, shall be charged to expense when incurred.[2] This includes costs incurred during all phases of software development because all of those costs are incurred in a research and development activity.

.09 *Development of software to be used as a part of a product or process.* An enterprise may undertake internal development of software as a part of a newly developed or significantly improved product or process that will be sold, leased, or otherwise marketed to others, or as a part of a process whose output is a product that will be sold, leased, or otherwise marketed to others. For example, a manufacturer of computerized typesetting machinery may undertake to develop and use software as a part of that machinery, or a medical laboratory may undertake to develop software

[2] The alternative future use test does not apply to the internal development of computer software; paragraph 11(c) of *Statement No. 2* [section 4211.11(c)] applies only to intangibles *purchased from others.*

for use in a newly developed analytical process. In those cases, costs incurred for *conceptual formulation or the translation of knowledge into a design* would be research and development costs (see paragraph 8 of *Statement No. 2* [section 4211.08]). Other costs, including those incurred for programming and testing software, are research and development costs when incurred in the search for or the evaluation of product or process alternatives or in the design of a pre-production model. On the other hand, costs for programming and testing are *not* research and development costs when incurred, for example, in routine or other on-going efforts to improve an existing product or process or adapt a product or process to a particular requirement or customer's need.

EFFECTIVE DATE AND TRANSITION

.10 Because there have been varying interpretations of *Statement No. 2* [section 4211] with respect to costs of computer software, this Interpretation shall be effective for fiscal years beginning on or after April 1, 1975. Earlier application is encouraged, except that this Interpretation shall not be applied prior to initial application of *Statement No. 2* [section 4211]. Retroactive application of this Interpretation, as described in paragraphs 15 and 16 of *Statement No. 2* [sections 4211.15 and 4211.16], to costs incurred in prior fiscal years is also encouraged but is not required.

The next page is 9181.

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AC Section 4311

Accounting for Contingencies

[Source: FASB Statement No. 5, as amended.]

March 1975

INTRODUCTION

.01 For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss[1] (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

.02 Not all uncertainties inherent in the accounting process give rise to contingencies as that term is used in this Statement. Estimates are required in financial statements for many on-going and recurring activities of an enterprise. The mere fact that an estimate is involved does not of itself constitute the type of uncertainty referred to in the definition in paragraph .01. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by an enterprise does not make depreciation a contingency; the eventual expiration of the utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency as defined in paragraph .01, nor are such matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. Also, amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred.

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

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[1] The term *loss* is used for convenience to include many charges against income that are commonly referred to as *expenses* and others that are commonly referred to as *losses*.

a) *Probable.* The future event or events are likely to occur.

b) *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.

c) *Remote.* The chance of the future event or events occurring is slight.

.04 Examples of loss contingencies include:

a) Collectibility of receivables.

b) Obligations related to product warranties and product defects.

c) Risk of loss or damage of enterprise property by fire, explosion, or other hazards.

d) Threat of expropriation of assets.

e) Pending or threatened litigation.

f) Actual or possible claims and assessments.

g) Risk of loss from catastrophes assumed by property and casualty insurance companies including reinsurance companies.

h) Guarantees of indebtedness of others.

i) Obligations of commercial banks under "standby letters of credit."[2]

j) Agreements to repurchase receivables (or to repurchase the related property) that have been sold.

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[2] As defined by the Federal Reserve Board, "standby letters of credit" include "every letter of credit (or similar arrangement however named or designated) which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party or (2) to make payment on account of any evidence of indebtedness undertaken by the account party or (3) to make payment on account of any default by the account party in the performance of an obligation." A note to that definition states that "as defined, 'standby letter of credit' would not include (1) commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer and which do not 'guaranty' payment of a money obligation or (2) a guaranty or similar obligation issued by a foreign branch in accordance with and subject to the limitations of Regulation M [of the Federal Reserve Board]." Regulations of the Comptroller of the Currency and the Federal Deposit Insurance Corporation contain similar definitions.

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.05 Some enterprises now accrue estimated losses from some types of contingencies by a charge to income prior to the occurrence of the event or events that are expected to resolve the uncertainties while, under similar circumstances, other enterprises account for those losses only when the confirming event or events have occurred.

.06 This Statement establishes standards of financial accounting and reporting for loss contingencies (see paragraphs .08—.16) and carries forward without reconsideration the conclusions of *Accounting Research Bulletin (ARB) No. 50*, "Contingencies," with respect to gain contingencies (see paragraph .17) and other disclosures (see paragraphs .18—.19). The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in Appendix C. Examples of application of this Statement are presented in Appendix A, and background information is presented in Appendix B.

.07 This Statement supersedes both *ARB No. 50* and Chapter 6 "Contingency Reserves," of *ARB No. 43*. The conditions for accrual of loss contingencies in paragraph .08 of this Statement do not amend any other present requirement in an Accounting Research Bulletin or Opinion of the Accounting Principles Board to accrue a particular type of loss or expense. Thus, for example, accounting for pension cost, deferred compensation contracts, and stock issued to employees are excluded from the scope of this Statement. Those matters are covered, respectively, in *APB Opinion No. 8* [section 4063], "Accounting for the Cost of Pension Plans," *APB Opinion No. 12*, "Omnibus Opinion—1967," paragraphs 6—8 [section 4064], and *APB Opinion No. 25* [section 4062], "Accounting for Stock Issued to Employees." Accounting for other employment-related costs, such as group insurance, vacation pay, workmen's compensation, and disability benefits, is also excluded from the scope of this Statement. Accounting practices for those types of costs and pension accounting practices tend to involve similar considerations.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accrual of Loss Contingencies

.08 An estimated loss from a loss contingency (as defined in paragraph .01) shall be accrued by a charge to income[3] if *both* of the following conditions are met:

a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.[4] It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b) The amount of loss can be reasonably estimated.

Disclosure of Loss Contingencies

.09 Disclosure of the nature of an accrual[5] made pursuant to the provisions of paragraph .08, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

.10 If no accrual is made for a loss contingency because one or both of the conditions in paragraph .08 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph .08, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or

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[3] [Superseded, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.] (See section 2014.)

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

[5] Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57—64 of *Accounting Terminology Bulletin No. 1,* "Review and Resume").

[6] For example, disclosure shall be made of any loss contingency that meets the condition in paragraph .08(a) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph .08(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph .08(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements.

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

.11 After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph .08(a) is, therefore, not met. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements.

.12 Certain loss contingencies are presently being disclosed in financial statements even though the possibility of loss may be remote. The common characteristic of those contingencies is a guarantee, normally with a right to proceed against an

outside party in the event that the guarantor is called upon to satisfy the guarantee. Examples include (a) guarantees of indebtedness of others, (b) obligations of commercial banks under "standby letters of credit," and (c) guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned. The Board concludes that disclosure of those loss contingencies, and others that in substance have the same characteristic, shall be continued. The disclosure shall include the nature and amount of the guarantee. Consideration should be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.

.13 This Statement applies to regulated enterprises in accordance with provisions of the Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit.'" If, in conformity with the Addendum, a regulated enterprise accrues for financial accounting and reporting purposes an estimated loss without regard to the conditions in paragraph .08, the following information shall be disclosed in its financial statements:

a) The accounting policy including the nature of the accrual and the basis for estimation.

b) The amount of any related "liability" or "asset valuation" account included in each balance sheet presented.

General or Unspecified Business Risks

.14 Some enterprises have in the past accrued so-called "reserves for general contingencies." General or unspecified business risks do not meet the conditions for accrual in paragraph .08, and no accrual for loss shall be made. No disclosure about them is required by this Statement.

Appropriation of Retained Earnings

.15 Some enterprises have classified a portion of retained earnings as "appropriated" for loss contingencies. In some cases, the appropriation has been shown outside the stockholders' equity section of the balance sheet. Appropriation of retained earnings is not prohibited by this Statement provided that it is shown within the stockholders' equity section of the balance sheet and is clearly identified as

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an appropriation of retained earnings. Costs or losses shall not be charged to an appropriation of retained earnings, and no part of the appropriation shall be transferred to income.

Examples of Application of this Statement

.16 Examples of application of the conditions for accrual of loss contingencies in paragraph .08 and the disclosure requirements in paragraphs .09—.11 are presented in Appendix A.

Gain Contingencies

.17 The Board has not reconsidered *ARB No. 50* with respect to gain contingencies. Accordingly, the following provisions of paragraphs 3 and 5 of that Bulletin shall continue in effect:

a) Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

b) Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

Other Disclosures

.18 Paragraph 6 of *ARB No. 50* required disclosure of a number of situations including "unused letters of credit, long-term leases, assets pledged as security for loans, pension plans, the existence of cumulative preferred stock dividends in arrears, and commitments such as those for plant acquisition or an obligation to reduce debts, maintain working capital, or restrict dividends." Subsequent Opinions issued by the Accounting Principles Board established more explicit disclosure requirements for a number of those items, i. e., leases (see *APB Opinion Nos. 5 and 31*)*, pension plans (see *APB Opinion No. 8* [section 4063]), and preferred stock dividend arrearages (see *APB Opinion No. 10,* paragraph 11(b) [section 5515.02b]).

.19 Situations of the type described in the preceding paragraph shall continue to be disclosed in financial statements, and this Statement does not alter the present disclosure requirements with respect to those items.

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* Ed. Note: *APB Opinion Nos. 5 and 31* have been superseded by *FASB Statement No. 13, Accounting for Leases.* See section 4053.

Effective Date and Transition

.20 This Statement shall be effective for fiscal years beginning on or after July 1, 1975, although earlier application is encouraged. Thereafter, if financial statements for periods before the effective date, and financial summaries or other data derived therefrom, are presented, they shall be restated, if practicable, to conform to the provisions of paragraph .08 or .14 of this Statement.* In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period restated. If restatement of financial statements or summaries for all prior periods presented is not practicable, information presented shall be restated for as many consecutive periods immediately preceding the effective date of this Statement as is practicable, and the cumulative effect of applying paragraph .08 or .14 on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which this Statement is first applied if it is not practicable to restate any prior periods) shall be included in determining net income of that period (see paragraph 20 of *APB Opinion No. 20* [section 1051.20]).** The effect on income before extraordinary items, net income, and related per share amounts of applying this Statement in a period in which the cumulative effect is included in determining net income shall be disclosed for that period, and the reason for not restating all of the prior periods presented shall be explained. Reclassification of an appropriation of retained earnings to comply with paragraph .15 of this Statement shall be made in any financial statements for periods before the effective date of this Statement, or financial summaries or other data derived therefrom, that are presented after the effective date of this Statement. [As amended December 1975 by FASB Statement No. 11.] (See section 4312.)

The provisions of this Statement need not be applied to immaterial items.

* This does not alter the accounting for changes in estimates — see paragraph 31 of *APB Opinion No. 20* [section 1051.31].

** Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* [sections 1051.19(d) and 1051.21] are not applicable.

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Appendix A

EXAMPLES OF APPLICATION OF THIS STATEMENT

.21 This Appendix contains examples of application of the conditions for accrual of loss contingencies in paragraph .08 and of the disclosure requirements in paragraphs .09—.11. Some examples have been included in response to questions raised in letters of comment on the Exposure Draft. It should be recognized that no set of examples can encompass all possible contingencies or circumstances. Accordingly, accrual and disclosure of loss contingencies should be based on an evaluation of the facts in each particular case.

Collectibility of Receivables

.22 The assets of an enterprise may include receivables that arose from credit sales, loans, or other transactions. The conditions under which receivables exist usually involve some degree of uncertainty about their collectibility, in which case a contingency exists as defined in paragraph .01. Losses from uncollectible receivables shall be accrued when both conditions in paragraph .08 are met. Those conditions may be considered in relation to individual receivables or in relation to groups of similar types of receivables. If the conditions are met, accrual shall be made even though the particular receivables that are uncollectible may not be identifiable.

.23 If, based on available information, it is probable that the enterprise will be unable to collect all amounts due and, therefore, that at the date of its financial statements the net realizable value of the receivables through collection in the ordinary course of business is less than the total amount receivable, the condition in paragraph .08(a) is met because it is probable that an asset has been impaired. Whether the amount of loss can be reasonably estimated (the condition in paragraph .08(b)) will normally depend on, among other things, the experience of the enterprise, information about the ability of individual debtors to pay, and appraisal of the receivables in light of the current economic environment. In the case of an enterprise that has no experience of its own, reference to the experience of other enterprises in the same business may be appropriate. Inability to make a reasonable estimate of the amount of loss from uncollectible receivables (i. e., failure to satisfy the condition in paragraph .08(b))

precludes accrual and may, if there is significant uncertainty as to collection, suggest that the installment method, the cost recovery method, or some other method of revenue recognition be used (see paragraph 12 of *APB Opinion No. 10* [section 4020.01], "Omnibus Opinion—1966"); in addition, the disclosures called for by paragraph .10 of this Statement should be made.

Obligations Related to Product Warranties and Product Defects

.24 A warranty is an obligation incurred in connection with the sale of goods or services that may require further performance by the seller after the sale has taken place. Because of the uncertainty surrounding claims that may be made under warranties, warranty obligations fall within the definition of a contingency in paragraph .01. Losses from warranty obligations shall be accrued when the conditions in paragraph .08 are met. Those conditions may be considered in relation to individual sales made with warranties or in relation to groups of similar types of sales made with warranties. If the conditions are met, accrual shall be made even though the particular parties that will make claims under warranties may not be identifiable.

.25 If, based on available information, it is probable that customers will make claims under warranties relating to goods or services that have been sold, the condition in paragraph .08(a) is met at the date of an enterprise's financial statements because it is probable that a liability has been incurred. Satisfaction of the condition in paragraph .08(b) will normally depend on the experience of an enterprise or other information. In the case of an enterprise that has no experience of its own, reference to the experience of other enterprises in the same business may be appropriate. Inability to make a reasonable estimate of the amount of a warranty obligation at the time of sale because of significant uncertainty about possible claims (i.e., failure to satisfy the condition in paragraph .08(b)) precludes accrual and, if the range of possible loss is wide, may raise a question about whether a sale should be recorded prior to expiration of the warranty period or until sufficient experience has been gained to permit a reasonable estimate of the obligation; in addition, the disclosures called for by paragraph .10 of this Statement should be made.

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.26 Obligations other than warranties may arise with respect to products or services that have been sold, for example, claims resulting from injury or damage caused by product defects. If it is probable that claims will arise with respect to products or services that have been sold, accrual for losses may be appropriate. The condition in paragraph .08(a) would be met, for instance, with respect to a drug product or toys that have been sold if a health or safety hazard related to those products is discovered and as a result it is considered probable that liabilities have been incurred. The condition in paragraph .08(b) would be met if experience or other information enables the enterprise to make a reasonable estimate of the loss with respect to the drug product or the toys.

Risk of Loss or Damage of Enterprise Property

.27 At the date of an enterprise's financial statements, it may not be insured against risk of future loss or damage to its property by fire, explosion, or other hazards. The absence of insurance against losses from risks of those types constitutes an existing condition involving uncertainty about the amount and timing of any losses that may occur, in which case a contingency exists as defined in paragraph .01. Uninsured risks may arise in a number of ways, including (a) noninsurance of certain risks or co-insurance or deductible clauses in an insurance contract or (b) insurance through a subsidiary or investee[7] to the extent not reinsured with an independent insurer. Some risks, for all practical purposes, may be noninsurable, and the self-assumption of those risks is mandatory.

.28 The absence of insurance does not mean that an asset has been impaired or a liability has been incurred at the date of an enterprise's financial statements. Fires, explosions, and other similar events that may cause loss or damage of an enterprise's property are random in their occurrence.[8] With respect to events of that type, the condition for accrual in

[7] The effects of transactions between a parent or other investor and a subsidiary or investee insurance company shall be eliminated from an enterprise's financial statements (see paragraph 6 of *ARB No. 51* [section 2051.07], "Consolidated Financial Statements," and paragraph 19(a) of *APB Opinion No. 18* [section 5131.19(a)], "The Equity Method of Accounting for Investments in Common Stock").

[8] The Board recognizes that, in practice, experience regarding loss or damage to depreciable assets is in some cases one of the factors considered in estimating the depreciable lives of a group of depreciable assets, along with such other factors as wear and tear, obsolescence, and maintenance and replacement policies. This Statement is not intended to alter present depreciation practices (see paragraph .02).

paragraph .08(a) is not satisfied prior to the occurrence of the event because until that time there is no diminution in the value of the property. There is no relationship of those events to the activities of the enterprise prior to their occurrence, and no asset is impaired prior to their occurrence. Further, unlike an insurance company, which has a contractual obligation under policies in force to reimburse insureds for losses, an enterprise can have no such obligation to itself and, hence, no liability.

Risk of Loss from Future Injury to Others, Damage to the Property of Others, and Business Interruption

.29 An enterprise may choose not to purchase insurance against risk of loss that may result from injury to others, damage to the property of others, or interruption of its business operations.[9] Exposure to risks of those types constitutes an existing condition involving uncertainty about the amount and timing of any losses that may occur, in which case a contingency exists as defined in paragraph .01.

.30 Mere exposure to risks of those types, however, does not mean that an asset has been impaired or a liability has been incurred. The condition for accrual in paragraph .08(a) is not met with respect to loss that may result from injury to others, damage to the property of others, or business interruption that may occur after the date of an enterprise's financial statements. Losses of those types do not relate to the current or a prior period but rather to the *future* period in which they occur. Thus, for example, an enterprise with a fleet of vehicles should not accrue for injury to others or damage to the property of others that may be caused by those vehicles in the future even if the amount of those losses may be reasonably estimable. On the other hand, the conditions in paragraph .08 would be met with respect to uninsured losses resulting from injury to others or damage to the property of others that took place prior to the date of the financial statements, even though the enterprise may not become aware of those matters until after that date, if the experience of the enterprise or other information enables it to make a reasonable estimate of the loss that was incurred prior to the date of its financial statements.

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[9] As to injury or damage resulting from products that have been sold, see paragraph .26.

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Write-Down of Operating Assets

.31 In some cases, the carrying amount of an operating asset not intended for disposal may exceed the amount expected to be recoverable through future use of that asset even though there has been no physical loss or damage of the asset or threat of such loss or damage. For example, changed economic conditions may have made recovery of the carrying amount of a productive facility doubtful. The question of whether, in those cases, it is appropriate to write down the carrying amount of the asset to an amount expected to be recoverable through future operations is not covered by this Statement.

Threat of Expropriation

.32 The threat of expropriation of assets is a contingency within the definition of paragraph .01 because of the uncertainty about its outcome and effect. If information indicates that expropriation is imminent and compensation will be less than the carrying amount of the assets, the condition for accrual in paragraph .08(a) is met. Imminence may be indicated, for example, by public or private declarations of intent by a government to expropriate assets of the enterprise or actual expropriation of assets of other enterprises. Paragraph .08(b) requires that accrual be made only if the amount of loss can be reasonably estimated. If the conditions for accrual are not met, the disclosures specified in paragraph .10 would be made when there is at least a reasonable possibility that an asset has been impaired.

Litigation, Claims, and Assessments

.33 The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

a) The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.

b) The degree of probability of an unfavorable outcome.

c) The ability to make a reasonable estimate of the amount of loss.

.34 As a condition for accrual of a loss contingency, paragraph .08(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued, for example, a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. Disclosure may be required, however, by paragraph .11.

.35 On the other hand, accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an enterprise's financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued, accrual of a loss related to the litigation, claim, or assessment would be required if the probability of loss is such that the condition in paragraph .08(a) is met and the amount of loss can be reasonably estimated.

.36 If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph .08(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph .08(a) is met.

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.37 The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph .08(a) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph .10 of this Statement.

.38 With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph .08. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph .10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph .10.

.39 As a condition for accrual of a loss contingency, paragraph .08(b) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of

the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph .08(a)), but the range of possible loss is wide. For example, an enterprise may be litigating an income tax matter. In preparation for the trial, it may determine that, based on recent decisions involving one aspect of the litigation, it is probable that it will have to pay additional taxes of $2 million. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay taxes of $8 million over and above the $2 million. In that case, paragraph .08 requires accrual of the $2 million if that is considered a reasonable estimate of the loss. Paragraph .10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that additional taxes will be paid. Depending on the circumstances, paragraph .09 may require disclosure of the $2 million that was accrued.

Catastrophe Losses of Property and Casualty Insurance Companies

.40 At the time that a property and casualty insurance company or reinsurance company issues an insurance policy covering risk of loss from catastrophes, a contingency arises. The contingency is the risk of loss *assumed* by the insurance company, that is, the risk of loss from catastrophes that may occur *during the term of the policy*. The insurance company has not assumed risk of loss for catastrophes that may occur *beyond* the term of the policy. Clearly, therefore, no asset has been impaired or liability incurred with respect to catastrophes that may occur beyond the terms of policies in force.

.41 The conditions in paragraph .08 should be considered with respect to the risk of loss assumed by an insurance company for catastrophes that may occur during the terms of policies in force to determine whether accrual of a loss is appropriate. To satisfy the condition in paragraph .08(a) that it be probable that a liability has been incurred to existing policyholders, the occurrence of catastrophes (i.e., the confirming future events) would have to be reasonably predictable within the terms of policies in force. Further, to satisfy the condition in paragraph .08(b), the amounts of losses therefrom would have to be reasonably estimable. Actuarial techniques are employed by insurance companies to predict the rate of occurrence of and amounts of losses from catastrophes over long periods of time for insurance rate-setting purposes.

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Predictions over relatively short periods of time, such as an individual accounting period or the terms of a large number of existing insurance policies in force, are subject to substantial deviations. Consequently, assumption of risk of loss from catastrophes by property and casualty insurance companies and reinsurance companies fails to satisfy the conditions for accrual in paragraphs .08(a) and .08(b). Moreover, deferral of unearned premiums *within* the terms of policies in force represents the "unknown liability" for loss (including catastrophe losses) on unexpired policies, making an accrual inappropriate—see paragraphs .94—.96 in Appendix C. Recognition of premium income as earned revenue within the terms of policies in force is discussed in the AICPA Industry Audit Guide, "Audits of Fire and Casualty Insurance Companies."

.42 Although some property and casualty insurance companies have accrued an estimated amount for catastrophe losses, other insurance companies have accomplished the same objective by deferring a portion of the premium income. Deferral of any portion of premium income *beyond the terms of policies in force* is, in substance, similar to premature accrual of catastrophe losses and, therefore, also does not meet the conditions of paragraph .08.

.43 The conditions for accrual in paragraph .08 do not prohibit a property and casualty insurance company from accruing probable catastrophe losses that have been incurred on or before the date of its financial statements but that have not been reported by its policyholders as of that date. If the amount of loss can be reasonably estimated, paragraph .08 requires accrual of those incurred-but-not-reported losses.

Payments to Insurance Companies That May Not Involve Transfer of Risk

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

.45 Operations in certain industries may be subject to such high risks that insurance is unavailable or is available only at what is considered to be a prohibitively high cost. Some enterprises in those industries have "pooled" their risks by forming a mutual insurance company in which they retain an equity interest and to which they pay insurance premiums. For example, some electric utility companies have formed such a mutual insurance company to insure risks related to nuclear power plants, and some oil companies have formed a company to insure against risks associated with petroleum exploration and production. Whether the premium paid represents a payment for the transfer of risk or whether it represents merely a deposit will depend on the circumstances surrounding each enterprise's interest in and insurance arrangement with the mutual insurance company. An analysis of the contract is required to determine whether risk has been transferred and to what extent.

Appendix B

BACKGROUND INFORMATION

.46 In April 1973, the FASB placed on its technical agenda a project then entitled "Accounting for Future Losses." The project addressed accrual and disclosure of loss contingencies. The Board believes that "Accounting for Contingencies" is a more descriptive title for this Statement than "Accounting for Future Losses."

.47 A task force of 16 persons from industry, public accounting, the financial community, and academe was appointed in the summer of 1973 to provide counsel to the Board in preparing a Discussion Memorandum analyzing issues related to the project.

.48 The Discussion Memorandum gave examples of various types of contingencies and considered several of those at length to assist in the development of standards of financial accounting and reporting. These included (a) uninsured risks ("self-insurance"), (b) risk of losses from catastrophes assumed by property and casualty insurance companies, and (c) risk of losses from expropriations by foreign governments.

.49 Research undertaken in connection with this project included (a) a search of relevant literature, (b) an examination of published financial statements in annual reports to shareholders and in filings with the SEC on Form 10-K, (c) a questionnaire survey conducted by the Financial

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Executives Institute to which 64 companies responded, and (d) a study of catastrophe reserve accounting methods employed by property and casualty insurance companies. Summaries of research findings are included in appendices to the Discussion Memorandum.

.50 On January 3, 1973 (prior to the date the Board placed this subject on its agenda), the Securities and Exchange Commission issued its *Accounting Series Release No. 134*, which pointed out that a number of property and casualty insurance companies had adopted the accounting policy of making a provision from each period's income to cover a portion of major losses expected to occur in future periods. The SEC Release indicated that the Committee on Insurance Accounting and Auditing of the AICPA was working actively on the subject in cooperation with industry groups. The Release set forth certain disclosure requirements pending resolution of the question of accrual.

.51 The AICPA committee's report (dated July 17, 1973) was in the form of a memorandum setting forth the views of those committee members favoring and those opposing accrual of losses from future catastrophes. In the course of its study, the AICPA committee had gathered considerable data on the subject, in part from a survey of member companies of the American Insurance Association, and this information was made available to the Board.

.52 On August 2, 1973, the SEC announced in *Accounting Series Release No. 145* that property and casualty insurance companies should not change their method of accounting for catastrophe losses "until a single method has been adopted by the Financial Accounting Standards Board."

.53 The Board issued the Discussion Memorandum on March 13, 1974, and held a public hearing on the subject on May 13, 1974. The Board received 87 position papers, letters of comment, and outlines of oral presentations in response to the Discussion Memorandum. Eighteen presentations were made at the public hearing.

.54 An Exposure Draft of a proposed Statement on "Accounting for Contingencies" was issued on October 21, 1974. The Board received 212 letters of comment on the Exposure Draft.

Appendix C

BASIS FOR CONCLUSIONS

.55 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others.

SCOPE OF THIS STATEMENT

.56 Some respondents to the Exposure Draft proposed that the Statement not deal with accrual and disclosure of loss contingencies in general but, rather, only with the following three specific matters: "self-insurance," risks of losses from catastrophes assumed by property and casualty insurance companies including reinsurance companies, and threat of expropriation. As the basis for that position, they noted that the Discussion Memorandum considered those three matters at length. Other respondents suggested that catastrophe losses be dealt with in a separate Statement.

.57 The Board has concluded, however, that the broad issue of accrual and disclosure of loss contingencies should be dealt with in a single Statement, just as the Discussion Memorandum encompassed "the broad issue of accounting for future losses."[10] As the Discussion Memorandum stated, "future losses of all types presently known to affect enterprises and new types of future losses that may arise are conceptually included in the scope of this project." The three matters dealt with at length in the Discussion Memorandum were used "as examples to assist in the evaluation and development of criteria for accounting for future losses," and other examples were discussed. The Board has concluded that

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[10] The Board believes that *contingencies* is a more descriptive term than *future losses,* and the Discussion Memorandum indicated that the project would necessarily involve reconsideration of both *ARB No. 50* and Chapter 6 of *ARB No. 43.*

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loss contingencies such as those given as examples in paragraph .04 of this Statement have common characteristics and that questions about accounting for and reporting of those contingencies should be resolved comprehensively. It is for that reason, also, that the Board believes it inappropriate to deal with catastrophe losses in a separate Statement.

.58 A question has been raised whether uncollectibility of receivables and product warranties constitute contingencies within the scope of this Statement. The Board recognizes that uncertainties associated with uncollectibility of some receivables and some product warranties are likely to be, in part, inherent in making accounting estimates (described in paragraph .02) as well as, in part, the type of uncertainties that give rise to a contingency (described in paragraph .01). The Board believes that no useful purpose would be served by attempting to distinguish between those two types of uncertainties for purposes of establishing conditions for accrual of uncollectible receivables and product warranties. Consequently, those matters are deemed to be contingencies within the definition of paragraph .01 and should be accounted for pursuant to the provisions of this Statement.

ACCRUAL OF LOSS CONTINGENCIES

.59 Paragraph .08 requires that a loss contingency be accrued if the two specified conditions are met. The purpose of those conditions is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. The requirement that the loss be reasonably estimable is intended to prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of those statements. The Board has concluded that disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Further, even losses that are reasonably estimable should not be accrued if it is not probable that an asset has been impaired or a liability has been incurred at the date of an enterprise's financial statements because those losses relate to a future period rather than the current or a prior period. Attribution of a loss to events or activities of

the current or prior periods is an element of asset impairment or liability incurrence.

.60 In establishing the conditions in paragraph .08, Board members considered the factors discussed in paragraphs .61—.101. Individual Board members gave greater weight to some factors than to others.

Accounting Accruals Do Not Provide Protection Against Losses

.61 Accrual of a loss related to a contingency does not create or set aside funds to lessen the possible financial impact of a loss, although some respondents to the Discussion Memorandum and the Exposure Draft argued to the contrary. The Board believes that confusion exists between accounting accruals (sometimes referred to as "accounting reserves") and the reserving or setting aside of specific assets to be used for a particular purpose or contingency. Accounting accruals are simply a method of allocating costs among accounting periods and have no effect on an enterprise's cash flow. An enterprise may choose to maintain or have access to sufficient liquid assets to replace or repair lost or damaged property or to pay claims in case a loss occurs. Alternatively, it may transfer the risk to others by purchasing insurance. Those are financial decisions, and if enterprise management decides to do neither, the presence or absence of an accrued credit balance on the balance sheet will have no effect on the consequences of that decision. The accounting standards set forth in this Statement do not affect the fundamental business economics of that decision.

.62 In that regard, some respondents to the Discussion Memorandum and the Exposure Draft contended that an accounting standard that does not permit periodic accrual of so-called "self-insurance reserves" and, in the case of insurance companies, so-called "catastrophe reserves" will force enterprises to purchase insurance or reinsurance because the "protection" afforded by the accrual would no longer exist. Those accruals, however, in no way protect the assets available to replace or repair uninsured property that

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may be lost or damaged, or to satisfy claims that are not covered by insurance, or, in the case of insurance companies, to satisfy the claims of insured parties. Accrual, in and of itself, provides no financial protection that is not available in the absence of accrual.

.63 The sole result of accrual, for financial accounting and reporting purposes, is allocation of costs among accounting periods. Some respondents to the Discussion Memorandum and the Exposure Draft took the position that estimated losses from loss contingencies should be accrued even before available information indicates that it is probable that an asset has been impaired or a liability has been incurred to avoid reporting net income that fluctuates widely from period to period. In their view, financial statement users may be misled by those fluctuations. They believe that estimated losses should be accrued without regard to whether the loss relates to the current period if, based on experience, it is reasonable to expect losses sometime in the future.

.64 Financial statement users have indicated, however, that information about earnings variability is important to them. Two elements often cited as basic to the decision models of many financial statement users are (a) expected return — the predicted amount and timing of the return on an investment — and (b) risk — the variability of that expected return. If the nature of an enterprise's operations is such that irregularities in the incurrence of losses cause variations in periodic net income, that fact should not be obscured by accruing for anticipated losses that do not relate to the current period.

.65 The Board recognizes that some investors may have a preference for investments in enterprises having a stable pattern of earnings, because that indicates lesser uncertainty or risk than fluctuating earnings. That preference, in turn, is perceived by many as having a favorable effect on the market prices of those enterprises' securities. If accruals for such matters as future uninsured losses and catastrophes were prohibited, some respondents contended, enterprises would be forced to purchase insurance or reinsurance to achieve the more stable pattern of reported earnings that tends to

accompany the use of an "accounting reserve." Insurance or reinsurance reduces or eliminates risks and the inherent earnings fluctuations that accompany risks. Unlike insurance and reinsurance, however, the use of "accounting reserves" does not reduce or eliminate risk. The Board rejects the contention, therefore, that the use of "accounting reserves" is an alternative to insurance and reinsurance in protecting against risk. Earnings fluctuations are inherent in risk retention, and they should be reported as they occur. The Board cannot sanction the use of an accounting procedure to create the illusion of protection from risk when, in fact, protection does not exist.

.66 The Board has also considered the argument that periodic accrual of losses without regard to whether an asset has been impaired or liability incurred is justified on grounds of comparability of financial statements among enterprises. Some respondents contended, for example, that accrual is necessary to make the financial statements of enterprises that do not purchase insurance comparable to those of enterprises that do purchase insurance (and report the premiums as expenses) and to make the financial statements of property and casualty insurance companies comparable regardless of the extent to which reinsurance has been purchased. In the Board's view, however, to report activity when there has been none would obscure a fundamental difference in circumstance between enterprises that transfer risks to others and those that do not.

Financial Accounting and Reporting Reflects Primarily the Effects of Past Transactions and Existing Conditions

.67 Financial accounting and reporting reflects primarily the effects of past transactions and existing conditions, not future transactions or conditions. For example, paragraph 35 of *APB Statement No. 4* [section 1022.27], "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," states:

> Financial accounting and financial statements are primarily historical in that information about events that have taken place provides the basic data of financial accounting and financial statements.

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.68 The first condition in paragraph .08—that a loss contingency not be accrued until it is probable that an asset has been impaired or a liability has been incurred — is consistent with this concept of financial accounting and financial statements. That condition is not so past-oriented that accrual of a loss must await the occurrence of the confirming future event, for example, final adjudication or settlement of a lawsuit. The condition requires only that it be probable that the confirming future event will occur. The condition is intended to prohibit the recognition of a liability when it is not probable that one has been incurred and to prohibit the accrual of an asset impairment when it is not probable that an asset of an enterprise has been impaired.

The Concept of a Liability

.69 In many cases, the accrual of a loss contingency results in the recording of a liability, for example, accruals for a probable tax assessment, a warranty obligation, or a probable loss resulting from the guarantee of indebtedness of others. In the course of its deliberations, therefore, the Board found it relevant to consider the concept of a liability as expressed in accounting literature.

.70 The economic obligations of an enterprise are defined in paragraph 58 of *APB Statement No. 4* [section 1023.19] as "its present responsibilities to transfer economic resources or provide services to other entities in the future." Two aspects of that definition are especially relevant to accounting for contingencies: first, that liabilities are *present* responsibilities and, second, that they are obligations to *other entities.* Those notions are supported by other definitions of liabilities in published accounting literature, for example:

> Liabilities are claims of creditors against the enterprise, arising out of past activities, that are to be satisfied by the disbursement or utilization of corporate resources.[11]

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[11] American Accounting Association, *Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements* (Sarasota, Fla.: AAA, 1957), p. 16.

> A liability is the result of a transaction of the past, not of the future.[12]

.71 The condition in paragraph .08(a)—that a loss contingency shall be accrued if it is probable that a liability has been incurred — is intended to proscribe recognition of losses that relate to future periods but to require accrual of losses that relate to the current or a prior period (assuming the amount of loss can be reasonably estimated -- see paragraph .08(b)).

.72 Liability definitions also generally require that the amount of an economic obligation be known or susceptible of reasonable estimation before it is recorded as a liability. For example:

> [Liabilities] are measured by cash received, by the established price of noncash assets or services received, or by estimates of a definitive character when the amount owing cannot be measured more precisely.[13]

> The amount of the liability must be the subject of calculation or of close estimation.[14]

.73 The condition in paragraph .08(b)—that an estimated loss from a loss contingency not be accrued until the amount of loss can be reasonably estimated — is consistent with this feature of the liability concept.

Accounting for Impairment of Value of Assets

.74 The accrual of some loss contingencies may result in recording the impairment of the value of an asset rather than in recording a liability, for example, accruals for expropriation of assets or uncollectible receivables.

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[12] Maurice Moonitz, "The Changing Concept of Liabilities," *The Journal of Accountancy*, May 1960, p. 44.

[13] American Accounting Association, *Accounting and Reporting Standards for Corporate Financial Statements*, p. 16.

[14] Maurice Moonitz, "The Changing Concept of Liabilities," p. 44.

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Accounting presently recognizes impairments of the value of assets such as the following:

a) Paragraph 9 of Chapter 3A, "Current Assets and Current Liabilities," of *ARB No. 43* [section 2031.09] provides that "in the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value."

b) Statement 5 of Chapter 4, "Inventory Pricing," of *ARB No. 43* [section 5121.07—.08] states that "a departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. . . . A loss of utility is to be reflected as a charge against the revenues of the period in which it occurs."

c) Paragraph 19(h) of *APB Opinion No. 18* [section 5131.19 (h)], "The Equity Method of Accounting for Investments in Common Stock," states that "a loss in value of an investment which is other than a temporary decline should be recognized the same as a loss in value of other long-term assets."

d) Paragraph 15 of *APB Opinion No. 30* [section 2012.15], "Reporting the Results of Operations," states that "if a loss is expected from the proposed sale or abandonment of a segment, the estimated loss should be provided for at the measurement date. . . ." Paragraph 14 [section 2012.14] states that the measurement date is the date on which management "commits itself to a formal plan to dispose of a segment of the business, whether by sale or abandonment."

e) Paragraph 183 of *APB Statement No. 4* [section 1027.09] states that "when enterprise assets are damaged by others, asset amounts are written down to recoverable costs and a loss is recorded."

.75 A recurring principle underlying all of these references to asset impairments in the accounting literature is that a loss should not be accrued until it is probable that an asset *has*

been impaired and the amount of the loss can be reasonably estimated. As indicated by those references, impairment is recognized, for instance, when a non-temporary decline in the market price of marketable securities below cost *has taken place*, when the utility of inventory *is no longer* as great as its cost, when a commitment, in terms of a formal plan, *has been made* to abandon a segment of a business or to sell a segment at less than its carrying amount, when enterprise assets *are damaged*, and so forth. The condition in paragraph .08(a) is intended to proscribe accrual of losses that relate to future periods, and the condition in paragraph .08(b) further requires that the amount of loss be reasonably estimable before it is accrued.

The Matching Concept

.76 A number of respondents to the Discussion Memorandum and the Exposure Draft noted that losses from certain types of contingencies are likely to occur irregularly over an extended period of time encompassing a number of accounting periods. In their view, the matching process in accounting requires that estimated losses from those types of contingencies be accrued in each accounting period even if not directly related to events or activities of the period.

.77 *APB Statement No. 4* [sections 1021—1029] explicitly avoids using the term "matching" because it has a variety of meanings in the accounting literature. In its broadest sense, matching refers to the entire process of income determination —described in paragraph 147 of *APB Statement No. 4* [section 1026.11] as "identifying, measuring, and relating revenue and expenses of an enterprise for an accounting period." Matching may also be used in a more limited sense to refer only to the process of expense recognition or in an even more limited sense to refer to the recognition of expenses by associating costs with revenue on a cause and effect basis.

.78 Three pervasive principles for recognizing costs as expenses are set forth in paragraphs 156-160 of *APB Statement No. 4* [section 1026.20—.24] as follows:

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> *Associating Cause and Effect.* . . . Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue . . . recognizing them as expenses accompanies recognition of the revenue.
>
> *Systematic and Rational Allocation.* . . . If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect.
>
> *Immediate Recognition.* Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.

.79 Some who believe that matching requires accrual of losses that are likely to occur irregularly over an extended period of time encompassing a number of accounting periods cite the systematic and rational allocation principle of expense recognition as justification for their position. That principle, however, involves the systematic and rational allocation of the cost of an asset (an asset that *has been* acquired) throughout the estimated periods that the asset provides benefits or the systematic and rational accrual of the amount of some obligations (obligations that *have been* incurred) throughout the estimated periods that the obligations are incurred. The customary depreciation of plant and equipment is an example of the former; when reasonably estimable, the accrual of vacation pay is an example of the latter. The systematic and rational allocation principle has no application to assets that are expected to be acquired in the future or to obligations that are expected to be incurred in the future.

.80 Matching, in the sense of recognizing expenses by associating costs with specific revenue on a cause and effect basis, is a consideration in relation to accrual for such matters as uncollectible receivables and warranty obligations. For example, most enterprises that make credit sales or warrant

their products or services regularly incur losses from uncollectible receivables and warranty obligations. Frequently, those losses can be associated with revenue on a cause and effect basis. If the amount of those losses can be reasonably estimated, paragraph .08 of this Statement requires accrual if it is probable that an asset has been impaired (estimated uncollectible receivables) or that a liability has been incurred (estimated warranty claims).

Spreading the Burden of Irregularly Occurring Costs to Successive Generations of Customers and Shareholders

.81 Some respondents to the Discussion Memorandum and the Exposure Draft contended that all costs of doing business should be accrued in each accounting period so that successive generations of customers and shareholders would bear their share of all costs including those that occur irregularly. It would seem, however, that those irregularly occurring costs are usually borne by customers through pricing policy and that pricing is not necessarily dependent upon financial accounting and reporting practices. With regard to accrual on grounds that it enables successive generations of shareholders to bear their share of irregularly occurring costs, see paragraphs .63—.65.

Conservatism

.82 On the grounds of conservatism, some respondents supported accrual of estimated losses from loss contingencies before available information indicates that it is probable that an asset has been impaired or a liability has been incurred. Conservatism is indicated as one of the "characteristics and limitations" of financial accounting in paragraph 35 of *APB Statement No. 4* [section 1022.27] as follows:

> *Conservatism.* The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income.

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.83 Conservatism is further discussed in paragraph 171 of *APB Statement No. 4* [section 1026.35]:

> *Conservatism.* Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism. . . .

.84 The conditions for accrual in paragraph .08 are not inconsistent with the accounting concept of conservatism. Those conditions are not intended to be so rigid that they require virtual certainty before a loss is accrued. They require only that it be *probable* that an asset has been impaired or a liability has been incurred and that the amount of loss be *reasonably* estimable. In the absence of that probability or estimability, however, the Board has concluded that disclosure is preferable to accruing in the financial statements amounts so uncertain as to impair the integrity of the financial statements.

Risk of Future Loss or Damage of Enterprise Property, Injury to Others, Damage to the Property of Others, and Business Interruption

.85 Some persons contend that the decision not to purchase insurance against losses that can be reasonably expected some time in the future (such as risk of loss or damage of enterprise property, injury to others, damage to the property of others, and business interruption) justifies periodic accrual for those losses without regard to whether it is probable that an asset has been impaired or a liability incurred at the date of the financial statements. As a basis for their position, they frequently cite the following factors: matching of revenue and expense, spreading the burden of irregularly occurring costs to successive generations of customers, and conservatism. They also believe that accrual of estimated losses from those types of risks improves the comparability of the financial statements of enterprises that do not insure with those of enterprises that purchase insurance. Some

contend that a prohibition against periodic accrual for uninsured losses will force enterprises to purchase insurance coverage that would not otherwise be purchased.

.86 In the Board's judgment, however, the mere existence of risk, at the date of an enterprise's financial statements, does not mean that a loss should be accrued. Anticipation of asset impairments or liabilities or losses from business interruption that do not relate to the current or a prior period is not justified by the matching concept.

.87 The Board's views regarding the contention that periodic accrual for uninsured losses is a way of providing protection against loss and improving comparability among enterprises that do and do not purchase insurance, and the contention that prohibition of accrual will force enterprises to purchase insurance, are discussed in paragraphs .61—.66. The Board's position regarding periodic accrual for uninsured risks and other loss contingencies on the grounds of spreading the burden of irregularly occurring costs to successive generations of customers or on the grounds of conservatism is discussed in paragraphs .81—.84.

.88 Some respondents to the Exposure Draft said that prohibition against periodic accrual for uninsured losses would be detrimental to government contractors because requirements of Federal government agencies in auditing costs subject to procurement regulations currently allow reimbursement for periodic accruals for uninsured losses only if they are included in the contractor's financial statements. Contract reimbursement and financial accounting and reporting may well have different objectives. Accordingly, the provisions of this Statement may not be appropriate for contract reimbursement purposes.

Catastrophe Losses of Property and Casualty Insurance Companies

.89 At the time that a property and casualty insurance company or reinsurance company issues an insurance policy covering risk of loss from catastrophes, a contingency arises.

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The contingency is the risk of loss *assumed* by the insurance company, that is, the risk of loss from catastrophes that may occur *during the term of the policy.*

.90 Some respondents to the Discussion Memorandum and the Exposure Draft proposed that insurance companies accrue estimated losses from catastrophes including both those that may occur during the terms of insurance policies in force and those that may occur beyond the terms of policies in force. Other respondents proposed that some portion of the premium revenue of a property and casualty insurance company be deferred beyond the terms of insurance policies in force to provide what, in substance, is an estimated liability for future castasrophe losses. Some respondents proposed that accrual of estimated losses or deferral of premiums be permitted but not required. On the other hand, some respondents to the Discussion Memorandum and the Exposure Draft were opposed to any accrual for future catastrophe losses by means of an estimated liability or deferral of premium revenue. Because those estimated liabilities and revenue deferrals have come to be referred to as "catastrophe reserves," that term will be used in paragraphs .91—.101 for convenience.

.91 In response to the Exposure Draft, it was recommended that the FASB appoint a special committee to study further the matter of catastrophe reserve accounting and to make recommendations thereon. The Board has concluded, however, that its own research and that of others (mentioned in Appendix B to this Statement and summarized in the Discussion Memorandum), the written responses received to the Discussion Memorandum, the presentations made at the public hearing, and the letters of comment on the Exposure Draft provide the Board with sufficient information with which to reach a conclusion.

.92 Proponents of catastrophe reserve accounting generally cite the following reasons for their position:

a) *Catastrophes certain to occur.* Over the long term, catastrophes are certain to occur; therefore, they are not contingencies.

b) *Predictability of catastrophe losses.* On the basis of experience and by application of appropriate statistical techniques, catastrophe losses can be predicted over the long term with reasonable accuracy.

c) *Matching.* Some portion of property and casualty insurance premiums is intended to cover losses that usually occur infrequently and at intervals longer than both the terms of the policies in force and the financial accounting and reporting period. Catastrophe losses should, therefore, be accrued when the revenue is recognized (or premiums should be deferred beyond the terms of policies in force to periods in which the catastrophes occur) to match catastrophe losses with the related revenue.

d) *Stabilization of reported income.* Catastrophe reserve accounting stabilizes reported income and avoids erratic variations caused by irregularly occurring catastrophes.

e) *Comparability.* Reinsurance premiums paid by a prime insurer are said to be similar to accrual of catastrophe losses prior to their occurrence because the reinsurance premiums paid reduce income before a catastrophe loss occurs. Accrual of catastrophe losses as an expense prior to occurrence of a catastrophe makes the financial statements of property and casualty insurance companies comparable regardless of the extent to which reinsurance has been purchased.

f) *Non-accrual would force purchase of reinsurance.* Non-accrual of catastrophe losses will force property and casualty insurance companies to purchase reinsurance.

g) *Generations of policyholders.* Periodic accrual of estimated catastrophe losses charges each generation of policyholders with its share of the loss through the premium structure.

.93 The Board does not find those arguments persuasive. The fact that over the long term catastrophes are certain to occur does not justify accrual before the catastrophes occur. As

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stated in paragraph .59, the purpose of the conditions for accrual in paragraph .08 is to require accrual of losses if they are reasonably estimable *and relate to the current or a prior period.* An enterprise may know with certainty, for example, next year's administrative salaries, but that does not justify accrual in the current accounting period because those salaries do not relate to that period. As indicated in paragraphs .67—.68, financial accounting and reporting reflects primarily the effects of past transactions and existing conditions, not future transactions or conditions; accrual for losses from catastrophes that are expected to occur *beyond the terms of insurance policies in force* would amount to accrual of a liability before one has been incurred. Existing policyholders are insured only during the period covered by their insurance contracts; an insurance company is not presently obligated to policyholders for catastrophes that may occur after expiration of their policies. Accrual for those catastrophe losses would record a liability that is inconsistent with the concept of a liability discussed in paragraphs .69—.73.

.94 The Board recognizes that the costs of catastrophes to insurance companies are large and are incurred irregularly and that insurance companies recoup those costs in the long run through periodic adjustments in the premiums charged to policyholders. It is the view of the Board, however, that the long-run nature of pricing of premiums should not be a determinant of the time when a liability is recorded.

.95 The AICPA Industry Audit Guide, "Audits of Fire and Casualty Insurance Companies," describes accounting for premiums as follows (pp. 24-25):

> As soon as a policy is issued promising to indemnify for loss, the insurance company incurs a potential liability. The company may be called upon to pay the full amount of the policy, a portion of the policy, or nothing. It would be impossible to try to measure the liability under a single policy. However, since insurance is based on the law of averages, one may estimate from experience the loss on a large number of policies.

> As state supervision of insurance developed, the insurance departments set about providing a legal basis for determining the potential liability under outstanding policies in order to establish an ample reserve for the protection of policyholders and provide a uniform method of calculation. It was recognized that, since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term on a uniform basis for all companies. Therefore the unearned premium was adopted as the basis for computing the unknown liability on unexpired policies.

.96 Because unearned premiums represents the "unknown liability," the Board is of the view that it is inappropriate to accrue an additional amount as an estimate for that same unknown liability. Further, in the Board's view, deferral of premiums beyond the terms of policies in force is inconsistent with the concept of revenue recognition set forth in the Audit Guide and is without any conceptual basis. Moreover, the Board believes that its conclusion regarding the time at which accruals shall be made for catastrophic losses is consistent with the Audit Guide. It should be noted that this Statement does not prohibit (and, in fact, requires) accrual of a *net* loss (that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated, just as accrual of net losses on long-term construction-type contracts is required (see *ARB No. 45* [section 4031], "Long-Term Construction-Type Contracts").

.97 With respect to catastrophes that may occur within the terms of policies in force, to satisfy the conditions for accrual in paragraph .08, the occurrence of catastrophes would have to be probable during the terms of those policies, and the amounts of losses therefrom would have to be reasonably estimable. The letters of comment and position papers received in response to the Discussion Memorandum and the Exposure Draft and presentations at the public hearing lead

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the Board to conclude that neither the timing of catastrophes nor the amounts of losses therefrom are reasonably predictable within the terms of policies in force.

.98 The Board is of the view that accrual of losses from catastrophes is not justified by the accounting concept of matching. Systematic and rational allocation does not apply to costs that have not been incurred. The Board recognizes that large and irregularly occurring costs must of necessity be considered in systematically and rationally determining premiums to be charged to customers but does not believe that pricing considerations should dictate the accrual of losses for financial accounting purposes. The Board also does not believe that matching in the sense of recognizing expenses by associating losses with specific revenue on a cause and effect basis is, in and of itself, a basis for accrual of catastrophe losses prior to the event causing the loss. The Board believes that, for the reasons stated in paragraphs .94—.96, there can be no presumed direct association with specific revenue prior to the event causing the catastrophe loss.

.99 The Board's views regarding justification of periodic accrual of catastrophe reserves on grounds of (a) stabilizing reported income, (b) improving comparability among financial statements of insurance companies, and (c) preventing the "forced" purchase of reinsurance are discussed in paragraphs .61—.66.

.100 The argument that accrual of catastrophe reserves enables each generation of policyholders to bear its share of the losses through the premiums that it is charged is also questionable because amounts established for premiums are not necessarily dependent on financial accounting and reporting practices.

.101 The Board considered the proposal that catastrophe reserve accounting be permitted but not made mandatory. Whether it is probable that an asset has been impaired or a liability incurred is determined by the circumstances, not by choice. Accordingly, the conditions for accrual in paragraph

.08 apply to all loss contingencies, including risk of loss from catastrophes assumed by property and casualty insurance companies and reinsurance companies. In the Board's view, the use of different methods to report catastrophe losses in similar circumstances cannot be justified.

APPLICABILITY TO LIFE INSURANCE COMPANIES

.102 Some respondents to the Exposure Draft inquired as to whether the conditions for accrual in paragraph .08 are intended to change accounting practices of life insurance companies. This Statement does not amend the AICPA Industry Audit Guide, "Audits of Stock Life Insurance Companies."

DISCLOSURE OF NONINSURANCE

.103 A number of respondents to the Exposure Draft inquired as to whether it is the Board's intent to require disclosure of noninsurance or underinsurance. Some recommended that the Board require disclosures with respect to uninsured risks that enterprises ordinarily insure against. Others said that they were unable to define risks that would ordinarily be insured against because the insurance practices of enterprises are so varied. Because of the problems involved in developing operational criteria for disclosure of noninsured or underinsured risks, this Statement does not require disclosure of uninsured risks. However, the Board does not discourage those disclosures in appropriate circumstances.

EFFECTIVE DATE AND TRANSITION

.104 The Board considered three alternative approaches to a change in the method of accounting for contingencies: (1) prior period adjustment, (2) the "cumulative effect" method described in *APB Opinion No. 20* [section 1051], "Accounting Changes," and (3) retention of amounts accrued for contingencies that do not meet the conditions for accrual in paragraph .08 until

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those amounts are exhausted by actual losses charged thereto. The Exposure Draft had proposed the change be effected by the prior period adjustment method. A large number of respondents to the Exposure Draft, however, opposed the prior period adjustment method for a number of reasons, including significant difficulties involved in determining the degree of probability and estimability that had existed in prior periods as would have been required if the conditions in paragraph .08 were applied retroactively. On further consideration of all the circumstances, the Board has concluded that use of the "cumulative effect" method described in *APB Opinion No. 20* [section 1051] represents a satisfactory solution and has concluded that the effective date in paragraph .20 is advisable.

The next page is 9221.

AC Section 4311-1

Reasonable Estimation of the Amount of a Loss: An Interpretation of Section 4311

[Source: FASB Interpretation No. 14.]

September 1976

INTRODUCTION

.01 The two conditions for accrual of an estimated loss from a loss contingency set forth in paragraph 8 of *FASB Statement No. 5* [section 4311.08], "Accounting for Contingencies," are that "(a) information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. . . ." and "(b) the amount of loss can be reasonably estimated." In some situations in which condition (a) in paragraph 8 [section 4311.08] is met, a range of loss can be reasonably estimated but no single amount within the range appears at the time to be a better estimate than any other amount within the range. The Board has been asked to clarify whether, in those situations, condition (b) in paragraph 8 [section 4311.08] also is met and, if so, to explain what amount of loss should be accrued.

INTERPRETATION

.02 As indicated in paragraph 59 of *FASB Statement No. 5* [section 4311.59], the purpose of the two conditions in paragraph 8 [section 4311.08] of the Statement is "to require accrual of losses when they are reasonably estimable and relate to the current or a prior period." Condition (b) in paragraph 8 [section 4311.08], that "the amount of loss can be reasonably estimated," does not delay accrual of a loss until only a single amount can be reasonably estimated. To the contrary, when condition (a) in paragraph 8 [section 4311.08] is met, i. e., "it is probable that an asset had been impaired or a liability had been incurred," and information available indicates that the estimated amount of loss is within a range of amounts, it follows that some amount of loss has occurred and can be reasonably estimated.

.03 When condition (a) in paragraph 8 [section 4311.08] is met with respect to a particular loss contingency and the reasonable estimate of the loss is a range, condition (b) in paragraph 8 [section 4311.08] is met and an amount shall be accrued for the loss. When some amount within the range appears at the time to be a

better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued.[1] In addition, paragraph 9 [section 4311.09] of the Statement may require disclosure of the nature and, in some circumstances, the amount accrued, and paragraph 10 [section 4311.10] requires disclosure of the nature of the contingency and the additional exposure to loss if there is at least a reasonable possibility of loss in excess of the amount accrued.

.04 As an example, assume that an enterprise is involved in litigation at the close of its fiscal year ending December 31, 1976 and information available indicates that an unfavorable outcome is probable. Subsequently, after a trial on the issues, a verdict unfavorable to the enterprise is handed down, but the amount of damages remains unresolved at the time the financial statements are issued. Although the enterprise is unable to estimate the exact amount of loss, its reasonable estimate at the time is that the judgment will be for not less than $3 million or more than $9 million. No amount in that range appears at the time to be a better estimate than any other amount. *FASB Statement No. 5* [section 4311] requires accrual of the $3 million at December 31, 1976, disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $6 million, and possibly disclosure of the amount of the accrual.

.05 The same answer would result under the example in paragraph .04 above if it is probable that a verdict will be unfavorable even though the trial has not been completed before the financial statements are issued. In that situation, condition (a) in paragraph 8 [section 4311.08] would be met because information available to the enterprise indicates that an unfavorable verdict is probable. An assessment that the range of loss is between $3 million and $9 million would meet condition (b) in paragraph 8 [section 4311.08]. If no single amount in that range is a better estimate than any other amount, *FASB Statement No. 5* [section 4311] requires accrual of $3 million at December 31, 1976, disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $6 million, and possibly disclosure of the amount of the accrual. Note, however, that if the enterprise had assessed the verdict differently (e.g., that an unfavorable verdict was *not* probable but was only reasonably possible), condition (a) in paragraph 8 [section 4311.08] would not have been met and no amount of loss would be accrued but

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

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the nature of the contingency and any amount of loss that is reasonably possible would be disclosed.

.06 Assume that in the examples given in paragraphs .04 and .05 above condition (a) in paragraph 8 [section 4311.08] has been met and a reasonable estimate of loss is a range between $3 million and $9 million but a loss of $4 million is a better estimate than any other amount in that range. In that situation, *FASB Statement No. 5* [section 4311] requires accrual of $4 million, disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $5 million, and possibly disclosure of the amount of the accrual.

.07 As a further example, assume that at December 31, 1976 an enterprise has an investment of $1,000,000 in the securities of another enterprise that has declared bankruptcy, and there is no quoted market price for the securities. Condition (a) in paragraph 8 [section 4311.08] has been met because information available indicates that the value of the investment has been impaired, and a reasonable estimate of loss is a range between $300,000 and $600,000. No amount of loss in that range appears at the time to be a better estimate of loss than any other amount. *FASB Statement No. 5* [section 4311] requires accrual of the $300,000 loss at December 31, 1976, disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $300,000, and possibly disclosure of the amount of the accrual.

EFFECTIVE DATE AND TRANSITION

.08 The provisions of this Interpretation shall be effective for financial statements for annual and interim periods beginning after October 15, 1976. Earlier application is encouraged in financial statements for annual and interim periods beginning before October 15, 1976 that have not been previously issued. An accrual for a loss contingency or an adjustment of an established accrual for a loss contingency resulting from application of this Interpretation shall be accounted for as a change in estimate in accordance with the requirements of paragraph 31 of *APB Opinion No. 20* [section 1051.31], "Accounting Changes." This Interpretation shall not be applied retroactively for previously issued annual and interim financial statements.

The next page is 9239.

AC Section 4312

Accounting for Contingencies— Transition Method

an amendment of Section 4311

[Source: FASB Statement No. 11.]

December 1975

INTRODUCTION AND BACKGROUND INFORMATION

.01 *FASB Statement No. 5* [section 4311], "Accounting for Contingencies," was issued by the Board in March 1975. With respect to that Statement's effective date and transition, paragraph 20 of that Statement [section 4311.20] read as follows:

> This Statement shall be effective for fiscal years beginning on or after July 1, 1975, although earlier application is encouraged. A change in accounting principle resulting from compliance with paragraph .08 or .14 of this Statement shall be reported in accordance with *APB Opinion No. 20* [section 1051], "Accounting Changes." Accordingly, except in the special circumstances referred to in paragraphs 29-30 of *APB Opinion No. 20* [section 1051.29-.30], the cumulative effect of the change on retained earnings at the beginning of the year in which the change is made shall be included in net income of the year of the change, and the disclosures specified in *APB Opinion No. 20* [section 1051] shall be made. Reclassification of an appropriation of retained earnings to comply with paragraph .15 of this Statement shall be made in any financial statements for periods before the effective date of this Statement, or financial summaries or other data derived therefrom, that are presented after the effective date of this Statement.

.02 In Appendix C, "Basis for Conclusions," of that Statement, paragraph 104 [section 4311.104] reads as follows:

> The Board considered three alternative approaches to a change in the method of accounting for contingencies: (1) prior period adjustment, (2) the "cumulative effect" method described in *APB Opinion No. 20* [section 1051], "Accounting Changes," and (3) retention of amounts accrued for contingencies that do not meet the conditions for accrual in paragraph .08 until those amounts are exhausted by actual losses charged thereto. The Exposure Draft had proposed the change be effected by the prior period adjustment method. A large number of respondents to the Exposure Draft, however, opposed the prior period adjustment method for a number of reasons, including significant difficulties involved in determining the degree of probability and estimability that had existed in prior periods as would have been required if the conditions in paragraph .08 were applied retroactively. On further consideration of all the circumstances, the Board has concluded that use of the "cumulative effect" method

described in *APB Opinion No. 20* [section 1051] represents a satisfactory solution and has concluded that the effective date in paragraph .20 is advisable.

.03 The Exposure Draft of *FASB Statement No. 5* [section 4311] proposed a transition requiring retroactive restatement by prior period adjustment. In Appendix B, "Basis for Conclusions," of the Exposure Draft, the Board stated a preference for the prior period adjustment method because, in its judgment at the time, it would provide the most useful information for comparing financial data for periods after the adoption of the Statement with prior periods.

.04 The Board recently issued *FASB Statement No. 8* [section 1083], "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements." With respect to that Statement's effective date and transition, paragraphs 35 and 36 of that Statement [section 1083.035 and 1083.036] read as follows:

> This Statement shall be effective for fiscal years beginning on or after January 1, 1976,[14] although earlier application is encouraged. Thereafter, if financial statements for periods before the effective date, and financial summaries or other data derived therefrom, are presented, they shall be restated, if practicable, to conform to the provisions of paragraphs .007-.031 of this Statement. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period restated.[*]
>
> If restatement of financial statements or summaries for all prior periods presented is not practicable, information presented shall be restated for as many consecutive periods immediately preceding the effective date of this Statement as is practicable, and the cumulative effect of applying paragraphs .007-.031 on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which the Statement is first applied if it is not practicable to restate any prior periods) shall be included in determining net income of that period (see paragraph 20 of *APB Opinion No. 20* [section 1051.20], "Accounting Changes").[15] The effect on income before extraordinary items, net income, and related per share amounts of applying this Statement in a period in which the cumulative effect is included in determining net income shall be disclosed for that period, and the reason for not restating all of the prior periods presented shall be explained.

.05 Although the Exposure Draft of *FASB Statement No. 8* [section 1083] indicated that transition under that Statement

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[14] For enterprises having fiscal years of 52 or 53 weeks instead of the calendar year, this Statement shall be effective for fiscal years beginning in late December 1975.

[*] Amended, effective January 1, 1978, by FASB Statement No. 20. (See section 1084.)

[15] Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* [sections 1051.19(d) and 1051.21] are not applicable.

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would be required in accordance with paragraphs 19-21, 25, and 39 of *APB Opinion No. 20* [sections 1051.19-.21, 1051.25, and 1051.39] (viz., to include in the determination of net income in the year of change the effect of the accounting change), in the final Statement, the Board concluded that prior period restatement is the preferable method to provide useful information about foreign currency transactions and foreign operations for comparing financial data for a number of periods. In Appendix D, "Basis for Conclusions," of that Statement, paragraphs 240 and 241 [sections 1083.240 and 1083.241] read as follows:

> The Board concluded that because of the various methods of translation or of recognition of exchange gains and losses now followed in practice and because of the complex nature of the translation process, a prospective method of transition is not feasible. The Board considered whether the transition should be by prior period restatement or by cumulative effect adjustment (the method specified in the Exposure Draft). The Board concluded that prior period restatement is the preferable method to provide useful information about foreign currency transactions and foreign operations for purposes of comparing financial data for periods after the effective date of this Statement with data presented for earlier periods.
>
> The Board recognizes, however, that the procedures called for by this Statement may sometimes differ significantly from procedures followed in previous periods. In addition, restatement requires the availability of records or information that an enterprise may no longer have or that its past procedures did not require. Therefore, if the effect of the restatement on all individual periods presented cannot be computed or reasonably estimated, the cumulative effect adjustment method shall be used in accordance with paragraph .036.

Reconsideration of the Transition Method of Section 4311

.06 In considering and resolving the issue of transition in *FASB Statement No. 8* [section 1083], the Board was mindful that there were similarities in characteristics of certain accounts affected by *FASB Statement No. 8* [section 1083] and *FASB Statement No. 5* [section 4311]. As indicated in paragraph 104 of *FASB Statement No. 5* [section 4311.104], one of the factors that led the Board to conclude that use of the cumulative effect method would be preferable to restatement of financial statements for prior periods was its concern about the cases in which there might be significant difficulties in determining the degree of probability and estimability that existed in the prior periods. After reconsideration of the differences in the transition methods required by *FASB Statement Nos. 5* and *8* [sections 4311 and 1083] and the factors that led the Board to reach different conclusions on transition in those two Statements, the Board has concluded that the cumulative effect method should not be

required as it now is by *FASB Statement No. 5* [section 4311] in those cases in which the difficulties of determining probability and estimability retroactively are not present. On reconsideration of all the circumstances, the Board has concluded that, in order to provide the most useful information, it is preferable for an enterprise adopting *FASB Statement No. 5* [section 4311] to restate its financial statements for as many immediately preceding periods as is practicable in accordance with the revised transition method set forth in paragraph .10 of this Statement.

.07 Some enterprises elected to apply *FASB Statement No. 5* [section 4311] prior to its effective date (as encouraged in paragraph 20 of the Statement [section 4311.20]) and issued annual or interim financial statements or financial summaries or other data derived therefrom using the cumulative effect method of transition. The Board considered whether those enterprises should now be required to conform to the method of transition to *FASB Statement No. 5* [section 4311] specified by this Statement. Although the Board strongly encourages those enterprises to restate their financial statements in a manner similar to that required of enterprises that did not elect early application, it has concluded that it should not require them to do so.

.08 An Exposure Draft of a proposed Statement on "Accounting for Contingencies—Transition Method" was issued on October 31, 1975. Forty-five letters were received in response to that Exposure Draft.

.09 The Board concluded that on the basis of existing data it could make an informed decision on the matter addressed in this Statement without a public hearing and that the effective date in paragraph .11 is advisable.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to Section 4311

.10 Paragraph 20 of *FASB Statement No. 5* [section 4311.20] is amended to read as follows:

> *FASB Statement No. 5* [section 4311] shall be effective for fiscal years beginning on or after July 1, 1975, although earlier application is encouraged. Thereafter, if financial statements for periods before the effective date, and financial summaries or other data derived therefrom, are presented, they shall be restated, if practicable, to conform to the provisions of paragraph 8 or 14 of *FASB Statement No. 5* [section 4311.08 or 4311.14].* In the year that the Statement is

* This does not alter the accounting for changes in estimates—see paragraph 31 of *APB Opinion No. 20* [section 1051.31].

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first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period restated. If restatement of financial statements or summaries for all prior periods presented is not practicable, information presented shall be restated for as many consecutive periods immediately preceding the effective date of *FASB Statement No. 5* [section 4311] as is practicable, and the cumulative effect of applying paragraph 8 or 14 [sections 4311.08 or 4311.14] on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which the Statement is first applied if it is not practicable to restate any prior periods) shall be included in determining net income of that period (see paragraph 20 of *APB Opinion No. 20* [section 1051.20]).** The effect on income before extraordinary items, net income, and related per share amounts of applying *FASB Statement No. 5* [section 4311] in a period in which the cumulative effect is included in determining net income shall be disclosed for that period, and the reason for not restating all of the prior periods presented shall be explained. Reclassification of an appropriation of retained earnings to comply with paragraph 15 of *FASB Statement No. 5* [section 4311.15] shall be made in any financial statements for periods before the effective date of the Statement, or financial summaries or other data derived therefrom, that are presented after the effective date of the Statement.

Effective Date and Transition

.11 This amendment to *FASB Statement No. 5* [section 4311] shall be effective retroactively to the effective date of *FASB Statement No. 5* [section 4311] except that enterprises that have issued financial statements for annual or interim periods, or financial summaries or other data derived therefrom, prior to January 1, 1976 based on the original transition requirement in paragraph 20 of *FASB Statement No. 5* [section 4311.20] are strongly encouraged but not required to comply with this Statement when those financial statements or financial summaries or other data derived therefrom are subsequently presented for the first time on or after January 1, 1976.

The provisions of this Statement need not be applied to immaterial items.

** Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* [sections 1051.19(d) and 1051.21] are not applicable.

AC Section 5100

ASSETS

. . . receivable accounts . . . inventories . . .
investments . . . intangible assets

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AC Section 5111

Receivables from Officers, Employees or Affiliated Companies

[Source: ARB No. 43, Chap. 1A, Par. 5.]

Issue date, unless otherwise indicated: 1934[1]

.01 Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

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[1] The above rule was adopted by the membership of the Institute in 1934. It had been recommended in 1932 to the New York Stock Exchange by the Institute's committee on cooperation with stock exchanges.

AC Section 5121

Inventory Pricing

[Source: ARB No. 43, Chap. 4, as amended.]

Issue date, unless otherwise indicated: June, 1953

.01 Whenever the operation of a business includes the ownership of a stock of goods, it is necessary for adequate financial accounting purposes that inventories be properly compiled periodically and recorded in the accounts.[1] Such inventories are required both for the statement of financial position and for the periodic measurement of income.

.02 This section sets forth the general principles applicable to the pricing of inventories of mercantile and manufacturing enterprises. Its conclusions are not directed to or necessarily applicable to noncommercial businesses or to regulated utilities.

STATEMENT 1

The term *inventory* is used herein to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

Discussion

.03 The term *inventory* embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for

[1] Prudent reliance upon perpetual inventory records is not precluded.

production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of companies such as oil producers are usually treated as inventory.

STATEMENT 2

A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.

Discussion

.04 An inventory has financial significance because revenues may be obtained from its sale, or from the sale of the goods or services in whose production it is used. Normally such revenues arise in a continuous repetitive process or cycle of operations by which goods are acquired and sold, and further goods are acquired for additional sales. In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues. This balance is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward. In practice, this balance is determined by the process of pricing the articles comprised in the inventory.

STATEMENT 3

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures

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and charges directly or indirectly incurred in bringing an article to its existing condition and location.

Discussion

.05 In keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories should be stated at cost. The definition of cost as applied to inventories is understood to mean acquisition and production cost,[2] and its determination involves many problems. Although principles for the determination of inventory costs may be easily stated, their application, particularly to such inventory items as work in process and finished goods, is difficult because of the variety of problems encountered in the allocation of costs and charges. For example, under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges rather than as a portion of the inventory cost. Also, general and administrative expenses should be included as period charges, except for the portion of such expenses that may be clearly related to production and thus constitute a part of inventory costs (product charges). Selling expenses constitute no part of inventory costs. It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. The exercise of judgment in an individual situation involves a consideration of the adequacy of the procedures of the cost accounting system in use, the soundness of the principles thereof, and their consistent application.

STATEMENT 4

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

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[2] In the case of goods which have been written down below cost at the close of a fiscal period, such reduced amount is to be considered the cost for subsequent accounting purposes.

Discussion

.06 The cost to be matched against revenue from a sale may not be the identified cost of the specific item which is sold, especially in cases in which similar goods are purchased at different times and at different prices. While in some lines of business specific lots are clearly identified from the time of purchase through the time of sale and are costed on this basis, ordinarily the identity of goods is lost between the time of acquisition and the time of sale. In any event, if the materials purchased in various lots are identical and interchangeable, the use of identified cost of the various lots may not produce the most useful financial statements. This fact has resulted in the development of general acceptance of several assumptions with respect to the flow of cost factors (such as *first-in first-out, average,* and *last-in first-out*) to provide practical bases for the measurement of periodic income.[3] In some situations a reversed mark-up procedure of inventory pricing, such as the retail inventory method, may be both practical and appropriate. The business operations in some cases may be such as to make it desirable to apply one of the acceptable methods of determining cost to one portion of the inventory or components thereof and another of the acceptable methods to other portions of the inventory.

.07 Although selection of the method should be made on the basis of the individual circumstances, it is obvious that financial statements will be more useful if uniform methods of inventory pricing are adopted by all companies within a given industry.

STATEMENT 5

A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than

[3] Standard costs are acceptable if adjusted at reasonable intervals to reflect current conditions so that at the balance-sheet date standard costs reasonably approximate costs computed under one of the recognized bases. In such cases descriptive language should be used which will express this relationship, as, for instance, "approximate costs determined on the first-in first-out basis," or, if it is desired to mention standard costs, "at standard costs, approximating average costs."

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cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as *market*.

Discussion

.08 Although the cost basis ordinarily achieves the objective of a proper matching of costs and revenues, under certain circumstances cost may not be the amount properly chargeable against the revenues of future periods. A departure from cost is required in these circumstances because cost is satisfactory only if the utility of the goods has not diminished since their acquisition; a loss of utility is to be reflected as a charge against the revenues of the period in which it occurs. Thus, in accounting for inventories, a loss should be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. The measurement of such losses is accomplished by applying the rule of pricing inventories at *cost or market, whichever is lower*. This provides a practical means of measuring utility and thereby determining the amount of the loss to be recognized and accounted for in the current period.

STATEMENT 6

As used in the phrase *lower of cost or market*[4] the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:

(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and

(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

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[4] The terms *cost or market, whichever is lower* and *lower of cost or market* are used synonymously in general practice and in this section. The committee does not express any preference for either of the two alternatives.

Discussion

.09 The rule of *cost or market, whichever is lower* is intended to provide a means of measuring the residual usefulness of an inventory expenditure. The term *market* is therefore to be interpreted as indicating utility on the inventory date and may be thought of in terms of the equivalent expenditure which would have to be made in the ordinary course at that date to procure corresponding utility. As a general guide, utility is indicated primarily by the current cost of replacement of the goods as they would be obtained by purchase or reproduction. In applying the rule, however, judgment must always be exercised and no loss should be recognized unless the evidence indicates clearly that a loss has been sustained. There are therefore exceptions to such a standard. Replacement or reproduction prices would not be appropriate as a measure of utility when the estimated sales value, reduced by the costs of completion and disposal, is lower, in which case the realizable value so determined more appropriately measures utility. Furthermore, where the evidence indicates that cost will be recovered with an approximately normal profit upon sale in the ordinary course of business, no loss should be recognized even though replacement or reproduction costs are lower. This might be true, for example, in the case of production under firm sales contracts at fixed prices, or when a reasonable volume of future orders is assured at stable selling prices.

.10 Because of the many variations of circumstances encountered in inventory pricing, Statement 6 is intended as a guide rather than a literal rule. It should be applied realistically in the light of the objectives expressed in this section and with due regard to the form, content, and composition of the inventory. The committee considers, for example, that the retail inventory method, if adequate markdowns are currently taken, accomplishes the objectives described herein. It also recognizes that, if a business is expected to lose money for a sustained period, the inventory should not be written down to offset a loss inherent in the subsequent operations.

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STATEMENT 7

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

Discussion

.11 The purpose of reducing inventory to *market* is to reflect fairly the income of the period. The most common practice is to apply the *lower of cost or market* rule separately to each item of the inventory. However, if there is only one end-product category the cost utility of the total stock—the inventory in its entirety—may have the greatest significance for accounting purposes. Accordingly, the reduction of individual items to *market* may not always lead to the most useful result if the utility of the total inventory to the business is not below its cost. This might be the case if selling prices are not affected by temporary or small fluctuations in current costs of purchase or manufacture. Similarly, where more than one major product or operational category exists, the application of the *cost or market, whichever is lower* rule to the total of the items included in such major categories may result in the most useful determination of income.

.12 When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market equally in excess of cost, such components need not be adjusted to market to the extent that they are in balanced quantities. Thus, in such cases, the rule of *cost or market, whichever is lower* may be applied directly to the totals of the entire inventory, rather than to the individual inventory items, if they enter into the same category of finished product and if they are in balanced quantities, provided the procedure is applied consistently from year to year.

.13 To the extent, however, that the stocks of particular materials or components are excessive in relation to others, the more widely recognized procedure of applying

the *lower of cost or market* to the individual items constituting the excess should be followed. This would also apply in cases in which the items enter into the production of unrelated products or products having a material variation in the rate of turnover. Unless an effective method of classifying categories is practicable, the rule should be applied to each item in the inventory.

.14 When substantial and unusual losses result from the application of this rule it will frequently be desirable to disclose the amount of the loss in the income statement as a charge separately identified from the consumed inventory costs described as *cost of goods sold*.

STATEMENT 8

The basis of stating inventories must be consistently applied and should be disclosed in the financial statements; whenever a significant change is made therein, there should be disclosure of the nature of the change and, if material, the effect on income in accordance with section 1051, *Accounting Changes*. [As amended, effective for fiscal periods beginning after July 31, 1971 by APB Opinion No. 20.]

Discussion

.15 While the basis of stating inventories does not affect the over-all gain or loss on the ultimate disposition of inventory items, any inconsistency in the selection or employment of a basis may improperly affect the periodic amounts of income or loss. Because of the common use and importance of periodic statements, a procedure adopted for the treatment of inventory items should be consistently applied in order that the results reported may be fairly allocated as between years. A change of such basis may have an important effect upon the interpretation of the financial statements both before and after that change, and hence, in the event of a change, a full disclosure of its nature and of its effect, if material, upon income should be made. (See also section 2031.09.)

STATEMENT 9

Only in exceptional cases may inventories properly be stated above cost. For example, pre-

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cious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.

Discussion

.16 It is generally recognized that income accrues only at the time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordinarily reflected at selling prices. A similar treatment is not uncommon for inventories representing agricultural, mineral, and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may be difficult to obtain. Where such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the use of such basis should be fully disclosed in the financial statements.

STATEMENT 10

Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts thereof separately disclosed in the income statement.

Discussion

.17 The recognition in a current period of losses arising from the decline in the utility of cost expenditures is equally applicable to similar losses which are expected to arise from firm, uncancelable, and unhedged commitments for the future purchase of inventory items. The net loss on such commitments should be measured in the same way as are inventory losses and, if material, should be recognized

in the accounts and separately disclosed in the income statement. The utility of such commitments is not impaired, and hence there is no loss, when the amounts to be realized from the disposition of the future inventory items are adequately protected by firm sales contracts or when there are other circumstances which reasonably assure continuing sales without price decline.

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AC Section 5131

The Equity Method of Accounting for Investments in Common Stock

[Source: APB Opinion No. 18, as amended.]

Effective for fiscal periods beginning after December 31, 1971, unless otherwise indicated [1]

INTRODUCTION

.01 The Accounting Principles Board expresses in this section its views on the equity method of accounting for investments in common stock. This section clarifies the applicability of the equity method of accounting (paragraph .06b) to investments in common stock of subsidiaries and extends the applicability of the equity method of accounting to investments in common stock of corporate joint ventures and certain other investments in common stock. The section also applies to investments reported in parent-company financial statements when such statements are prepared for issuance to stockholders as the financial statements of the primary reporting entity.[2]

.02 This section does not apply to investments in common stock held by (a) investment companies registered under the Investment Company Act of 1940 or investment companies which would be included under the Act (including small business investment companies) except that the number of stockholders is limited and the securities are not offered publicly, or (b) nonbusiness entities, such as estates, trusts and individuals. The section also does not apply to investments in common stock other than those described in the section.

.03 Several terms are used in this section as indicated:

a. ''Investor'' refers to a business entity that holds an investment in voting stock of another company.

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[1] See paragraph .21.

[2] An accounting research study on the broader subject of accounting for intercorporate investments is now in process and will encompass the matters on parent-company financial statements and on consolidated financial statements covered in section 2051 and in section 1081.

b. "Investee" refers to a corporation that issued voting stock held by an investor.

c. "Subsidiary" refers to a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50%) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders or by court decree.

d. "Corporate joint venture" refers to a corporation owned and operated by a small group of businesses (the "joint venturers") as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity which is a subsidiary of one of the "joint venturers" is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A minority public ownership, however, does not preclude a corporation from being a corporate joint venture.

e. "Dividends" refers to dividends paid or payable in cash, other assets, or another class of stock and does not include stock dividends or stock splits.

f. "Earnings or losses of an investee" and "financial position of an investee" refer to net income (or net loss) and financial position of an investee determined in accordance with accounting principles generally accepted in the United States.

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DISCUSSION

.04 Section 2051.02 states that: "There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies." Consolidated financial statements combine the assets, liabilities, revenues and expenses of subsidiaries with the corresponding items of the parent company. Intercompany items are eliminated to avoid double counting and prematurely recognizing income. Consolidated financial statements report the financial position and results of operations of the parent company and its subsidiaries as an economic entity. In practice, consolidation has been limited to subsidiary companies, although under certain circumstances valid reasons may exist for omitting a subsidiary from consolidation.[3]

.05 Investments are sometimes held in stock of companies other than subsidiaries, namely corporate joint ventures and other noncontrolled corporations. These investments are usually accounted for by one of two methods—the cost method or the equity method. While practice varies to some extent, the cost method is generally followed for most investments in noncontrolled corporations, in some corporate joint ventures, and to a lesser extent in unconsolidated subsidiaries, particularly foreign. The equity method is generally followed for investments in unconsolidated domestic subsidiaries, some corporate joint ventures and some noncontrolled corporations. An adaptation of the cost method, the lower of cost or market, has also been followed for investments in certain marketable securities if a decline in market value is evidently not a mere temporary condition.*

.06 A summary of the two principal methods of accounting for the investments in common stock discussed in this section follows:

a. *The cost method.* An investor records an investment in the stock of an investee at cost, and recognizes as income dividends received that are distributed from net accumulated earnings of the investee since the date of acquisition by the investor. The net accumu-

[3] See section 2051.03-.04 and section 1081.08.

* Modified by section 5132, *Accounting for Certain Marketable Securities.*

lated earnings of an investee subsequent to the date of investment are recognized by the investor only to the extent distributed by the investee as dividends. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred which is other than temporary and should accordingly be recognized.*

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

.07 Under the cost method of accounting for investments in common stock, dividends are the basis for recognition by an investor of earnings from an investment. Financial statements of an investor prepared under the cost method may not reflect substantial changes in the affairs of an investee. Dividends included in income of an investor for a period may be unrelated to the earnings (or losses) of

* Modified by section 5132, *Accounting for Certain Marketable Securities.*

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an investee for that period. For example, an investee may pay no dividends for several periods and then pay dividends substantially in excess of the earnings of a period. Losses of an investee of one period may be offset against earnings of another period because the investor reports neither in results of operations at the time they are reported by the investee. Some dividends received from an investee do not cover the carrying costs of an investment whereas the investor's share of the investee's earnings more than covers those costs. Those characteristics of the cost method may prevent an investor from reflecting adequately the earnings related to an investment in common stock—either cumulatively or in the appropriate periods.

.08 Corporations have increasingly established or participated in corporate joint venture arrangements or taken substantial positions (but less than majority ownership) in other corporations. The significant increase in the number of intercorporate investments of less than majority ownership of voting stock has broadened interest in reflecting earnings from investments on a more timely basis than by receipt of dividends. Some hold that such investments should be accounted for at market value and that this basis of accounting is most appropriate, whether market value is lower than or higher than cost. Others hold that the equity method is the most appropriate basis of accounting for some or all investments of that type.

.09 Under the market value method, an investor recognizes both dividends received and changes in market prices of the stock of the investee company as earnings or losses from an investment. Dividends received are accounted for as part of income from the investment. In addition, an investor adjusts the carrying amount of its investment based on the market value of the investee's stock. Change in market value since the preceding reporting date is included in results of operations of the investor. Reporting of investments in common stock at market value (or at approximate fair value if market value is not available) is considered to meet most closely the objective of reporting the economic consequences of holding the investment. However, the market value method is now used only in special circumstances. While the Board believes the market value method provides the best presentation of investments

in some situations, it concludes that further study is necessary before the market value method is extended beyond current practice.

.10 Under the equity method, an investor recognizes its share of the earnings or losses of an investee in the periods for which they are reported by the investee in its financial statements rather than in the period in which an investee declares a dividend. An investor adjusts the carrying amount of an investment for its share of the earnings or losses of the investee subsequent to the date of investment and reports the recognized earnings or losses in income. Dividends received from an investee reduce the carrying amount of the investment. Thus, the equity method is an appropriate means of recognizing increases or decreases measured by generally accepted accounting principles in the economic resources underlying the investments. Furthermore, the equity method of accounting more closely meets the objectives of accrual accounting than does the cost method since the investor recognizes its share of the earnings and losses of the investee in the periods in which they are reflected in the accounts of the investee.

.11 Under the equity method, an investment in common stock is generally shown in the balance sheet of an investor as a single amount. Likewise, an investor's share of earnings or losses from its investment is ordinarily shown in its income statement as a single amount.

.12 The equity method tends to be most appropriate if an investment enables the investor to influence the operating or financial decisions of the investee. The investor then has a degree of responsibility for the return on its investment, and it is appropriate to include in the results of operations of the investor its share of the earnings or losses of the investee. Influence tends to be more effective as the investor's percent of ownership in the voting stock of the investee increases. Investments of relatively small percentages of voting stock of an investee tend to be passive in nature and enable the investor to have little or no influence on the operations of the investee.

.13 Some hold the view that neither the market value method nor the equity method is appropriate accounting for investments in common stock where the investor holds less

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than majority ownership of the voting stock. They would account for such investments at cost. Under that view the investor is not entitled to recognize earnings on its investment until a right to claim the earnings arises, and that claim arises only to the extent dividends are declared. The investor is considered to have no earnings on its investment unless it is in a position to control the distribution of earnings. Likewise, an investment or an investor's operations are not affected by losses of an investee unless those losses indicate a loss in value of the investment that should be recognized.

OPINION

.14 The Board reaffirms the conclusion that investors should account for investments in common stock of unconsolidated domestic subsidiaries by the equity method in consolidated financial statements, and the Board now extends this conclusion to investments in common stock of all unconsolidated subsidiaries (foreign as well as domestic) in consolidated financial statements. The equity method is not, however, a valid substitute for consolidation and should not be used to justify exclusion of a subsidiary when consolidation is otherwise appropriate. The Board also concludes that parent companies should account for investments in the common stock of subsidiaries by the equity method in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity.[4]

[.15] [Superseded, effective January 1, 1977, by FASB Statement No. 13] (see section 4053).

.16 The Board concludes that the equity method best enables investors in corporate joint ventures to reflect the underlying nature of their investment in those ventures.

[4] Section 2051.03-.04 and section 1081.08 described, among other things, the conditions under which a subsidiary should or might not be consolidated. The limitations on consolidation described in section 2051.03 and section 1081.08, should also be applied as limitations to the use of the equity method. The Board has deferred further consideration of the treatment of foreign subsidiaries in consolidated statements and the treatment of all subsidiaries in parent-company statements that are not prepared for issuance to stockholders as the financial statements of the primary reporting entity until the accounting research study on intercorporate investments is published. In the meantime, the provisions of section 1081 continue in effect. The conclusions in paragraph .14 of this section apply to investments in foreign subsidiaries unless those companies are operating under conditions of exchange restrictions, controls or other uncertainties of a type that would affect decisions as to consolidation or application of the equity method; if those conditions exist, the cost method should be followed.

Therefore, investors should account for investments in common stock of corporate joint ventures by the equity method, both in consolidated financial statements and in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity.[6]

.17 The Board concludes that the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor. The Board recognizes that determining the ability of an investor to exercise such influence is not always clear and applying judgment is necessary to assess the status of each investment. In order to achieve a reasonable degree of uniformity in application, the Board concludes that an investment (direct or indirect) of 20% or more of the voting stock of

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[5] Footnote 5 to paragraph .15 superseded by FASB Statement No. 13.

[6] The equity method should not be applied to the investments described in this paragraph insofar as the limitations on the use of the equity method outlined in footnote 4 would be applicable to investments other than those in subsidiaries.

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an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. When the equity method is appropriate, it should be applied in consolidated financial statements and in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity.[7]

.18 An investor's *voting stock interest* in an investee should be based on those currently outstanding securities whose holders have present voting privileges. Potential voting privileges which may become available to holders of securities of an investee should be disregarded. An investor's *share of the earnings or losses* of an investee should be based on the shares of *common* stock held by an investor without recognition of securities of the investee which are designated as "common stock equivalents" under section 2011.[8]

.19 *Applying the equity method.* The difference between consolidation and the equity method lies in the details reported in the financial statements. Thus, an investor's net income for the period and its stockholders' equity at the end of the period are the same whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated (except as indicated in paragraph .19 i). The procedures set forth below should be followed by an investor in applying the equity method of accounting to investments in common stock of unconsoli-

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[7] The equity method should not be applied to the investments described in this paragraph insofar as the limitations on the use of the equity method outlined in footnote 4 would be applicable to investments other than those in subsidiaries.

[8] Section 2011.39 states: "The designation of securities as common stock equivalents in this section is solely for the purpose of determining primary earnings per share. No changes from present practices are recommended in the accounting for such securities, in their presentation within the financial statements or in the manner of determining net assets per common share. Information is available in the financial statements and elsewhere for readers to make judgments as to the present and potential status of the various securities outstanding." Sections 2011A.20-.24 discuss the treatment of common stock equivalents of subsidiaries in computing earnings per share of a parent company. The provisions of those paragraphs also apply to investments in common stock of corporate joint ventures and investee companies accounted for under the equity method.

dated subsidiaries, corporate joint ventures, and other investees which qualify for the equity method:

a. Intercompany profits and losses should be eliminated until realized by the investor or investee as if a subsidiary, corporate joint venture or investee company were consolidated.

b. A difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as if the investee were a consolidated subsidiary.[9]

c. The investment(s) in common stock should be shown in the balance sheet of an investor as a single amount, and the investor's share of earnings or losses of an investee(s) should ordinarily be shown in the income statement as a single amount except for the extraordinary items as specified in (d) below.

d. The investor's share of extraordinary items and its share of prior-period adjustments reported in the financial statements of the investee in accordance with sections 2010 and 2012 should be classified in a similar manner unless they are immaterial in the income statement of the investor. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.]

e. A transaction of an investee of a capital nature that affects the investor's share of stockholders' equity of the investee should be accounted for as if the investee were a consolidated subsidiary.

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

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

[9] For investments made prior to November 1, 1970, the effective date of section 5141, investors are not required to amortize any goodwill in the absence of evidence that the goodwill has a limited term of existence; prospective amortization of such goodwill is encouraged.

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

i. An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. The investor ordinarily should discontinue applying the equity method when the investment (and net advances) is reduced to zero and should not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee.[10] If the investee subsequently reports net income, the investor should resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended.

[j.] [Superseded, effective for fiscal periods beginning after December 31, 1971 by APB Opinion No. 23.][11]

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

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

[11] See section 4095.

l. An investment in voting stock of an investee company may fall below the level of ownership described in paragraph .17 from sale of a portion of an investment by the investor, sale of additional stock by an investee, or other transactions and the investor may thereby lose the ability to influence policy, as described in that paragraph. An investor should discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. The earnings or losses that relate to the stock retained by the investor and that were previously accrued should remain as a part of the carrying amount of the investment. The investment account should not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the investor in subsequent periods which exceed his share of earnings for such periods should be applied in reduction of the carrying amount of the investment (see paragraph .06a).

m. An investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph .17 (i. e., acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). When an investment qualifies

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for use of the equity method, the investor should adopt the equity method of accounting. The investment, results of operations (current and prior periods presented), and retained earnings of the investor should be adjusted retroactively in a manner consistent with the accounting for a step-by-step acquisition of a subsidiary.

n. The carrying amount of an investment in common stock of an investee that qualifies for the equity method of accounting as described in subparagraph (m) may differ from the underlying equity in net assets of the investee. The difference should affect the determination of the amount of the investor's share of earnings or losses of an investee as if the investee were a consolidated subsidiary. However, if the investor is unable to relate the difference to specific accounts of the investee, the difference should be considered to be goodwill and amortized over a period not to exceed forty years, in accordance with section 5141.[12]

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

a. Financial statements of an investor should disclose parenthetically, in notes to financial statements, or in separate statements or schedules (1) the name of each investee and percentage of ownership of common stock, (2) the accounting policies of the investor with respect to investments in common stock,[13] and

[12] For investments made prior to November 1, 1970, the effective date of section 5141, investors are not required to amortize any goodwill in the absence of evidence that the goodwill has a limited term of existence; prospective amortization of such goodwill is encouraged.

[13] Disclosure should include the names of any significant investee corporations in which the investor holds 20% or more of the voting stock, but the common stock is not accounted for on the equity method, together with the reasons why the equity method is not considered appropriate, and the names of any significant investee corporations in which the investor holds less than 20% of the voting stock and the common stock is accounted for on the equity method, together with the reasons why the equity method is considered appropriate.

(3) the difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference.

b. For those investments in common stock for which a quoted market price is available, the aggregate value of each identified investment based on the quoted market price usually should be disclosed. This disclosure is not required for investments in common stock of subsidiaries.

c. When investments in unconsolidated subsidiaries are, in the aggregate, material in relation to financial position or results of operations, summarized information as to assets, liabilities, and results of operations should be presented in the notes or separate statements should be presented for such subsidiaries, either individually or in groups, as appropriate.

d. When investments in common stock of corporate joint ventures or other investments of 50% or less accounted for under the equity method are, in the aggregate, material in relation to the financial position or results of operations of an investor, it may be necessary for summarized information as to assets, liabilities, and results of operations of the investees to be presented in the notes or in separate statements, either individually or in groups, as appropriate.

e. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances should be disclosed in notes to the financial statements of an investor.[14]

EFFECTIVE DATE

.21 This section shall be effective for all fiscal periods beginning after December 31, 1971, and should be applied retroactively to all investments in common stock held

[14] See footnote 8.

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during any portion of the period for which results of operations are presented regardless of the date the investments were acquired. However, the Board encourages earlier application of the provisions of this section. Adjustments resulting from a change in accounting method to comply with this section should be treated as adjustments of prior periods, and financial statements presented for the periods affected should be restated appropriately.

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AC Section 5132

Accounting for Certain Marketable Securities

[Source: FASB Statement No. 12.]

December 1975

INTRODUCTION AND BACKGROUND INFORMATION

.01 There has long been diversity in accounting for marketable securities. Paragraph 9, Chapter 3A, "Current Assets and Current Liabilities," of *Accounting Research Bulletin (ARB) No. 43* [section 2031.09] (originally adopted as *ARB No. 30* in 1947) narrowed practice somewhat by stating:

> . . . practice varies with respect to the carrying basis for current assets such as marketable securities and inventories. In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value.

Chapter 3A of *ARB No. 43* [section 2031] did not, however, deal with the question of whether a write-up of a previous write-down might be permissible to reflect a recovery in the market. *Accounting Principles Board (APB) Opinion No. 18* [section 5131], "The Equity Method of Accounting for Investments in Common Stock," dealt with accounting for investments by the equity method when the investor has "significant influence" over the investee, thus establishing accounting principles for those investments. In addition, a number of Industry Audit Guides, issued by the AICPA for certain industries, describe specialized accounting practices applied in those industries. At present, some enterprises are carrying marketable securities at cost, some at market (or variations of market), some at the lower of cost or market, and some are applying more than one of those methods to different classes of securities. During

1973 and 1974, there were substantial declines in market values of many securities. As a result, in many enterprises where securities are carried at cost, the carrying amount is in excess of current market value. In other enterprises where carrying amounts were written down to reflect the market decline, the partial recovery in the market in 1975 has given rise to a situation in which securities are being carried at amounts which are below both original cost and current market value.

.02 Concern over the lack of definitive guidance in the authoritative literature with respect to certain accounting problems accentuated by these conditions led to requests for the FASB to consider those problems on an urgent basis. The issues raised were submitted to the members of the Board's Screening Committee on Emerging Problems, and their recommendations were weighed by the Board in arriving at its decision to proceed with a project of limited scope, based on the three questions stated in paragraph .03.

.03 The Board has concluded that the following questions concerning financial accounting and reporting for marketable securities require resolution as soon as possible:

a) Under what circumstances should marketable equity securities that are carried on a cost basis be written down below cost?

b) Should marketable equity securities that have been written down be written back up based on market recoveries or other criteria?

c) If a parent company and one or more subsidiaries or investees follow different methods of accounting for marketable securities, should any adjustments be made to conform the subsidiaries' or investees' methods of accounting to that of the parent company in consolidated or parent company financial statements?[1]

.04 An Exposure Draft of a proposed Statement on "Accounting for Certain Marketable Securities" was issued November 6, 1975, and a public hearing based on the Exposure Draft was held on December 8, 1975. The Board received 272 position papers and letters of comment in response to the Exposure Draft. Twenty presentations were made at the public hearing.

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[1] The term *parent company financial statements* as used in this Statement is limited to those parent company financial statements prepared for issuance as the financial statements of the primary reporting entity.

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.05 This Statement does not apply to not-for-profit organizations[2] or mutual life insurance companies; it does, however, apply to mutual savings banks (see paragraphs .39 and .40) as well as to other for-profit mutual enterprises. This Statement also does not apply to employee benefit plans because that subject is a separate item on the FASB's current agenda.

.06 Investments accounted for by the equity method, as described in *APB Opinion No. 18* [section 5131], are beyond the scope of this Statement except for the provisions of paragraph .18.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Enterprises in Industries Not Having Specialized Accounting Practices with Respect to Marketable Securities

.07 For purposes of applying paragraphs .08-.13 of this Statement, certain terms are defined as follows:

a) *Equity security* encompasses any instrument representing ownership shares (e.g., common, preferred, and other capital stock), or the right to acquire (e.g., warrants, rights, and call options) or dispose of (e.g., put options) ownership shares in an enterprise at fixed or determinable prices. The term does not encompass preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor, nor does it include treasury stock or convertible bonds.

b) *Marketable,* as applied to an equity security, means an equity security as to which sales prices or bid and ask prices are currently available on a national securities exchange (i.e., those registered with the Securities and Exchange Commission) or in the over-the-counter market. In the over-the-counter market, an equity security shall be considered marketable when a quotation is publicly reported by the National Association of Securities Dealers Automatic Quotations System or by the National Quotations Bureau Inc. (provided, in the latter case, that quotations are available from at least three dealers). Equity securities traded in foreign markets

[2] For this purpose, not-for-profit organizations are those described in the third sentence of paragraph 5 of the Introduction to *ARB No. 43* [section 510.05].

shall be considered marketable when such markets are of a breadth and scope comparable to those referred to above. Restricted stock[3] does not meet this definition.

c) *Market price* refers to the price (see paragraph .07(b)) of a single share or unit of a marketable equity security.

d) *Market value* refers to the aggregate of the market price times the number of shares or units of each marketable equity security in the portfolio. When an entity has taken positions involving short sales, sales of calls, and purchases of puts for marketable equity securities and the same securities are included in the portfolio, those contracts shall be taken into consideration in the determination of market value of the marketable equity securities.

e) *Cost* refers to the original cost of a marketable equity security unless a new cost basis has been assigned based on recognition of an impairment of value that was deemed other than temporary or as the result of a transfer between current and noncurrent classifications as described in paragraph .10. In such cases, the new cost basis shall be the cost for the purposes of this Statement.

f) The *valuation allowance* for a marketable equity securities portfolio represents the net unrealized loss (the amount by which aggregate cost exceeds market value) in that portfolio.

g) The *carrying amount* of a marketable equity securities portfolio is the amount at which that portfolio of marketable equity securities is reflected in the financial statements of an enterprise.

h) A *realized gain or loss* represents the difference between the net proceeds from the sale of a marketable equity security and its cost.

i) *Net unrealized gain or loss* on a marketable equity securities

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[3] Restricted stock for purposes of this Statement shall mean securities for which sale is restricted by a governmental or contractual requirement except where such requirement terminates within one year or where the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the stock which can reasonably be expected to qualify for sale within one year, such as may be the case under Rule 144 or similar rules of the Securities and Exchange Commission, is not considered restricted.

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portfolio represents the difference between the market value of its securities and their aggregate cost at any given date.

.08 The carrying amount of a marketable equity securities portfolio shall be the lower of its aggregate cost or market value, determined at the balance sheet date. The amount by which aggregate cost of the portfolio exceeds market value shall be accounted for as the valuation allowance.

.09 Marketable equity securities owned by an entity[4] shall, in the case of a classified balance sheet, be grouped into separate portfolios according to the current or noncurrent classification of the securities for the purpose of comparing aggregate cost and market value to determine carrying amount. In the case of an unclassified balance sheet, marketable equity securities shall for the purposes of this Statement be considered as noncurrent assets. The current portfolios of entities that are consolidated in financial statements and that do not follow specialized industry accounting practices with respect to marketable securities shall be treated as a single consolidated portfolio for the comparison of aggregate cost and market value; similarly, the noncurrent portfolios of entities that are consolidated in financial statements and that do not follow specialized industry accounting practices with respect to marketable securities shall be treated as a single consolidated portfolio for the comparison of aggregate cost and market value. The portfolios of marketable equity securities owned by an entity (subsidiary or investee) that is accounted for by the equity method shall not be combined with the portfolios of marketable equity securities owned by any other entity included in the financial statements.[5] However, such an entity is, itself, subject to the requirements of this Statement.

.10 If there is a change in the classification of a marketable equity security between current and noncurrent, the security shall

[4] For this purpose, marketable equity securities owned by an investee accounted for by the equity method shall not be considered owned by the entity (investor).

[5] This constitutes an exception to paragraph 19 of *APB Opinion No. 18* [section 5131.19] in those cases in which a subsidiary accounted for under the equity method has a net unrealized gain or loss on a portfolio of marketable equity securities that would serve to offset, in whole or in part, the net unrealized gain or loss on a comparable portfolio of marketable equity securities of the parent or consolidated entity. If the subsidiary were consolidated and its portfolios were combined with comparable portfolios of other entities in the consolidation in accordance with this paragraph, a different effect on consolidated net income would be produced, as compared with the equity method.

be transferred between the corresponding portfolios at the lower of its cost or market value at date of transfer. If market value is less than cost, the market value shall become the new cost basis, and the difference shall be accounted for as if it were a realized loss and included in the determination of net income.

.11 Realized gains and losses shall be included in the determination of net income of the period in which they occur. Changes in the valuation allowance for a marketable equity securities portfolio included in current assets shall be included in the determination of net income of the period in which they occur. Accumulated changes in the valuation allowance for a marketable equity securities portfolio included in noncurrent assets or in an unclassified balance sheet shall be included in the equity section of the balance sheet and shown separately.

.12 The following information with respect to marketable equity securities owned shall be disclosed either in the body of the financial statements or in the accompanying notes:

a) As of the date of each balance sheet presented, aggregate cost and market value (each segregated between current and noncurrent portfolios when a classified balance sheet is presented) with identification as to which is the carrying amount.

b) As of the date of the latest balance sheet presented, the following, segregated between current and noncurrent portfolios when a classified balance sheet is presented:

   i) Gross unrealized gains representing the excess of market value over cost for all marketable equity securities in the portfolio having such an excess.

   ii) Gross unrealized losses representing the excess of cost over market value for all marketable equity securities in the portfolio having such an excess.

c) For each period for which an income statement is presented:

   i) Net realized gain or loss included in the determination of net income.

   ii) The basis on which cost was determined in computing realized gain or loss (i.e., average cost or other method used).

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iii) The change in the valuation allowance(s) that has been included in the equity section of the balance sheet during the period and, when a classified balance sheet is presented, the amount of such change included in the determination of net income.

.13 An enterprise's financial statements shall not be adjusted for realized gains or losses or for changes in market prices with respect to marketable equity securities when such gains or losses or changes occur after the date of the financial statements but prior to their issuance, except for situations covered by paragraph .21. However, significant net realized and net unrealized gains and losses arising after the date of the financial statements, but prior to their issuance, applicable to marketable equity securities owned at the date of the most recent balance sheet shall be disclosed.

Enterprises in Industries Having Specialized Accounting Practices with Respect to Marketable Securities

.14 Certain industries apply specialized industry accounting practices with respect to marketable securities. Such industries include investment companies, brokers and dealers in securities, stock life insurance companies, and fire and casualty insurance companies. Except for the requirements in paragraphs .15, .21, and .22, this Statement does not alter any industry's specialized accounting practices. Paragraphs .15, .17, and .19 deal with marketable equity securities as that term is defined in paragraph .07. Paragraphs .16, .18, and .20-.22 deal with marketable securities as that term is used in the particular industries concerned, including, but not limited to, marketable equity securities.

.15 Entities that carry marketable equity securities at cost shall hereafter carry them at the lower of their aggregate cost or market value.[6] In making this determination, the provisions of paragraphs .07-.09 shall be applied with the exception of the third sentence of paragraph .09. The portfolios of entities that are consolidated in financial statements and that follow the same specialized industry accounting practices with respect to marketable equity securities

[6] This does not preclude entities in industries in which either the cost basis or the market basis is an accepted specialized practice from electing the market basis where such election is permissible in that industry. In such an election, the provisions of paragraphs 15-17 of *APB Opinion No. 20* [section 1051.15-.17], "Accounting Changes," shall not apply.

shall be treated as a single portfolio for the comparison of aggregate cost and market value. This Statement does not alter any entity's specialized industry practice for reporting gains and losses, whether realized or unrealized, for marketable equity securities.

.16 Entities that do not include unrealized gains and losses[7] on marketable securities in the determination of net income but that do include them in the equity section of the balance sheet shall disclose the following information, either in the body of the financial statements or in the accompanying notes:

a) Gross unrealized gains and gross unrealized losses as of the date of the latest balance sheet presented.

b) Change in net unrealized gain or loss (the amount by which equity has been increased or decreased as a result of unrealized gains and losses) for each period for which an income statement is presented.

.17 An enterprise's financial statements shall not be adjusted for realized gains or losses or for changes in market prices with respect to marketable equity securities when such gains or losses or changes occur after the date of the financial statements, but prior to their issuance, except for situations covered by paragraph .21. However, significant net realized and net unrealized gains and losses arising after the date of the financial statements, but prior to their issuance, applicable to marketable equity securities in the portfolio at the date of the most recent balance sheet shall be disclosed.

Enterprises That Include Entities Whose Accepted Accounting Practices Differ with Respect to Marketable Securities

.18 If an investee accounted for by the equity method or a subsidiary follows accepted accounting practices that are different from those of the parent or investor with respect to marketable securities, those practices shall be retained in the consolidated or parent company financial statements in which those entities are included. As an exception to this requirement, if it is the practice of the parent or investor to include realized gains and

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[7] For the purposes of paragraph .16, unrealized gains and losses shall have the same meaning as is presently accepted in the particular industry's specialized accounting practice.

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losses in the determination of net income, or would so include them if present, the accounting treatment of a subsidiary or an investee that does not follow such practice shall be conformed to that of the parent or investor in that particular respect in consolidated or parent company financial statements.

.19 If the parent company in a consolidation follows specialized industry accounting practices with respect to marketable securities but two or more consolidated subsidiaries do not (and hence are subject to the provisions of paragraphs .08-.13 of this Statement), the current and noncurrent portfolios of marketable equity securities of such subsidiaries shall be consolidated as separate current and noncurrent portfolios in the manner provided in paragraph .09, exclusive of the portfolios of the parent company, for the purpose of determining carrying amounts in accordance with paragraph .09. The information required by paragraph .12 shall be disclosed in the consolidated financial statements with respect to such subsidiaries.

.20 If the consolidated financial statements reflect more than one accepted practice of accounting for marketable securities, the disclosures required by this Statement and those encompassed by specialized industry practice, as applicable, shall be disclosed either in the body of the financial statements or in the accompanying notes for the marketable securities accounted for under each such practice.

Decline in Market Value Is Assessed to Be Other Than Temporary

.21 For those marketable securities for which the effect of a change in carrying amount is included in stockholders' equity rather than in net income (including marketable securities in unclassified balance sheets), a determination must be made as to whether a decline in market value below cost as of the balance sheet date of an individual security is other than temporary.[8] If the decline is judged to be other than temporary, the cost basis of the individual security shall be written down to a new cost basis and the amount of the write-down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in market value.

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[8] For a recent discussion of this subject, see the Auditing Interpretation published by the staff of the Auditing Standards Division, AICPA, "Evidential Matter for the Carrying Amount of Marketable Securities," in *The Journal of Accountancy,* April 1975. (See AU section 9332.01-.14.)

Income Taxes

.22 Unrealized gains and losses on marketable securities, whether recognized in net income or included in the equity section of the balance sheet, shall be considered as timing differences, and the provisions of *APB Opinion No. 11* [section 4091], "Accounting for Income Taxes," shall be applied in determining whether such net unrealized gain or loss shall be reduced by the applicable income tax effect. A tax effect shall be recognized on an unrealized capital loss only when there exists assurance beyond a reasonable doubt that the benefit will be realized by an offset of the loss against capital gains.

Effective Date and Transition

.23 The provisions of this Statement, other than those of paragraph .18, shall be effective for financial statements for annual and interim periods ending on or after December 31, 1975.[9] If initial application of this Statement necessitates establishment of a valuation allowance for a marketable equity securities portfolio included in current assets, the amount thereof shall be included in the determination of net income for the period in which this Statement is initially applied. If initial application of this Statement necessitates establishment of a valuation allowance for a marketable equity securities portfolio included in noncurrent assets or in an unclassified balance sheet, the amount thereof shall be reflected separately in stockholders' equity as of the end of the period in which this Statement is initially applied. For initial application of this Statement, the provisions of paragraph .10 shall not apply to transfers between current and noncurrent classifications made as of or before December 31, 1975.[10] Financial statements for annual and interim periods ending before December 31, 1975[11] shall not be restated except as stated below. The provisions of paragraph .18 of this Statement shall be effective for financial statements for annual and interim periods ending on or after December 31, 1975.[12] Those provisions shall be applied retroactively by prior period adjustment (described in paragraphs 18 and 26 of *APB Opinion No. 9* [sections 2010.17 and 2010.25], "Reporting the Results of Operations"). When prior period

[9] For enterprises having fiscal years of 52 or 53 weeks instead of the calendar year, this Statement shall be effective for financial statements for periods ending in late December 1975.

[10] See footnote 9.

[11] See footnote 9.

[12] See footnote 9.

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financial statements or financial summaries or other data derived therefrom are presented, they shall be restated to conform to those provisions.

> **The provisions of this Statement need not be applied to immaterial items.**

Appendix A

BASIS FOR CONCLUSIONS

.24 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including alternatives considered and the reasons for accepting some and rejecting others.

Scope

.25 The three questions which the Board addressed as constituting financial reporting problems requiring early resolution are those listed in paragraph .03. Questions (a) and (b) relate to the determination of carrying amount for marketable equity securities, whereas question (c) relates to the issue of conformity in consolidated or parent company financial statements of different methods of accounting with respect to all marketable securities, whether or not they are equity securities.

.26 Because of the urgency of resolving these questions within a limited time frame, the Board concluded that the scope of the project should be limited essentially to the questions as presented. Although a number of respondents objected to the short exposure period and the proximity of the proposed effective date, the Board determined that the problems should be resolved for application in 1975. As stated in paragraph .02, the requests that the Board deal with the problems had indicated that such a timely answer was needed. On the basis of available information, including that obtained at the public hearing and in position papers and letters of comment, the Board concluded that it could make an informed decision on the questions as presented and that the effective date and method of transition specified herein are advisable.

.27 The Board is mindful of the fact that enterprises in certain industries apply specialized accounting practices presently accepted in those industries. The Board concluded that consideration of questions (a) and (b) with respect to those particular industries should be limited to the enterprises within those industries that carry marketable equity securities on the basis of cost. The alternative bases for carrying marketable equity securities

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(e.g., market value, appraised value, fair value) which are permitted in certain specialized industry accounting practices with respect to marketable securities have not been considered by the Board and are not altered by this Statement. The Board further concluded that it would not, as a part of this project, examine or change specialized industry practice for reporting gains and losses, whether realized or unrealized, for marketable securities. To do so would expand the scope of the project in that consideration of the fundamental issues that led to the adoption of those specialized practices would be required. This, the Board decided, could not be done in the limited time available for the completion of this project.

.28 For the reasons discussed in paragraph .27, the "Standards of Financial Accounting and Reporting" of this Statement contain separate provisions for two categories of enterprises: those in industries not having specialized accounting practices with respect to marketable securities, and those in industries having such specialized accounting practices.

Enterprises in Industries Not Having Specialized Accounting Practices with Respect to Marketable Securities

.29 In considering questions (a) and (b) of paragraph .03 the Board noted that the questions pertain to marketable equity securities carried on a cost basis. The Board's conclusion that the lower of cost or market should apply in the determination of carrying amount for such securities was based on the following factors:

a) The Board excluded from its consideration market value alone as the determinant of carrying value. Consideration of that alternative would raise pervasive issues concerning the valuation of other types of assets, including the concept of historic cost versus current or realizable value. The Board concluded that it could not examine these conceptual issues in a project of such limited scope.

b) The Board noted that continuance of original cost as the carrying amount of a portfolio of marketable equity securities when its market value is lower has the effect of deferring

recognition of the decline in the realizable value of such securities based on the expectation of a future recovery in market value which may or may not occur. Because of the uncertainty of such future recovery, the Board concluded that original cost is not a proper determinant of carrying amount for marketable equity securities when market value is below cost. A number of respondents advanced the argument that, in the case of securities held as long-term investments, a decline in market value viewed as temporary should not be reflected in net income. While not necessarily accepting this argument, the Board took into account the fact that this argument has considerable support in current practice, and that the Auditing Interpretation referred to in footnote 8 is consistent with it. The Board concluded that the conceptual question of whether such differences should or should not be included in income could not be dealt with in this project, and hence no such requirement should be made at this time. However, the Board concluded that a decline in market value below cost should in all cases be reflected in the balance sheet and when such securities are classified as current assets, the decline in market value below cost should enter into the determination of net income. In the case of current assets, it is the Board's view that the realization of the loss in value of the securities should be regarded as imminent and therefore should be recognized in the determination of net income.

c) In adopting the lower of cost or market as the determinant for carrying amount, the Board required that when write-downs have been made because the market value of the portfolio has dropped below cost, if market value subsequently rises, the write-down be reversed to the extent that the resulting carrying amount does not exceed cost. The Board does not regard the reversal of the write-down as representing recognition of an unrealized gain. Rather, the Board views the write-down as establishing a valuation allowance representing the estimated reduction in the realizable value of the portfolio, and it views a subsequent market increase as having reduced or eliminated the requirement for such an allowance. In the Board's view, the reversal of the write-down represents a change in an accounting estimate of an unrealized loss (see paragraph 2 of *FASB Statement No.* 5 [section 4311.02], "Accounting for Contingencies" and paragraph 10 of *APB Opinion No.* 20 [section 1051.10]).

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.30 The Exposure Draft required that all changes in the carrying amounts of the marketable equity securities portfolio be reflected in income currently and made no distinction in that regard between the current or noncurrent classifications of such securities. Some respondents favored the separation of the single portfolio called for by the Exposure Draft into current and noncurrent portfolios with the change in carrying amount for the noncurrent portfolio to be reflected in equity rather than in income. They argued that fluctuations in the market value of long-term investments should not be reflected in income and to do so would cause distortions which would not be understood by investors. While not necessarily agreeing with these arguments, for the reasons discussed in paragraph .29(b), the Board decided not to require in this Statement that declines in the market value below cost of noncurrent marketable equity securities be reflected in net income. In reaching this decision, the Board recognized that the present concepts of income require authoritative clarification with respect to the recognition of unrealized gains and losses on long-term assets. Such clarification, the Board noted, is beyond the scope of this Statement. For these reasons, the Board concluded that marketable equity securities classified as noncurrent assets should constitute a separate portfolio from those securities classified as current assets for the determination of carrying amount, and that changes in the carrying amount of the noncurrent portfolio should be reflected in the equity section of the balance sheet rather than included in income, provided that the decline in market value is assessed as temporary.

.31 An issue inherent in the determination of carrying amount for marketable equity securities was whether the lower of cost or market method adopted by the Board should be applied on the basis of individual security holdings or on a portfolio basis. In deciding to require application on a portfolio basis (with the exceptions noted in paragraph .09), the Board considered the following factors: Many enterprises regard their portfolios of marketable equity securities (excluding long-term investments accounted for under the equity method) as collective assets. A requirement that the application of lower of cost or market be made on an individual security basis would, in the Board's view, be unduly conservative and at variance with the manner in which enterprises generally view their investment in marketable equity securities. The Board recognized that the application of the criterion on a portfolio basis may be regarded as having the effect of offsetting the unrealized losses on one security with unrealized gains on

another. However, the Board agrees with those respondents who regard the current and noncurrent portfolios of marketable equity securities each as collective assets, hence the determination of the carrying amount on a collective (portfolio) basis is in the Board's view appropriate despite the offsets referred to. The disclosures required by paragraph .12(b) are intended to inform as to the extent to which such offsets exist in the portfolio.

.32 Paragraph .30 discussed the reasons for the Board's decision to change from a single portfolio basis as provided by the Exposure Draft to separate portfolios for current and noncurrent assets. The Exposure Draft noted that such a separation of portfolios would provide opportunities for transfers between portfolios simply by changing classifications and that such transfers could result in significant changes in net income. The Board had this feature in mind in requiring that transfers between the current and noncurrent portfolios be accounted for in the manner prescribed by paragraph .10. This has the effect of accounting for an unrealized loss at the date of transfer in the same manner as if it had been realized, thus reducing the incentive to cause significant changes in income by transferring securities between portfolios. The Board recognized, however, that the above requirement would not be effective in the case of a transfer from noncurrent to current classifications of a security having an excess of market value over cost which would serve to offset a reverse situation in the current portfolio, thus affecting the determination of net income. However, as mentioned in paragraph .31, the disclosures required by paragraph .12(b) should assist users of financial statements in assessing the effects of such transfers.

.33 The definition of "equity security" in the Exposure Draft included convertible bonds. Many respondents believed that such inclusion was in conflict with *APB Opinion No. 14* [section 5516], "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants." It was pointed out further that the market sometimes values a convertible bond primarily on its equity characteristics and at other times primarily on its debt characteristics. The Board concluded that it was impractical to apply criteria under which a convertible bond might in some time intervals come under the definition and at other times be excluded. Accordingly, the Board decided that convertible bonds, and, for consistency, convertible preferred stock with redemption requirements, would be excluded from the definition of equity securities.

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.34 A number of respondents asked for clarification of what was encompassed by the term "restricted stock" with respect to the statement in the Exposure Draft that restricted stock did not meet the definition of "marketable." Footnote 3 of this Statement is intended to provide the requested clarification. The Board's decision to consider restricted stock as meeting the definition of marketable where the restriction terminates or can be terminated by the holder within one year is based on the view that current market value is relevant in applying the lower of cost or market determination to such securities, whereas in the case of longer term restrictions, the application of current market value is of lesser relevance.

.35 Paragraph .09 provides, as did the Exposure Draft, that "The portfolios of marketable equity securities owned by an entity (subsidiary or investee) that is accounted for by the equity method shall not be combined with the portfolios of marketable equity securities owned by any other entity included in the financial statements.[5]" Some respondents were of the opinion that the portfolio(s) of unconsolidated subsidiaries accounted for by the equity method should be so combined, especially in the case of 100 percent owned subsidiaries, and that failure to do so would be contrary to paragraph 19 of *APB Opinion No. 18* [section 5131.19]. Some of the respondents expressing this view acknowledged that there were both conceptual and mechanical problems involved in implementing this recommendation, but none offered specific suggestions for resolving them. The Board noted in the Exposure Draft and in footnote 5 of this Statement that the procedure called for constitutes an exception to paragraph 19 of *APB Opinion No. 18* [section 5131.19]. The Board rejected the recommendation that the portfolios of equity method subsidiaries be combined with others, because to do so could produce illogical results either with respect to the carrying amount of marketable securities as reflected in the consolidated balance sheet, or the carrying amount of the equity method subsidiary as reflected in the same balance sheet.

Enterprises in Industries Having Specialized Accounting Practices with Respect to Marketable Securities

.36 Paragraph .14 states that, with the exception of paragraphs .15, .21, and .22, this Statement does not alter any industry's specialized accounting practices with respect to marketable securities.

.37 Paragraph .15 requires that entities that carry marketable equity securities at cost shall hereafter carry them at the lower of their aggregate cost or market value with the following exception: entities in industries whose specialized accounting practices permit market value as an acceptable alternate carrying basis may elect that basis. The cost basis is no longer acceptable for determining carrying amount for marketable equity securities and is replaced by the lower of aggregate cost or market value.

.38 The Board's decision to replace the cost basis with the lower of cost or market basis in industries having specialized accounting practices took into account the following factors:

a) Having concluded that the cost basis should be replaced in all enterprises in industries with nonspecialized accounting practices, the Board could find no justification for maintaining cost as a basis for marketable equity securities in the other industries.

b) As stated in paragraph .27, this Statement does not alter specialized industry practice for reporting gains and losses on marketable securities because to do so would involve a reconsideration of fundamental issues in those industries. However, a change in the carrying basis for marketable equity securities does not, in the Board's view, necessitate such a reconsideration.

c) Elimination of cost as a carrying basis for marketable equity securities in the industries having specialized accounting practices serves to reduce some of the disparity in practice among those industries as well as with industries not having specialized accounting practices.

Applicability

.39 Numerous responses from the mutual savings bank industry urged that mutual savings banks be excluded from the scope of this Statement. The principal arguments advanced were: mutual savings banks are regulated and, in some states, are required to

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carry marketable securities at cost; the exclusion of not-for-profit organizations should apply to mutual savings banks; the element of mutuality (absence of shareholders) applies equally to these organizations as it does to mutual life insurance companies. The Board did not find these arguments persuasive. When mutual savings banks, which are in an industry not having specialized accounting practices, present financial statements purporting to be in conformity with generally accepted accounting principles, the fact that they are regulated or that they do not have shareholders does not, in the Board's view, justify different accounting for marketable equity securities from that required to be followed by other entities not having specialized accounting practices. Accordingly, the provisions of this Statement apply to mutual savings banks, as well as to other for-profit mutual enterprises, except mutual life insurance companies.

.40 Mutual life insurance companies were excluded from the scope of this Statement because, unlike stock life insurance companies (see paragraph .14), there is disagreement as to whether generally accepted accounting principles exist for mutual life insurance companies.[13] This coupled with the complexity of some of the issues involved in life insurance accounting caused the Board to conclude that it could not resolve these questions within this project. On the other hand, mutual savings banks, which are not excluded from the scope of this Statement, do present financial statements prepared in conformity with generally accepted accounting principles and there are no complex related accounting issues involved as is the case with mutual life insurance companies.

.41 The Exposure Draft proposed that the Statement be applied retroactively by prior period restatement. That method of transition was proposed on the premise that it would afford maximum comparability among financial statements. The Board has obtained information, subsequent to the issuance of the Exposure Draft, that a number of companies have in past years made substantial reclassifications of marketable equity securities as between current and noncurrent assets. With the Board's decision to provide for separate portfolios of current and noncurrent marketable equity securities with different accounting for changes in carrying value of the two portfolios, the number of and seemingly divergent

[13] See the Preface to *AICPA Industry Audit Guide,* "Audits of Stock Life Insurance Companies."

bases for reclassifications that have occurred in recent years would, in the case of retroactive restatement, result in less rather than more comparability. The new requirement that transfers between current and noncurrent portfolios be accounted for in a manner to treat reductions in market value below cost as realized losses at the date of transfer would, if applied retroactively, accentuate this effect. For these reasons, the Board concluded that the interests of users of financial statements would best be served by making the Statement effective December 31, 1975 [14] (except for paragraph .18 for which retroactive application is still required).

[14] See footnote 9.

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Appendix B

ILLUSTRATION OF DISCLOSURES REQUIRED BY PARAGRAPH .12 OF THIS STATEMENT

.42 The following example illustrates the disclosure requirements of paragraph .12 for an enterprise having a classified balance sheet. For purposes of this illustration it is presumed that the only marketable securities that the enterprise owns are marketable equity securities as defined in paragraph .07. The illustration does not encompass all possible circumstances that may arise in connection with the disclosure requirements, nor does it indicate the Board's preference for a particular format.

Computational Information

The details on the following pages pertain to marketable equity securities owned at December 31:

	1975			1974		
	Cost	Market	Unrealized Gain (Loss)	Cost	Market	Unrealized Gain (Loss)
In Current Assets:						
Security A	$100,000	$100,000	$ —	$200,000	$250,000	$ 50,000
B	200,000	150,000	(50,000)	300,000	250,000	(50,000)
C	200,000	175,000	(25,000)	200,000	150,000	(50,000)
D	150,000	100,000	(50,000)	150,000	200,000	50,000
E	50,000	100,000	50,000	50,000	75,000	25,000
F	200,000	225,000	25,000	—	—	—
Total of Portfolio	$900,000	$850,000	$(50,000)	$900,000	$925,000	$ 25,000
Valuation Allowance—Current			$(50,000)			Not Applicable
In Noncurrent Assets:						
Security G	$300,000	$200,000	$(100,000)	$300,000	$100,000	$(200,000)
H	100,000	190,000	90,000	100,000	250,000	150,000
I	250,000	150,000	(100,000)	250,000	150,000	(100,000)
Total of Portfolio	$650,000	$540,000	$(110,000)	$650,000	$500,000	$(150,000)
Valuation Allowance—Noncurrent			$(110,000)			Not Applicable

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During 1975 the following sales of securities took place. (There were no sales of securities in 1974.):

	Net Proceeds of Sale	Cost	Realized Gain (Loss)
Security A	$125,000	$100,000	$ 25,000
Security B	65,000	100,000	(35,000)
	$190,000	$200,000	$(10,000)

The valuation allowances required at December 31, 1975 are as follows:

	Charged Against Income	Charged Against Equity
In Current Assets:		
Cost $900,000 less market $850,000	$50,000*	
In Noncurrent Assets:		
Cost $650,000 less market $540,000		$110,000*

* No tax effect was recognized because there is no assurance beyond a reasonable doubt that the benefit will be realized by an offset of the loss against capital gains.

Disclosure Requirements

BALANCE SHEET

	December 31,	
	1975	1974
Current Assets		
Marketable equity securities, carried at market in 1975 and at cost in 1974 (Note 1)	$850,000	$900,000
Noncurrent Assets		
Marketable equity securities, carried at market in 1975 and at cost in 1974 (Note 1)	540,000	650,000
Stockholders' Equity		
Net unrealized loss on noncurrent marketable equity securities (Note 1)	(110,000)	—

NOTES TO FINANCIAL STATEMENTS

Note 1—Marketable Equity Securities

At December 31, 1975, the current and noncurrent portfolios of marketable equity securities are each carried at their lower of cost or market at the balance sheet date. Marketable equity securities included in current and noncurrent assets had a cost of $900,000 and $650,000, respectively, at December 31, 1975.

To reduce the carrying amount of the current marketable equity securities portfolio to market, which was lower than cost at December 31, 1975, a valuation allowance in the amount of $50,000 was established with a corresponding charge to net income at that date. To reduce the carrying amount of the noncurrent marketable equity securities portfolio to market, which was lower than cost at December 31, 1975, a valuation allowance in the amount of $110,000 was established by a charge to stockholders' equity representing the net unrealized loss.

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At December 31, 1974, the current and noncurrent portfolios of marketable equity securities were not required to be carried at their lower of cost or market at the balance sheet date and were carried at cost. Marketable equity securities included in current and noncurrent assets had a market value of $925,000 and $500,000, respectively, at December 31, 1974.

At December 31, 1975, gross unrealized gains and gross unrealized losses pertaining to the marketable equity securities in the portfolios were as follows:

	Gains	Losses
Current	$75,000	$125,000
Noncurrent	$90,000	$200,000

A net realized loss of $10,000 on the sale of marketable equity securities was included in the determination of net income for 1975. The cost of the securities sold was based on the average cost of all the shares of each such security held at the time of sale. There were no sales of marketable equity securities during 1974.

The next page is 9417.

AC Section 5132-1

Application of Section 5132 to Personal Financial Statements: An Interpretation of Section 5132

[Source: FASB Interpretation No. 10.]

September 1976

INTRODUCTION

.01 Paragraph 5 of *FASB Statement No. 12* [section 5132.05], "Accounting for Certain Marketable Securities," enumerates the entities excluded from the scope of the Statement but does not mention individuals. The AICPA Industry Audit Guide, "Audits of Personal Financial Statements," states that ". . . financial statements for individuals should be prepared on a cost basis, in conformity with generally accepted accounting principles" and that ". . . financial information on an estimated value basis is useful . . . as additional financial information" (pages 2 and 3). Further, the Industry Audit Guide recommends a two-column presentation of personal financial statements: "The first column should present financial data on the cost basis, paralleled by a second column presenting estimated values" (page 3). The FASB has been asked to clarify whether in personal financial statements prepared in conformity with generally accepted accounting principles the presentation of marketable equity securities on an estimated value basis in the second column supplants the requirement of paragraph 8 of *FASB Statement No. 12* [section 5132.08] to carry marketable equity securities at the lower of aggregate cost or aggregate market value in the first column.

INTERPRETATION

.02 Personal financial statements prepared in conformity with generally accepted accounting principles are included in the scope of *FASB Statement No. 12* [section 5132]. The presentation of marketable equity securities on an estimated value basis as additional financial information in the second column does not supplant the requirement of paragraph 8 of *FASB Statement No. 12* [section 5132.08] to carry marketable equity securities at the lower of aggregate cost or aggregate market value in the first column.

EFFECTIVE DATE AND TRANSITION

.03 The provisions of this Interpretation shall be effective for financial statements for annual and interim periods ending after

October 15, 1976. Earlier application is encouraged in financial statements for annual and interim periods ending before October 16, 1976 that have not been previously issued. This Interpretation shall not be applied retroactively for previously issued annual or interim financial statements.

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AC Section 5132-2

Changes in Market Value after the Balance Sheet Date: An Interpretation of Section 5132

[Source: FASB Interpretation No. 11.]

September 1976

INTRODUCTION

.01 Paragraphs 13 and 17 [1] of *FASB Statement No. 12* [sections 5132.13 and 5132.17], "Accounting for Certain Marketable Securities," specify in part that "an enterprise's financial statements shall not be adjusted for realized gains or losses or for changes in market prices with respect to marketable equity securities when such gains or losses or changes occur after the date of the financial statements but prior to their issuance, except for situations covered by paragraph 21 [section 5132.21]." The Board has been requested to clarify the meaning of the qualification, *except for situations covered by paragraph 21* [section 5132.21].

.02 Paragraph 21 of *FASB Statement No. 12* [section 5132.21] states:

> For those marketable securities for which the effect of a change in carrying amount is included in stockholders' equity rather than in net income (including marketable securities in unclassified balance sheets), a determination must be made as to whether a decline in market value below cost as of the balance sheet date of an individual security is other than temporary. . . . If the decline is judged to be other than temporary, the cost basis of the individual security shall be written down to a new cost basis and the amount of the write-down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in market value.

The Board also has been asked to elaborate on the amount of the write-down that shall be accounted for as a realized loss when the "decline in market value below cost *as of the balance sheet date* of an individual security is other than temporary." (Emphasis added.)

INTERPRETATION

.03 In the case of those marketable securities for which the effect of a change in carrying amount is included in stockholders' equity rather than in net income, the phrase "except for situations covered by paragraph 21 [section 5132.21]" in paragraphs 13 [section 5132.13] and 17 [section 5132.17] refers to the provi-

[1] Paragraph 13 applies to enterprises in industries not having specialized accounting practices with respect to marketable securities, and paragraph 17 applies to enterprises in industries having specialized accounting practices with respect to marketable securities.

sions in paragraph 21 [section 5132.21] requiring a decline in market value below cost as of the balance sheet date of an individual security that is determined to be other than temporary to be accounted for as a realized loss. In judging whether a decline in market value below cost at the balance sheet date is other than temporary, a gain or loss realized on subsequent disposition or changes in market price occurring after the date of the financial statements but prior to their issuance shall be taken into consideration along with other factors.

.04 The amount of decline in market value below cost of an individual marketable equity security that is accounted for as a realized loss as of the balance sheet date because the decline is other than temporary shall not exceed the difference between market value at the balance sheet date and cost of the marketable equity security. Further declines in market value after the balance sheet date might indicate that the decline in market value below cost at the balance sheet date was other than temporary. However, those declines result from information, events, or changes in expectations occurring after the balance sheet date. Accordingly, if a decline in market value below cost as of the balance sheet date of an individual security is judged to be other than temporary, further declines in market value occurring after the date of the balance sheet shall not be included in the amount that is accounted for as a realized loss as of the balance sheet date. Recoveries in market value after the balance sheet date also result from information, events, or changes in expectations occurring after the balance sheet date, but they tend to indicate that a portion or all of the decline at the balance sheet date was in fact temporary. Accordingly, such recoveries shall be considered when estimating the amount of decline as of the balance sheet date that is judged to be other than temporary.

EFFECTIVE DATE AND TRANSITION

.05 The provisions of this Interpretation shall be effective for financial statements for annual and interim periods ending after October 15, 1976. Earlier application is encouraged in financial statements for annual and interim periods ending before October 16, 1976 that have not been previously issued. This Interpretation shall not be applied retroactively for previously issued annual or interim financial statements.

The next page is 9423.

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AC Section 5132-3

Accounting for Previously Established Allowance Accounts: An Interpretation of Section 5132

[Source: FASB Interpretation No. 12.]

September 1976

INTRODUCTION

.01 Paragraph 8 of *FASB Statement No. 12* [section 5132.08], "Accounting for Certain Marketable Securities," specifies that the "carrying amount of a marketable equity securities portfolio shall be the lower of its aggregate cost or market value, determined at the balance sheet date." Paragraph 7(e) of *FASB Statement No. 12* [section 5132.07(e)] defines "cost" of a marketable equity security as "original cost . . . unless a new cost basis has been assigned based on recognition of an impairment of value that was deemed other than temporary. . . . In such cases, the new cost basis shall be the cost. . . ."

.02 Prior to the issuance of *FASB Statement No. 12* [section 5132], some enterprises that carried marketable equity securities at cost had reduced the carrying amount of individual marketable equity securities to market value through an allowance account with a corresponding amount included in the determination of net income. In some of those cases, a new cost basis was not established for individual securities and the allowance account was expected to increase or decrease depending on fluctuations in the market price of the marketable equity security because the decline in market value below cost was assessed to be temporary. The Board has been asked to clarify whether, in those cases, the original cost of the individual securities or the original cost reduced by an existing allowance account should be used in applying paragraphs 7(e) and 8 of *FASB Statement No. 12* [sections 5132.07(e) and 5132.08].

INTERPRETATION

.03 The original cost of individual marketable equity securities shall be used in applying paragraphs 7(e) and 8 of *FASB Statement No. 12* [sections 5132.07(e) and 5132.08] by an enterprise that carried marketable equity securities at cost and that (a) had reduced the carrying amount of individual marketable equity securities through an allowance account with a corresponding amount included in the determination of net income prior to the

effective date of the Statement and (b) expected the allowance account to increase or decrease in the future based on fluctuations in the market price of the security because the decline in market value below cost was assessed to be temporary. Any balance remaining in such an existing allowance account shall be eliminated and credited to income in the period in which this Interpretation is initially applied. The valuation allowance would then be determined in accordance with paragraph 8 of *FASB Statement No. 12* [section 5132.08].

.04 If, prior to the effective date of *FASB Statement No. 12* [section 5132], a new cost basis had been assigned to a marketable equity security based on recognition of an impairment of value that was deemed other than temporary, the new cost basis shall be used in applying the provisions of *FASB Statement No. 12* [section 5132].

EFFECTIVE DATE AND TRANSITION

.05 The provisions of this Interpretation shall be effective for financial statements for annual and interim periods ending after October 15, 1976. Earlier application is encouraged in financial statements for annual and interim periods ending before October 16, 1976 that have not been previously issued. This Interpretation shall not be applied retroactively for previously issued annual or interim financial statements.

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AC Section 5132-4

Consolidation of a Parent and Its Subsidiaries Having Different Balance Sheet Dates: An Interpretation of Section 5132

[Source: FASB Interpretation No. 13.]

September 1976

INTRODUCTION

.01 Paragraphs 8, 9, and 15 of *FASB Statement No. 12* [sections 5132.08, 5132.09, and 5132.15], "Accounting for Certain Marketable Securities," set forth the requirements of the portfolio basis for comparing cost and market value. The portfolio basis requires that marketable equity securities owned by enterprises that are consolidated and that do not follow specialized accounting practices with respect to marketable equity securities, or that are consolidated and follow the same specialized accounting practices with respect to marketable equity securities, shall be aggregated into separate portfolios according to the current or noncurrent classifications of the securities. The aggregate cost and aggregate market value of the portfolios are compared to determine carrying amount.

.02 Paragraph 13 of *FASB Statement No. 12* [section 5132.13], which applies to enterprises in industries not having specialized accounting practices with respect to marketable securities, states:

> An enterprise's financial statements shall not be adjusted for realized gains or losses or for changes in market prices with respect to marketable equity securities when such gains or losses or changes occur after *the date of the financial statements* but prior to their issuance, except for situations covered by paragraph 21. However, significant net realized and net unrealized gains and losses arising after *the date of the financial statements,* but prior to their issuance, applicable to marketable equity securities owned at the date of the most recent balance sheet shall be disclosed. (Emphasis added.)

Paragraph 17 of *FASB Statement No. 12* [section 5132.17], which applies to enterprises in industries having specialized accounting practices with respect to marketable securities, is in substance identical to paragraph 13 of the Statement.

.03 The financial statements of a subsidiary sometimes are consolidated with the financial statements of its parent even though the financial statements of the subsidiary are as of a date different from the financial statements of the parent. The use of different dates is permitted by paragraph 4 of *ARB No.*

51 [section 2051.05], "Consolidated Financial Statements," which states:

> A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations.

.04 The Board has been requested to clarify application of the portfolio basis specified in *FASB Statement No. 12* [section 5132] when the financial statements of a subsidiary are as of a date different from that of its parent and are consolidated with the financial statements of its parent. Further, the Board has been asked to explain the meaning of "the date of the financial statements" in paragraphs 13 and 17 of *FASB Statement No. 12* [sections 5132.13 and 5132.17] when the financial statements of a subsidiary or investee are as of a date different from that of its parent or investor and are consolidated with or accounted for by the equity method in the financial statements of its parent or investor.

INTERPRETATION

.05 To compute the amount of any valuation allowance(s) required by *FASB Statement No. 12* [section 5132] in the consolidated financial statements, aggregate cost and aggregate market value of the portfolio(s) shall be determined for each subsidiary that is consolidated as of the date of each subsidiary's balance sheet, and those aggregates shall be combined with aggregate cost and aggregate market value of the parent's portfolio(s) determined as of the parent's balance sheet date. For example, assume that consolidated financial statements dated December 31, 1976 and issued on March 1, 1977 include the financial statements of the parent as of December 31, 1976 and of the subsidiary as of October 31, 1976. The cost of the marketable equity securities owned by the subsidiary at October 31, 1976 is added to the cost of the marketable equity securities owned by the parent at December 31, 1976. The market values at October 31, 1976 of the securities owned by the subsidiary and the market values at December 31, 1976 of the securities owned by the parent are aggregated in the same manner. The aggregate cost and aggregate market value of the portfolios are compared to determine the carrying amount in the consolidated financial statements.

.06 For purposes of applying paragraphs 13 and 17 of *FASB Statement No. 12* [sections 5132.13 and 5132.17], "the date of the

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financial statements" shall be for each subsidiary or investee the date of the financial statements that are consolidated with or accounted for by the equity method in the financial statements of its parent or investor. The last sentence in each of those paragraphs requires disclosure of significant net realized gains or losses and of significant net unrealized gains or losses arising after the date of the financial statements. Using the assumptions in the example in paragraph .05 above, aggregate amounts are computed as follows for possible disclosure: the net *realized* gains or losses arising after October 31, 1976 and prior to March 1, 1977 applicable to the marketable equity securities in the portfolio of the subsidiary at October 31, 1976 are aggregated with the net *realized* gains or losses arising after December 31, 1976 and prior to March 1, 1977 applicable to the marketable equity securities in the portfolio of the parent at December 31, 1976. Likewise, net *unrealized* gains or losses arising in the portfolio of the subsidiary after October 31, 1976 and prior to March 1, 1977 applicable to the marketable equity securities in the portfolio of the subsidiary at October 31, 1976 are aggregated with the net *unrealized* gains or losses arising after December 31, 1976 and prior to March 1, 1977 applicable to the marketable equity securities in the portfolio of the parent at December 31, 1976. If significant, each of the aggregate amounts shall be disclosed.

.07 If the financial statements of a subsidiary are consolidated with the financial statements of its parent and the financial statements of the subsidiary are as of a date different from the financial statements of the parent, paragraph 4 of *ARB No. 51* [section 2051.05] requires that "recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations." In the case of the subsidiary in the example in paragraph .05 above, that requirement pertains to the period from October 31, 1976 to December 31, 1976. Accordingly, in addition to the disclosure required by paragraph .06 above, the net realized gains or losses and the net unrealized gains or losses arising after October 31, 1976 and prior to December 31, 1976 applicable to the marketable equity securities of the subsidiary shall be disclosed if they "materially affect the financial position or results of operations." Further, as required by paragraphs 13 and 17 of *FASB Statement No. 12* [sections 5132.13 and 5132.17],[1] the subsidiary's financial statements shall not be adjusted for realized gains or losses or for changes in market prices with respect to its marketable equity securities occurring after October 31, 1976

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[1] See also *FASB Interpretation No. 11* [section 5132-2], "Changes in Market Value after the Balance Sheet Date: an interpretation of FASB Statement No. 12 [section 5132]."

and prior to December 31, 1976, unless the decline in market value below cost of an individual marketable equity security is determined to be other than temporary and, accordingly, shall be accounted for as a realized loss.

EFFECTIVE DATE AND TRANSITION

.08 The provisions of this Interpretation shall be effective for financial statements for annual and interim periods ending after October 15, 1976. Earlier application is encouraged in financial statements for annual and interim periods ending before October 16, 1976 that have not been previously issued. This Interpretation shall not be applied retroactively for previously issued annual or interim financial statements.

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AC Section 5132-5

Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable: An Interpretation of Section 5132

[Source: FASB Interpretation No. 16.]

February 1977

INTRODUCTION

.01 The FASB has been asked to clarify the definitions of the terms "marketable" and "restricted stock" as used in *FASB Statement No. 12* [section 5132], "Accounting for Certain Marketable Securities," and to clarify whether paragraph 10 of *FASB Statement No. 12* [section 5132.10] requires a new cost basis to be assigned when a marketable equity security becomes nonmarketable if its market value is less than its cost at that time.

.02 For purposes of applying paragraphs 8-13, 15, 17, and 19 of *FASB Statement No. 12* [section 5132.08—.13, section 5132.15, section 5132.17, and section 5132.19], the term "marketable" is defined in paragraph 7(b) of the Statement [section 5132.07(b)] as follows:

> *Marketable,* as applied to an equity security, means an equity security as to which sales prices or bid and ask prices are currently available on a national securities exchange (i. e., those registered with the Securities and Exchange Commission) or in the over-the-counter market. In the over-the-counter market, an equity security shall be considered marketable when a quotation is publicly reported by the National Association of Securities Dealers Automatic Quotations System or by the National Quotations Bureau Inc. (provided, in the latter case, that quotations are available from at least three dealers). Equity securities traded in foreign markets shall be considered marketable when such markets are of a breadth and scope comparable to those referred to above. Restricted stock[3] does not meet this definition.

Footnote 3 to that paragraph defines restricted stock as follows:

> Restricted stock for purposes of this Statement shall mean securities for which sale is restricted by a governmental or contractual requirement except where such requirement terminates within one year or where the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the stock which can reasonably be expected to qualify for sale within one year, such as may be the case under Rule 144 or similar rules of the Securities and Exchange Commission, is not considered restricted [under *FASB Statement No. 12*] [section 5132].

.03 Paragraph 10 of *FASB Statement No. 12* [section 5132.10] states:

> If there is a change in the classification of a marketable equity security between current and noncurrent, the security shall be transferred between the corresponding portfolios at the lower of its cost or market value at date of transfer. If market value is less than cost, the market value shall become the new cost basis, and the difference shall be accounted for as if it were a realized loss and included in the determination of net income.

INTERPRETATION

Definitions

.04 For purposes of applying paragraphs 8-13, 15, 17, and 19 of *FASB Statement No. 12* [section 5132.08—.13, section 5132.15, section 5132.17, and section 5132.19], an equity security is not considered marketable if market price quotations specified by the Statement (see paragraph .02 above) are not available or if it is "restricted stock" as defined in the Statement (see paragraph .02 above) even though market price quotations are available for securities of the same class that are not restricted.

.05 The determination of whether an equity security is marketable is made as of the balance sheet date,[1] but a temporary lack of trades or price quotations for an equity security at the balance sheet date does not make it nonmarketable for purposes of applying *FASB Statement No. 12* [section 5132] if the required market prices are available on days closely preceding and following the balance sheet date in that situation, the market price of a security traded on a national securities exchange shall be determined from the sales or bid and ask prices on the first day following the balance sheet date that the information is available. If the lack of a publicly reported quotation by the National Association of Securities Dealers Automatic Quotations System or the lack of three quotations by the National Quotations Bureau Inc. is a mere temporary condition as described above for a security traded in the over-the-counter market, its market price shall be determined from:

a. The quotation publicly reported by the National Association of Securities Dealers Automatic Quotations System on the first day following the balance sheet date that a quotation is publicly reported, or

b. The quotation(s) reported by the National Quotations Bureau Inc. as of the balance sheet date if at least one quotation is

[1] If the balance sheet date falls on a date that securities are not normally traded (e. g., Saturday or Sunday), the availability of market price quotations shall be determined as of the most recent business day preceding the balance sheet date.

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available as of that date or on the first day following the balance sheet date that quotations are reported if no quotations are available on the balance sheet date.

.06 If it can be reasonably expected that a security "for which sale is restricted by a governmental or contractual requirement" can qualify for sale within one year of the balance sheet date and market price quotations for unrestricted securities of the same class are available as of the balance sheet date, the security is considered marketable at the balance sheet date for purposes of applying *FASB Statement No. 12* [section 5132] (see paragraph .02 above). In this situation, market price quotations for unrestricted shares of the same class at the balance sheet date provide a surrogate market price for the restricted shares and shall be considered as the market price for the security. If the restricted security cannot qualify for sale within one year or market price quotations are not available for unrestricted shares of the same class, the security is considered nonmarketable for purposes of applying the Statement.

.07 As an example of the application of paragraph .06 above, assume that an enterprise pledges a marketable equity security as collateral for a loan due in three years. Normally, debt agreements permit substitution for the collateral or sale of the collateral if the proceeds are used to repay the loan. However, if the debt agreement prohibits sale of or substitution for the collateral for the term of the loan, the pledged security becomes "restricted stock" and nonmarketable for purposes of applying *FASB Statement No. 12* [section 5132] at the time it is pledged and shall be excluded from the enterprise's portfolio of marketable equity securities from that date until one year before expiration of the long-term debt agreement.

.08 As a further example, assume that an enterprise owns common stock that cannot be sold to the public, except pursuant to Rule 144 of the Securities and Exchange Commission (see explanation below), until a registration statement has been filed with the SEC and has become effective. Also assume that the stock is marketable at one balance sheet date pursuant to an effective registration statement. At the next balance sheet date, the registration statement is no longer effective and the enterprise does not have the power to cause another one to be filed within one year. Then, only the portion of the stock that "can reasonably be expected to qualify for sale within one year . . . under Rule 144 . . . is not considered restricted" under *FASB*

Statement No. 12 [section 5132]. Rule 144 specifies that if certain conditions are met a security may be sold to the public without an effective registration statement on file with the SEC, subject to a limitation on the number of shares that may be sold during a given time period. The number of shares eligible for sale is based on the total number of shares of the security outstanding or the average weekly trading volume of the security for a stated past period. Changes in the number of shares outstanding or in trading volume change the number of shares that qualify for sale under Rule 144. The number of shares considered marketable for purposes of applying the Statement are those that "can reasonably be expected to qualify for sale within one year"; the determination of such number is a matter of judgment based on past trading volumes, the presently outstanding shares and plans for changes therein, and other relevant factors. The number of shares considered nonmarketable are those that cannot qualify for sale within one year under the preceding sentence.

Accounting

.09 Paragraph 10 of *FASB Statement No. 12* [section 5132.10] applies to all transfers between current and noncurrent classifications of equity securities that are marketable, as that term is defined in the Statement (see paragraph .02 above). If the change in the classification of an equity security is coincident with a change in its status from marketable to nonmarketable or from nonmarketable to marketable, paragraph 10 of the Statement [section 5132.10] shall apply to the transfer between current and noncurrent classifications. Paragraph 10 of the Statement [section 5132.10] requires that if the market value of the security is less than its cost when it is transferred between current and noncurrent classifications, "the market value shall become the new cost basis, and the difference shall be accounted for as if it were a realized loss and included in the determination of net income." In that situation, market value shall be the security's last available market price if the transfer between classifications is coincident with a change in status from marketable to nonmarketable and the first available market price if the transfer between classifications is coincident with a change in status from nonmarketable to marketable.

.10 The accounting for a nonmarketable security is outside of the scope of *FASB Statement No. 12* [section 5132]. When a marketable equity security becomes nonmarketable, the cost of that security shall be excluded from the portfolio of marketable equity securities of which it was a part for purposes of applying the Statement. When a nonmarketable equity security becomes marketable, that security shall be included in the portfolio of

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marketable equity securities at cost. The term *cost* is defined in paragraph 7(e) of the Statement [section 5132.07(e)] as "the original cost . . . unless a new cost basis has been assigned based on recognition of an impairment of value that was deemed other than temporary or as the result of a transfer between current and noncurrent classifications as described in paragraph 10 [of the Statement] [section 5132.10]. In such cases, the new cost basis shall be the cost for the purposes of this Statement."

EFFECTIVE DATE AND TRANSITION

.11 The provisions of this Interpretation shall be effective for financial statements for annual and interim periods ending after March 15, 1977. Earlier application is encouraged in financial statements for annual and interim periods ending before March 16, 1977 that have not been previously issued. This Interpretation shall not be applied retroactively for previously issued annual or interim financial statements.

The next page is 9491.

AC Section 5141

Accounting for Intangible Assets

[Source: APB Opinion No. 17, as amended.]

Effective to account for intangible assets acquired after October 31, 1970, unless otherwise indicated [1]

SUMMARY

Problem

.01 An enterprise may acquire intangible assets from others or may develop them itself. Many kinds of intangible assets may be identified and given reasonably descriptive names, for example, patents, franchises, trademarks, and the like. Other types of intangible assets lack specific identifiability. Both identifiable and unidentifiable assets may be developed internally. Identifiable intangible assets may be acquired singly, as a part of a group of assets, or as part of an entire enterprise, but unidentifiable assets cannot be acquired singly. The excess of the cost of an acquired company over the sum of identifiable net assets, usually called goodwill, is the most common unidentifiable intangible asset.

.02 Accounting for an intangible asset involves the same kinds of problems as accounting for other long-lived assets, namely, determining an initial carrying amount, accounting for that amount after acquisition under normal business conditions (amortization), and accounting for that amount if the value declines substantially and permanently. Solving the problems is complicated by the characteristics of an intangible asset: its lack of physical qualities makes evidence of its existence elusive, its value is often difficult to estimate, and its useful life may be indeterminable.

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[1] See paragraphs .33-.35.

.03 The Director of Accounting Research of the American Institute of Certified Public Accountants has published Accounting Research Study No. 10, *Accounting for Goodwill,* by George R. Catlett and Norman O. Olson.[2] The study emphasizes accounting for goodwill acquired in a business combination but also discusses accounting for goodwill developed internally. The study cites the supporting authoritative pronouncements and their influences on accounting practices and evaluates the effects of practices on financial reporting.

Scope and Effect of Section

.04 The Board has considered the conclusions and recommendations of Accounting Research Study No. 10, the discussions of the appropriateness of accepted methods of accounting for intangible assets, and proposals for alternative accounting procedures. The Board expresses in this section its conclusions on accounting for intangible assets. Those research and development costs encompassed by FASB Statement of Financial Accounting Standards No. 2 are excluded from the scope of this section. [As amended, effective for fiscal years beginning on or after January 1, 1975, by FASB Statement No. 2.] (See section 4211.)

.05 This section covers the accounting for both identifiable and unidentifiable intangible assets that a company acquires, including those acquired in business combinations. "Company" in this section refers to both incorporated and unincorporated enterprises. The conclusions of the section apply to intangible assets recorded, if any, on the acquisition of some or all of the stock held by minority stockholders of a subsidiary company. This section also covers accounting for costs of developing goodwill and other unidentifiable intangible assets with indeterminate lives.

.06 The provisions of this section apply to costs of developing identifiable intangible assets that a company defers and records as assets. Some companies defer costs incurred to develop identifiable intangible assets while others record the costs as expenses as incurred. Certain

[2] Accounting research studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.

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costs, for example, preoperating costs, present problems which need to be studied separately. The question of deferral of those costs is beyond the scope of this section. [As amended, effective for fiscal years beginning on or after January 1, 1975, by FASB Statement No. 2.] (See section 4211.)

.07 This section applies to regulated companies in accordance with the provisions of section 6011, *Accounting Principles for Regulated Industries.*

.08 The conclusions of this section modify previous views of the Board and its predecessor, the Committee on Accounting Procedure.

Conclusions

.09 The Board concludes that a company should record as assets the costs of intangible assets acquired from others, including goodwill acquired in a business combination. A company should record as expenses the costs to develop intangible assets which are not specifically identifiable. The Board also concludes that the cost of each type of intangible asset should be amortized by systematic charges to income over the period estimated to be benefited. The period of amortization should not, however, exceed forty years.

BACKGROUND

Bases of Classification

.10 Various intangible assets differ in their characteristics, their useful lives, their relations to operations, and their later dispositions. Intangible assets may be classified on several different bases:

Identifiability—separately identifiable or lacking specific identification.

Manner of acquisition—acquired singly, in groups, or in business combinations or developed internally.

Expected period of benefit—limited by law or contract, related to human or economic factors, or indefinite or indeterminate duration.

Separability from an entire enterprise—rights transferable without title, salable, or inseparable from the enterprise or a substantial part of it.

Present Accounting

Accounting for Costs at Acquisition

.11 Present principles of accounting for intangible assets are generally similar to those for tangible, long-lived assets such as property, plant, and equipment. Intangible assets acquired from other entities are recorded at cost when acquired. Costs incurred to develop specifically identifiable intangible assets are often recorded as assets if the periods of expected future benefit are reasonably determinable. Costs of developing other intangible assets are usually recorded as expenses when incurred.

Accounting for Deferred Costs After Acquisition

.12 Intangible assets have been divided into two classes for purposes of accounting for their costs: (a) those with a

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determinable term of existence because it is limited by law, regulation, or agreement, or by the nature of the asset, and (b) those having no limited term of existence and no indication of limited life at the time of acquisition. The cost of a type (a) intangible asset is amortized by systematic charges to income over the term of existence or other period expected to be benefited. The cost of a type (b) intangible asset may be treated in either of two ways: (1) the cost may be retained until a limit on the term of existence or a loss of value is evident, at which time the cost is amortized systematically over the estimated remaining term of existence or, if worthless, written off as an extraordinary item in the income statement, or (2) the cost may be amortized at the discretion of management by charges to income even though no present evidence points to a limited term of existence or a loss of value.

.13 The cost of an intangible asset, including goodwill acquired in a business combination, may not be written off as a lump sum to capital surplus or to retained earnings nor be reduced to a nominal amount at or immediately after acquisition (section 2010, and Chapter 5, ARB No. 43).

Criticism of Present Practice

.14 Present accounting for goodwill and other unidentifiable intangible assets is often criticized because alternative methods of accounting for costs are acceptable. Some companies amortize the cost of acquired intangible assets over a short arbitrary period to reduce the amount of the asset as rapidly as practicable, while others retain the cost as an asset until evidence shows a loss of value and then record a material reduction in a single period. Selecting an arbitrary period of amortization is criticized because it may understate net income during the amortization period and overstate later net income. Retaining the cost as an asset is criticized because it may overstate net income before the loss of value is recognized and understate net income in the period of write-off.

Appraisal of Alternative Procedures

Cost of Intangible Assets

.15 The cost of intangible assets acquired either singly or in groups, including intangible assets acquired in a busi-

ness combination, from other businesses or individuals is determined by general principles of the historical-cost basis of accounting. The costs of developing goodwill and other intangible assets with indeterminate lives are ordinarily not distinguishable from the current costs of operations and are thus not assignable to specific assets.

Treatment of Costs

.16 Costs of intangible assets which have fixed or reasonably determinable terms of existence are now amortized by systematic charges to income over their terms of existence. Differences of opinion center on the amortization of acquired intangible assets with lives which cannot be estimated reliably either at the date of acquisition or perhaps long after, for example, goodwill and trade names.

.17 The literature on business combinations and goodwill, including Accounting Research Study No. 10, *Accounting for Goodwill,* contains at least four possible accounting treatments of goodwill and similar intangible assets:

a. Retain the cost as an asset indefinitely unless a reduction in its value becomes evident.

b. Retain the cost as an asset but permit amortization as an operating expense over an arbitrary period.

c. Retain the cost as an asset but require amortization as an operating expense over its estimated limited life or over an arbitrary but specified maximum and minimum period.

d. Deduct the cost from stockholders' equity at the date acquired.

.18 *Arguments for nonamortization.* The two of the four accounting proposals which do not involve amortization of goodwill as an operating expense are based in part on the contention that goodwill value is not consumed or used to produce earnings in the same manner as various property rights, and therefore net income should not be reduced by amortization of goodwill. Further, net income should not be reduced by both amortization of goodwill and current expenditures that are incurred to enhance or maintain the value of the acquired intangible assets. All

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methods of amortizing goodwill are criticized as arbitrary because the life of goodwill is indefinite and an estimated period of existence is not measurable.

.19 The basis for proposing that the cost of goodwill be retained as an asset until a loss in value becomes evident is that the cost incurred for acquired goodwill should be accounted for as an asset at the date acquired and in later periods. The cost should not be reduced as long as the value of the asset is at least equal to that cost.

.20 The basis for proposing that the cost of goodwill be deducted from stockholders' equity at the date acquired is that the nature of goodwill differs from other assets and warrants special accounting treatment. Since goodwill attaches only to a business as a whole and its value fluctuates widely for innumerable reasons, estimates of either the terms of existence or current value are unreliable for purposes of income determination.

Accounting on the Historical-Cost Basis

.21 All assets which are represented by deferred costs are essentially alike in historical-cost based accounting. They result from expenditures or owners' contributions and are expected to increase revenue or reduce costs to be incurred in future periods. If future benefit or the period to be benefited is questionable, the expenditure is usually treated as a current expense and not as a deferred cost. Associating deferred costs with the revenue or period to which they are expected to relate is a basic problem in historical-cost based accounting both in measuring periodic income and in accounting for assets. The basic accounting treatment does not depend on whether the asset is a building, a piece of equipment, an element of inventory, a prepaid insurance premium, or whether it is tangible or intangible. The cost of goodwill and similar intangible assets is therefore essentially the same as the cost of land, buildings, or equipment under historical-cost based accounting. Deducting the cost of an asset from stockholders' equity (either retained earnings or capital in excess of par or stated value) at the date incurred does not match costs with revenue.

.22 Accounting for the cost of a long-lived asset after acquisition normally depends on its estimated life. The cost of assets with perpetual existence, such as land, is carried forward as an asset without amortization, and the cost of assets with finite lives is amortized by systematic charges to income. Goodwill and similar intangible assets do not clearly fit either classification; their lives are neither infinite nor specifically limited, but are indeterminate. Thus, although the principles underlying present practice conform to the principles of accounting for similar types of assets, their applications have led to alternative treatments. Amortizing the cost of goodwill and similar intangible assets on arbitrary bases in the absence of evidence of limited lives or decreased values may recognize expenses and decreases of assets prematurely, but delaying amortization of the cost until a loss is evident may recognize the decreases after the fact.

A Practical Solution

.23 A solution to this dilemma is to set minimum and maximum amortization periods. This accounting follows from the observation that few, if any, intangible assets last forever, although some may seem to last almost indefinitely. Allocating the cost of goodwill or other intangible assets with an indeterminate life over time is necessary because the value almost inevitably becomes zero at some future date. Since the date at which the value becomes zero is indeterminate, the end of the useful life must necessarily be set arbitrarily at some point or within some range of time for accounting purposes.

OPINION

Acquisition of Intangible Assets

.24 The Board concludes that a company should record as assets the costs of intangible assets acquired from other enterprises or individuals. Costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred.

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.25 *Cost of intangible assets.* Intangible assets acquired singly should be recorded at cost at date of acquisition. Cost is measured by the amount of cash disbursed, the fair value of other assets distributed, the present value of amounts to be paid for liabilities incurred, or the fair value of consideration received for stock issued as described in section 1091.67.

.26 Intangible assets acquired as part of a group of assets or as part of an acquired company should also be recorded at cost at date of acquisition. Cost is measured differently for specifically identifiable intangible assets and those lacking specific identification. The cost of identifiable intangible assets is an assigned part of the total cost of the group of assets or enterprise acquired, normally based on the fair values of the individual assets. The cost of unidentifiable intangible assets is measured by the difference between the cost of the group of assets or enterprise acquired and the sum of the assigned costs of individual tangible and identifiable intangible assets acquired less liabilities assumed. Cost should be assigned to all specifically identifiable intangible assets; cost of identifiable assets should not be included in goodwill. Principles and procedures of determining cost of assets acquired, including intangible assets, are discussed in detail in section 1091.66-.89.

Amortization of Intangible Assets

.27 The Board believes that the value of intangible assets at any one date eventually disappears and that the recorded costs of intangible assets should be amortized by systematic charges to income over the periods estimated to be benefited. Factors which should be considered in estimating the useful lives of intangible assets include:

a. Legal, regulatory, or contractual provisions may limit the maximum useful life.

b. Provisions for renewal or extension may alter a specified limit on useful life.

c. Effects of obsolescence, demand, competition, and other economic factors may reduce a useful life.

d. A useful life may parallel the service life expectancies of individuals or groups of employees.

e. Expected actions of competitors and others may restrict present competitive advantages.

f. An apparently unlimited useful life may in fact be indefinite and benefits cannot be reasonably projected.

g. An intangible asset may be a composite of many individual factors with varying effective lives.

The period of amortization of intangible assets should be determined from the pertinent factors.

.28 The cost of each type of intangible asset should be amortized on the basis of the estimated life of that specific asset and should not be written off in the period of acquisition. Analysis of all factors should result in a reasonable estimate of the useful life of most intangible assets. A reasonable estimate of the useful life may often be based on upper and lower limits even though a fixed existence is not determinable.

.29 The period of amortization should not, however, exceed forty years. Analysis at the time of acquisition may indicate that the indeterminate lives of some intangible assets are likely to exceed forty years and the cost of those assets should be amortized over the maximum period of forty years, not an arbitrary shorter period.

.30 *Method of amortization.* The Board concludes that the straight-line method of amortization—equal annual amounts—should be applied unless a company demonstrates that another systematic method is more appropriate. The financial statements should disclose the method and period of amortization. Amortization of acquired goodwill and of other acquired intangible assets not deductible in computing income taxes payable does not create a timing difference, and allocation of income taxes is inappropriate.

.31 *Subsequent review of amortization.* A company should evaluate the periods of amortization continually to determine whether later events and circumstances warrant revised estimates of useful lives. If estimates are changed, the unamortized cost should be allocated to the increased or reduced number of remaining periods in the revised useful life but not to exceed forty years after acquisition. Estimation of value and future benefits of an intangible asset

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may indicate that the unamortized cost should be reduced significantly by a deduction in determining net income (section 2012.19-.24). However, a single loss year or even a few loss years together do not necessarily justify an extraordinary charge to income for all or a large part of the unamortized cost of intangible assets. The reason for an extraordinary deduction should be disclosed. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

Disposal of Goodwill

.32 Ordinarily goodwill and similar intangible assets cannot be disposed of apart from the enterprise as a whole. However, a large segment or separable group of assets of an acquired company or the entire acquired company may be sold or otherwise liquidated, and all or a portion of the unamortized cost of the goodwill recognized in the acquisition should be included in the cost of the assets sold.

EFFECTIVE DATE

.33 The provisions of this section shall be effective to account for intangible assets acquired after October 31, 1970. Intangible assets recognized in business combinations initiated before November 1, 1970 and consummated on or after that date under the terms prevailing on October 31, 1970 [3] may be accounted for in accordance with this section or Chapter 5 of ARB No. 43 and section 2010.

.34 The provisions of this section should not be applied retroactively to intangible assets acquired before November 1, 1970, whether in business combinations or otherwise.

.35 The Board encourages the application on a prospective basis to all intangible assets held on October 31, 1970 of the provisions in paragraphs .27 to .31 of this section which require amortization of all intangible assets. Unless the provisions of this section are applied prospectively, the accounting for intangible assets held on October 31, 1970 should be in accordance with Chapter 5 of ARB No. 43 as modified by section 2010.

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[3] Sections 1091.46a and 1091.47a define date initiated and describe the effect of changes in terms of a plan of combination.

AC Section 5300

LIABILITIES AND DEFERRED CREDITS

. . . accounting for debt

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AC Section 5361

Amortization of Debt Discount and Expense or Premium[1]

[Source: APB Opinion No. 12, Pars. 16 and 17.]

Effective for fiscal periods beginning after December 31, 1967, unless otherwise indicated

.01 Questions have been raised as to the appropriateness of the "interest" method of periodic amortization of discount and expense or premium on debt (i.e., the difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity) over its term. The objective of the interest method is to arrive at a periodic interest cost (including amortization) which will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period. The difference between the periodic interest cost so calculated and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization.

.02 In the Board's opinion, the interest method of amortization is theoretically sound and an acceptable method.

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[1] See section 4111, *Interest on Receivables and Payables.*

AC Section 5362

Early Extinguishment of Debt

[Source: APB Opinion No. 26, as amended.]

Effective for all extinguishments of debt occurring on or after January 1, 1973, unless otherwise indicated [1]

INTRODUCTION

.01 Debt is frequently extinguished in various ways before its scheduled maturity. Generally, the amount paid upon reacquisition of debt securities will differ from the net carrying amount of the debt at that time. This section expresses the views of the Accounting Principles Board regarding the appropriate accounting for that difference.

.02 *Applicability.* This section applies to the early extinguishment of all kinds of debt. (For early extinguishments of debt through troubled debt restructurings, FASB Statement No. 15 [section 5363], *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* applies.) It supersedes section 5151. However, this section does not apply to debt that is converted pursuant to the existing conversion privileges of the holder. Moreover, it does not alter the accounting for convertible debt securities described in section 5516. This section applies to regulated companies in accordance with the provisions of section 6011, *Accounting Principles for Regulated Industries,* 1962. [As amended, effective for troubled debt restructurings consummated after Dec. 31, 1977, by FASB Statement No. 15.] (See section 5363.)

.03 *Definitions.* Several terms are used in this section as follows:

a. *Early extinguishment* is the reacquisition of any form of debt security or instrument before its scheduled maturity except through conversion by the holder, regardless of whether the debt is viewed as terminated or is held as so-called "treasury bonds." All open-market or mandatory reacquisitions of debt securities to meet sinking fund requirements are early extinguishments.

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[1] See paragraph .22.

b. *Net carrying amount* of debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.

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

d. *Difference* as used in this section is the excess of the reacquisition price over the net carrying amount or the excess of the net carrying amount over the reacquisition price.

DISCUSSION

.04 *Current practice.* Early extinguishment of debt is usually achieved in one of three ways: use of existing liquid assets, use of proceeds from issuance of equity securities, and use of proceeds from issuing other debt securities. The replacement of debt with other debt is frequently called refunding.

.05 Differences on nonrefunding extinguishments are generally treated currently in income as losses or gains. Three basic methods are generally accepted to account for the differences on refunding transactions:

a. Amortization over the remaining original life of the extinguished issue

b. Amortization over the life of the new issue

c. Recognition currently in income as a loss or gain.

Each method has been supported in court decisions, in rulings of regulatory agencies, and in accounting literature.

.06 *Amortization over life of old issue.* Some accountants believe that the difference on refunding should be amortized over the remaining original life of the extinguished issue. In effect, the difference is regarded as an adjustment of the cash cost of borrowing that arises from obtaining another arrangement for the unexpired term of the old agreement. Therefore, the cost of money over the remaining period of the original issue is affected by the difference that results upon extinguishment of the original contract. Early extinguishment occurs for various reasons, but usually because it is financially advantageous to the

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issuer, for example, if the periodic cash interest outlay can be reduced for future periods. Accordingly, under this view the difference should be spread over the unexpired term of the original issue to obtain the proper periodic cost of borrowed money. If the maturity date of the new issue precedes the maturity date of the original issue, a portion of the difference is amortized over the life of the new debt and the balance of the difference is recognized currently in income as a loss or gain.

.07 *Amortization over life of new issue.* Some accountants believe that the difference on refunding should be amortized over the life of the new issue if refunding occurs because of lower current interest rates or anticipated higher interest rates in the future. Under this view, the principal motivation for refunding is to establish a more favorable interest rate over the term of the new issue. Therefore, the expected benefits to be obtained over the life of the new issue justify amortization of the difference over the life of the new issue.

.08 *Recognition currently in income.* Some accountants believe a difference on refunding is similar to the difference on other early extinguishments and should be recognized currently in income in the period of the extinguishment. This view holds that the value of the old debt has changed over time and that paying the call price or current market value is the most favorable way to extinguish the debt. The change in the market value of the debt is caused by a change in the market rate of interest, but the change has not been reflected in the accounts. Therefore, the entire difference is recorded when the specific contract is terminated because it relates to the past periods when the contract was in effect. If the accountant had foreseen future events perfectly at the time of issuance, he would have based the accounting on the assumption that the maturity value of the debt would equal the reacquisition price. Thus, no difference upon early extinguishment would occur because previous periods would have borne the proper interest expense. Furthermore, a call premium necessary to eliminate an old contract and an unamortized discount or premium relate to the old contract and cannot be a source of benefits from a new debt issue. For example, a larger (or smaller) coupon rate could have been set on the old issue to avoid an

unamortized discount (or premium) at issuance. When such debt originally issued at par is refunded, few accountants maintain that some portion of past interest should be capitalized and written off over the remaining life of the old debt or over the life of the new debt.

.09 Another argument in favor of current recognition of the difference as gain or loss is also related to market forces but is expressed differently. If debt is callable, the call privilege is frequently exercised when the market value of the bonds as determined by the current yield rate exceeds the call price. A loss or gain is recognized on extinguishing the debt because an exchange transaction occurs in which the call or current market value of the debt differs from its net carrying amount. For example, the market value of the debt ordinarily rises as the market rate of interest falls. If market values were recorded as the market rate of interest fluctuates, the changes in the market value of the debt would have been recorded periodically as losses or gains. The bond liability would not exceed the call price.

.10 On the other hand, some accountants holding views opposing current recognition of the difference in income believe that recognizing the difference as gains or losses may induce a company to report income by borrowing money at high rates of interest in order to pay off discounted low-rate debt. Conversely, a large potential charge to income may discourage refunding even though it is economically desirable; the replacement of high cost debt with low cost debt may result in having to recognize a large loss. Thus, a company may show higher current income in the year of extinguishment while increasing its economic cost of debt and lower current income while decreasing its economic cost of debt. For these reasons, these accountants favor deferral.

.11 *Extinguishment of convertible debt.* Accountants have expressed differing views regarding accounting for the extinguishment of convertible debt. In section 5516, which is directed in part to accounting for convertible debt at time of issue, the Board concluded that no portion of the proceeds from the issuance of the types of convertible debt securities defined in section 5516 should be accounted for as attributable to the conversion feature. In reaching that conclusion, the Board placed greater weight on the inseparability of the

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debt and conversion option and less weight on practical difficulties. The Board emphasized that a convertible debt security is a complex hybrid instrument bearing an option the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore, the two choices are mutually exclusive; the holder cannot exercise the option to convert unless he foregoes the right to redemption, and vice versa. Therefore, section 5516 implies that (except for conversion) a difference on extinguishing convertible debt needs to be recognized in the same way as a difference on extinguishment of debt without conversion features.

.12 The various views expressed on how to account for the extinguishment of convertible debt to some extent reflect the same attitudes as to the nature of the debt at time of issue as were considered in section 5516. Thus, some accountants believe that a portion of the proceeds at issuance is attributable to the conversion feature. If the convertible debt is later extinguished, the initial value of the conversion feature should then be recorded as an increase in stockholders' equity. The balance of the difference would, under that view of the transaction, be a gain or loss in income of the period of extinguishment.

.13 Some accountants maintain that the intent of issuing convertible debt is to raise equity capital. A convertible debt is therefore in substance an equity security, and all the difference on extinguishing convertible debt should be an increase or decrease of paid-in capital.

.14 Another view is that the market price that gives rise to the difference reflects both the level of interest rates on debt and the prices of the related common stock or both. Those expressing this view believe that if the effects of these factors can be identified at the time of extinguishment, the difference attributable to the interest rate should be accounted for as gain or loss in income, and that the difference attributable to the market price of the issuer's common stock should be accounted for as an increase or decrease in paid-in capital.

.15 Some accountants believe that the accounting for a difference on extinguishment of convertible debt depends on the nature of the security at the time of extinguishment.

Events after time of issue may provide evidence that a convertible debt is either still debt in substance or equity in substance. Under this view the purchase price on extinguishment provides the best evidence as to whether the security is essentially debt or equity. Convertible debt that is selling below the call or redemption price at time of extinguishment is essentially debt; the difference should be a gain in current income. Moreover, if convertible debt has a coupon rate that exceeds the current market rate of interest and clearly causes the issue to trade at a premium as a debt instrument, the difference on extinguishment should be a loss in current income. On the other hand, if convertible debt is selling above the call or redemption price because of the conversion privilege, it is essentially a common stock. In effect, market forces have transformed a debt instrument into an equity security, and the extinguishment provides an explicit transaction to justify recognizing that the convertible debt is in substance a common stock equivalent. Those who hold this view believe that accounting should report the substance of the transaction rather than its form; convertible debt need not be converted into common stock to demonstrate that the extinguishment transaction is equivalent to a purchase of common stock for retirement.

.16 *Economic nature of extinguishment.* In many respects the essential economics of the decision leading to the early extinguishment of outstanding debt are the same, regardless of whether such debt is extinguished via the use of the existing liquid assets, new equity securities, or new debt. That is, the decision favoring early extinguishment usually implies that the net present value of future cash inflows and outflows is maximized by extinguishing the debt now rather than by letting it run to maturity. The savings may be in lower cash interest costs on a new debt issue, in increased earnings per share of common stock if the assets are not earning the interest rate on the outstanding debt, or in some other form. The essential event is early extinguishment. Under this view, the difference is associated with extinguishing the existing debt and is accounted for the same regardless of how extinguishment is accomplished.

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.17 To illustrate that view, assume that three firms each have long-term debt outstanding with ten years remaining to maturity. The first firm may have excess cash and no investment opportunities that earn a rate of return higher than the cash savings that would ensue from immediately extinguishing the debt. The second firm may wish to replace the debt with a similar issue bearing a lower coupon rate. The third firm may have excessive debt and may want to replace the debt with a new issue of common stock. The underlying reason for the early extinguishment in all three cases is to obtain a perceived economic advantage. The relevant comparison in the replacement of debt with other debt is with the costs of other debt. The comparison in other cases is with other means of financing. The means by which the debt is extinguished have no bearing on how to account for the loss or gain.

OPINION

.18 The following conclusions of the Board are based primarily on the reasoning in paragraphs .08, .09, .11, .16, and .17.

.19 *Reduction of alternatives.* The Board concludes that all extinguishments of debt before scheduled maturities are fundamentally alike. The accounting for such transactions should be the same regardless of the means used to achieve the extinguishment.

.20 *Disposition of amounts.* A difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item.[2] The criteria in section 2013 and in section 2012 as amended by section 2013 should be used to determine whether the losses or gains are ordinary or extraordinary items. Gains and losses should not be amortized to future periods. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.) [As amended, effective for extinguishments occurring after

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[2] If upon extinguishment of debt, the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges should be given appropriate accounting recognition. Moreover, extinguishment transactions between related entities may be in essence capital transactions.

March 31, 1975 by FASB Statement No. 4.] (See section 2013.)

.21 *Convertible debt.* The extinguishment of convertible debt before maturity does not change the character of the security as between debt and equity at that time. Therefore, a difference between the cash acquisition price of the debt and its net carrying amount should be recognized currently in income in the period of extinguishment as losses or gains.

EFFECTIVE DATE

.22 This section shall be effective for all extinguishments of debt occurring on or after January 1, 1973. Extinguishment transactions are considered to be terminated events similar to that set forth in section 1051.16 and as such, extinguishments that were previously recorded in fiscal years ending before January 1, 1973 should not be adjusted. However, the accounting for refunding transactions that have been previously reported in the fiscal year in which December 31, 1972 occurs may be retroactively restated to comply with the provisions of this section.

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AC Section 5363

Accounting by Debtors and Creditors for Troubled Debt Restructurings

[Source: FASB Statement No. 15.]

June 1977

INTRODUCTION

.001 This Statement establishes standards of financial accounting and reporting by the debtor and by the creditor for a troubled debt restructuring. The Statement does not cover accounting for allowances for estimated uncollectible amounts and does not prescribe or proscribe particular methods for estimating amounts of uncollectible receivables.

.002 A restructuring of a debt constitutes a *troubled debt restructuring* for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.[1]

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

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

.004 In this Statement, a *receivable* or *payable* (collectively referred to as *debt*) represents a contractual right to receive money or a contractual obligation to pay money on demand or on fixed or determinable dates that is already included as an asset or liability in the creditor's or debtor's balance sheet at the time of the restructuring. Receivables or payables that may be involved in troubled debt restructurings commonly result from lending or borrowing of cash, investing in debt securities that were previously issued, or selling or purchasing goods or services on credit. Examples are accounts receivable or payable, notes, debentures and bonds (whether those receivables or payables are secured or unsecured and whether they are convertible or nonconvertible), and related accrued interest, if any. Typically, each receivable or payable is negotiated separately, but sometimes two or more receivables or payables are negotiated together. For example, a debtor may negotiate with a group of creditors but sign separate debt instruments with each creditor. For purposes of this Statement, restructuring of each receivable or payable, including those negotiated and restructured jointly, shall be accounted for individually. The substance rather than the form of the receivable or payable shall govern. For example, to a debtor, a bond constitutes one payable even though there are many bondholders.

.005 A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

a. Transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession).

b. Issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest.

c. Modification of terms of a debt, such as one or a combination of:
   1. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt.

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2. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.
3. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement.
4. Reduction (absolute or contingent) of accrued interest.

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

.007 A debt restructuring is not necessarily a troubled debt restructuring for purposes of this Statement even if the debtor is experiencing some financial difficulties. For example, a troubled debt restructuring is not involved if (a) the fair value[2] of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable;[3] (b) the fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable; (c) the creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate; or (d) the debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors. In general, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. A debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor in the troubled debt restructuring, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them. Thus, in an attempt to protect as much of its investment as possible, the

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[2] Defined in paragraph .013.

[3] Defined in footnote 17.

creditor in a troubled debt restructuring grants a concession to the debtor that it would not otherwise consider.

.008 For purposes of this Statement, troubled debt restructurings do not include changes in lease agreements (the accounting is prescribed by *FASB Statement No. 13* [section 4053], "Accounting for Leases") or employment-related agreements (for example, pension plans and deferred compensation contracts). Nor do troubled debt restructurings include debtors' failures to pay trade accounts according to their terms or creditors' delays in taking legal action to collect overdue amounts of interest and principal, unless they involve an agreement between debtor and creditor to restructure.

.009 The Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit'," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process" and discusses the application of generally accepted accounting principles to regulated industries. FASB Statements and Interpretations should therefore be applied to regulated companies that are subject to the rate-making process in accordance with the provisions of the Addendum.

.010 This Statement supersedes *FASB Interpretation No. 2,* "Imputing Interest on Debt Arrangements Made under the Federal Bankruptcy Act," and shall be applied to the types of situations that were covered by that Interpretation. Thus, it shall be applied to troubled debt restructurings consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other Federal statutes related thereto.[4] It also amends *APB Opinion No. 26* [section 5362], "Early Extinguishment of Debt," to the extent needed to exclude from that Opinion's scope early extinguishments of debt through troubled debt restructurings.

.011 Appendix A provides background information. Appendix B sets forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others.

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[4] This Statement does not apply, however, if under provisions of those Federal statutes or in a quasi-reorganization or corporate readjustment (*ARB No. 43,* Chapter 7, Section A [section 5581], "Quasi-Reorganization or Corporate Readjustment . . .") with which a troubled debt restructuring coincides, the debtor restates its liabilities generally.

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STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting by Debtors

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

Transfer of Assets in Full Settlement

.013 A debtor that transfers its receivables from third parties, real estate, or other assets to a creditor to settle fully a payable shall recognize a gain on restructuring of payables (see paragraph .021). The gain shall be measured by the excess of (i) the carrying amount of the payable settled (the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs) over (ii) the fair value of the assets transferred to the creditor.[5] The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[6]

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[5] Paragraphs .013, .015 and .019 indicate that the fair value of assets transferred or the fair value of an equity interest granted shall be used in accounting for a settlement of a payable in a troubled debt restructuring. That guidance is not intended to preclude using the fair value of the payable settled if more clearly evident than the fair value of the assets transferred or of the equity interest granted in a full settlement of a payable (paragraphs .013 and .015). (See paragraph 67 of *APB Opinion No. 16* [section 1091.67], "Business Combinations.") However, in a partial settlement of a payable (paragraph .019), the fair value of the assets transferred or of the equity interest granted shall be used in all cases to avoid the need to allocate the fair value of the payable between the part settled and the part still outstanding.

[6] Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of *APB Opinion No. 16* [section 1091.88-.89], paragraphs 12-14 of *APB Opinion No. 21* [section 4111.11-.13], "Interest on Receivables and Payables," and paragraph 25 of *APB Opinion No. 29* [section 1041.25], "Accounting for Nonmonetary Transactions."

.014 A difference between the fair value and the carrying amount of assets transferred to a creditor to settle a payable is a gain or loss on transfer of assets.[7] The debtor shall include that gain or loss in measuring net income for the period of transfer, reported as provided in *APB Opinion No. 30* [section 2012], "Reporting the Results of Operations."

Grant of Equity Interest in Full Settlement

.015 A debtor that issues or otherwise grants an equity interest to a creditor to settle fully a payable shall account for the equity interest at its fair value.[8] The difference between the fair value of the equity interest granted and the carrying amount of the payable settled shall be recognized as a gain on restructuring of payables (see paragraph .021).

Modification of Terms

.016 A debtor in a troubled debt restructuring involving only modification of terms of a payable—that is, not involving a transfer of assets or grant of an equity interest—shall account for the effects of the restructuring prospectively from the time of restructuring, and shall not change the carrying amount of the payable at the time of the restructuring unless the carrying amount exceeds the total future cash payments specified by the new terms.[9] That is, the effects of changes in the amounts or timing (or both) of future cash payments designated as either interest or face amount shall be reflected in future periods.[10] Interest expense shall be computed in a way that a constant effective interest rate is ap-

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

[8] See footnote 5.

[9] In this Statement, *total future cash payments* includes related accrued interest, if any, at the time of the restructuring that continues to be payable under the new terms.

[10] All or a portion of the carrying amount of the payable at the time of the restructuring may need to be reclassified in the balance sheet because of changes in the terms, for example, a change in the amount of the payable due within one year after the date of the debtor's balance sheet. A troubled debt restructuring of a short-term obligation after the date of a debtor's balance sheet but before that balance sheet is issued may affect the classification of that obligation in accordance with *FASB Statement No. 6* [section 2033], "Classification of Short-Term Obligations Expected to Be Refinanced."

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plied to the carrying amount of the payable at the beginning of each period between restructuring and maturity (in substance the "interest" method prescribed by paragraph 15 of *APB Opinion No. 21* [section 4111.14]). The new effective interest rate shall be the discount rate that equates the present value of the future cash payments specified by the new terms (excluding amounts contingently payable) with the carrying amount of the payable.

.017 If, however, the total future cash payments specified by the new terms of a payable, including both payments designated as interest and those designated as face amount, are less than the carrying amount of the payable, the debtor shall reduce the carrying amount to an amount equal to the total future cash payments specified by the new terms and shall recognize a gain on restructuring of payables equal to the amount of the reduction (see paragraph .021).[11] Thereafter, all cash payments under the terms of the payable shall be accounted for as reductions of the carrying amount of the payable, and no interest expense shall be recognized on the payable for any period between the restructuring and maturity of the payable.[12]

.018 A debtor shall not recognize a gain on a restructured payable involving indeterminate future cash payments as long as the maximum total future cash payments may exceed the carrying amount of the payable. Amounts designated either as interest or as face amount by the new terms may be payable contingent on a specified event or circumstance (for example, the debtor may be required to pay specified amounts if its financial condition improves to a specified degree within a specified period). To determine whether the debtor shall recognize a gain according to the provisions of paragraphs .016 and .017, those contingent amounts shall be included in the "total future cash payments specified by the new terms" to the extent necessary to prevent recognizing a gain at the time of restructuring that may be offset by future interest expense. Thus, the debtor shall apply paragraph 17 of *FASB Statement No. 5* [section 4311.17], "Accounting for Contingencies," in which probability of occurrence of a gain con-

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

[12] The only exception is to recognize interest expense according to paragraph .022.

tingency is not a factor, and shall assume that contingent future payments will have to be paid. The same principle applies to amounts of future cash payments that must sometimes be estimated to apply the provisions of paragraphs .016 and .017. For example, if the number of future interest payments is flexible because the face amount and accrued interest is payable on demand or becomes payable on demand, estimates of total future cash payments shall be based on the maximum number of periods possible under the restructured terms.

Combination of Types

.019 A troubled debt restructuring may involve partial settlement of a payable by the debtor's transferring assets or granting an equity interest (or both) to the creditor and modification of terms of the remaining payable.[13] A debtor shall account for a troubled debt restructuring involving a partial settlement and a modification of terms as prescribed in paragraphs .016-.018 except that, first, assets transferred or an equity interest granted in that partial settlement shall be measured as prescribed in paragraphs .013 and .015, respectively, and the carrying amount of the payable shall be reduced by the total fair value of those assets or equity interest.[14] A difference between the fair value and the carrying amount of assets transferred to the creditor shall be recognized as a gain or loss on transfer of assets. No gain on restructuring of payables shall be recognized unless the remaining carrying amount of the payable exceeds the total future cash payments (including amounts contingently payable) specified by the terms of the debt remaining unsettled after the restructuring. Future interest expense, if any, shall be determined according to the provisions of paragraphs .016-.018.

Related Matters

.020 A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor or other transfer of assets to the creditor shall be accounted for according to the provisions of paragraphs .013, .014, and .019.

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[13] Even if the stated terms of the remaining payable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the transfer of assets or grant of an equity interest, the restructuring shall be accounted for as prescribed by paragraph .019.

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

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.021 Gains on restructuring of payables determined by applying the provisions of paragraphs .013-.020 of this Statement shall be aggregated, included in measuring net income for the period of restructuring, and, if material, classified as an extraordinary item, net of related income tax effect, in accordance with paragraph 8 of *FASB Statement No. 4* [section 2013.08], "Reporting Gains and Losses from Extinguishment of Debt."

.022 If a troubled debt restructuring involves amounts contingently payable, those contingent amounts shall be recognized as a payable and as interest expense in future periods in accordance with paragraph 8 of *FASB Statement No. 5* [section 4311.08]. Thus, in general, interest expense for contingent payments shall be recognized in each period in which (a) it is probable that a liability has been incurred and (b) the amount of that liability can be reasonably estimated. Before recognizing a payable and interest expense for amounts contingently payable, however, accrual or payment of those amounts shall be deducted from the carrying amount of the restructured payable to the extent that contingent payments included in "total future cash payments specified by the new terms" prevented recognition of a gain at the time of restructuring (paragraph .018).

.023 If amounts of future cash payments must be estimated to apply the provisions of paragraphs .016-.018 because future interest payments are expected to fluctuate—for example, the restructured terms may specify the stated interest rate to be the prime interest rate increased by a specified amount or proportion—estimates of maximum total future payments shall be based on the interest rate in effect at the time of the restructuring. Fluctuations in the effective interest rate after the restructuring from changes in the prime rate or other causes shall be accounted for as changes in estimates in the periods the changes occur. However, the accounting for those fluctuations shall not result in recognizing a gain on restructuring that may be offset by future cash payments (paragraphs .018 and .022). Rather, the carrying amount of the restructured payable shall remain unchanged, and future cash payments shall reduce the carrying amount until the time that any gain recognized cannot be offset by future cash payments.

.024 Legal fees and other direct costs that a debtor incurs in granting an equity interest to a creditor in a troubled debt restructuring shall reduce the amount otherwise recorded for that equity interest according to paragraphs .015 and .019. All other direct costs that a debtor incurs to effect a troubled debt restructuring shall be deducted in measuring gain on restructuring of payables or shall

be included in expense for the period if no gain on restructuring is recognized.

Disclosure by Debtors

.025 A debtor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about troubled debt restructurings that have occurred during a period for which financial statements are presented:

a. For each restructuring:[15] a description of the principal changes in terms, the major features of settlement, or both.

b. Aggregate gain on restructuring of payables and the related income tax effect (paragraph .021).

c. Aggregate net gain or loss on transfers of assets recognized during the period (paragraphs .014 and .019).

d. Per share amount of the aggregate gain on restructuring of payables, net of related income tax effect.

.026 A debtor shall disclose in financial statements for periods after a troubled debt restructuring the extent to which amounts contingently payable are included in the carrying amount of restructured payables pursuant to the provisions of paragraph .018. If required by paragraphs 9–13 of *FASB Statement No. 5* [section 4311.09-.13], a debtor shall also disclose in those financial statements total amounts that are contingently payable on restructured payables and the conditions under which those amounts would become payable or would be forgiven.

Accounting by Creditors

.027 A creditor shall account for a troubled debt restructuring according to the type of the restructuring as prescribed in the following paragraphs. Paragraphs .028-.042 do not apply to a receivable that the creditor is accounting for at market value in accordance with specialized industry practice (for example, a marketable debt security accounted for at market value by a mutual fund). Estimated cash expected to be received less estimated costs expected to be incurred is not market value in accordance with specialized industry practice as that term is used in this paragraph.

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

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Receipt of Assets in Full Satisfaction

.028 A creditor that receives from a debtor in full satisfaction of a receivable either (i) receivables from third parties, real estate, or other assets or (ii) shares of stock or other evidence of an equity interest in the debtor, or both, shall account for those assets (including an equity interest) at their fair value at the time of the restructuring (see paragraph .013 for how to measure fair value).[16] The excess of (i) the recorded investment in the receivable[17] satisfied over (ii) the fair value of assets received is a loss to be recognized according to paragraph .035.

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

Modification of Terms

.030 A creditor in a troubled debt restructuring involving only modification of terms of a receivable—that is, not involving receipt of assets (including an equity interest in the debtor)—shall account for the effects of the restructuring prospectively and shall not change the recorded investment in the receivable at the time of the restructuring unless that amount exceeds the total future cash receipts specified by the new terms.[18] That is, the

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[16] Paragraphs .028 and .033 indicate that the fair value of assets received shall be used in accounting for satisfaction of a receivable in a troubled debt restructuring. That guidance is not intended to preclude using the fair value of the receivable satisfied if more clearly evident than the fair value of the assets received in full satisfaction of a receivable (paragraph .028). (See paragraph 67 of *APB Opinion No. 16* [section 1091.67].) However, in a partial satisfaction of a receivable (paragraph .033), the fair value of the assets received shall be used in all cases to avoid the need to allocate the fair value of the receivable between the part satisfied and the part still outstanding.

[17] *Recorded investment in the receivable* is used in paragraphs .028-.041 instead of *carrying amount of the receivable* because the latter is net of an allowance for estimated uncollectible amounts or other "valuation" account, if any, while the former is not. The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous direct write-down of the investment.

[18] In this Statement, total future cash receipts includes related accrued interest, if any, at the time of the restructuring that continues to be receivable under the new terms. Uncertainty of collection of noncontingent amounts specified by the new terms (see paragraph .032 for inclusion of contingent amounts) is not a factor in applying paragraphs .030-.032 but should, of course, be considered in accounting for allowances for uncollectible amounts.

effects of changes in the amounts or timing (or both) of future cash receipts designated either as interest or as face amount shall be reflected in future periods.[19] Interest income shall be computed in a way that a constant effective interest rate is applied to the recorded investment in the receivable at the beginning of each period between restructuring and maturity (in substance the "interest" method prescribed by paragraph 15 of *APB Opinion No. 21* [section 4111.14]).[20] The new effective interest rate shall be the discount rate that equates the present value of the future cash receipts specified by the new terms (excluding amounts contingently receivable) with the recorded investment in the receivable.

.031 If, however, the total future cash receipts specified by the new terms of the receivable, including both receipts designated as interest and those designated as face amount, are less than the recorded investment in the receivable before restructuring, the creditor shall reduce the recorded investment in the receivable to an amount equal to the total future cash receipts specified by the new terms. The amount of the reduction is a loss to be recognized according to paragraph .035. Thereafter, all cash receipts by the creditor under the terms of the restructured receivable, whether designated as interest or as face amount, shall be accounted for as recovery of the recorded investment in the receivable, and no interest income shall be recognized on the receivable for any period between the restructuring and maturity of the receivable.[21]

.032 A creditor shall recognize a loss on a restructured receivable involving indeterminate future cash receipts unless the minimum future cash receipts specified by the new terms at least equals the recorded investment in the receivable. Amounts designated either as interest or as face amount that are receivable from the debtor may be contingent on a specified event or circumstance (for example, specified amounts may be receivable from the debtor if the debtor's financial condition improves to a specified degree within a specified period). To determine whether the creditor shall

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[19] All or a portion of the recorded investment in the receivable at the time of restructuring may need to be reclassified in the balance sheet because of changes in the terms.

[20] Some creditors—for example, finance companies (*AICPA Industry Audit Guide,* "Audits of Finance Companies," Chapter 2)—use methods that recognize less revenue in early periods of a receivable than does the "interest" method. The accounting for restructured receivables described in this Statement is not intended to change creditors' methods of recognizing revenue to require a different method for restructured receivables from that for other receivables.

[21] The only exception is to recognize interest income according to paragraph .036.

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recognize a loss according to the provisions of paragraphs .030 and .031, those contingent amounts shall be included in the "total future cash receipts specified by the new terms" only if at the time of restructuring those amounts meet the conditions that would be applied under the provisions of paragraph 8 of *FASB Statement No. 5* [section 4311.08] in accruing a loss. That is, a creditor shall recognize a loss unless contingent future cash receipts needed to make total future cash receipts specified by the new terms at least equal to the recorded investment in the receivable both are probable and can be reasonably estimated. The same principle applies to amounts of future cash receipts that must sometimes be estimated to apply the provisions of paragraphs .030 and .031. For example, if the number of interest receipts is flexible because the face amount and accrued interest is collectible on demand or becomes collectible on demand after a specified period, estimates of total future cash receipts should be based on the minimum number of periods possible under the restructured terms.

Combination of Types

.033 A troubled debt restructuring may involve receipt of assets (including an equity interest in the debtor) in partial satisfaction of a receivable and a modification of terms of the remaining receivable.[22] A creditor shall account for a troubled debt restructuring involving a partial satisfaction and modification of terms as prescribed in paragraphs .030-.032 except that, first, the assets received shall be accounted for at their fair values as prescribed in paragraph .028 and the recorded investment in the receivable shall be reduced by the fair value of the assets received.[23] No loss on the restructuring shall be recognized unless the remaining recorded investment in the receivable exceeds the total future cash receipts specified by the terms of the receivable remaining unsatisfied after the restructuring. Future interest income, if any, shall be determined according to the provisions of paragraphs .030-.032.

Related Matters

.034 A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, or in which the creditor

[22] Even if the stated terms of the remaining receivable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the receipt of assets (including an equity interest in the debtor), the restructuring shall be accounted for as prescribed by paragraph .033.

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

otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs .028 and .033 and, if appropriate, .039.

.035 Losses determined by applying the provisions of paragraphs .028-.034 of this Statement shall, to the extent that they are not offset against allowances for uncollectible amounts or other valuation accounts, be included in measuring net income for the period of restructuring and reported according to *APB Opinion No. 30* [section 2012]. Although this Statement does not address questions concerning estimating uncollectible amounts or accounting for the related valuation allowance (paragraph .001), it recognizes that creditors use allowances for uncollectible amounts. Thus, a loss from reducing the recorded investment in a receivable may have been recognized before the restructuring by deducting an estimate of uncollectible amounts in measuring net income and increasing an appropriate valuation allowance. If so, a reduction in the recorded investment in the receivable in a troubled debt restructuring is a deduction from the valuation allowance rather than a loss in measuring net income for the period of restructuring. A valuation allowance can also be used to recognize a loss determined by applying paragraphs .028-.034 that has not been previously recognized in measuring net income. For example, a creditor with an allowance for uncollectible amounts pertaining to a group of receivables that includes the restructured receivable may deduct from the allowance the reduction of recorded investment in the restructured receivable and recognize the loss in measuring net income for the period of restructuring by estimating the appropriate allowance for remaining receivables, including the restructured receivable.

.036 If a troubled debt restructuring involves amounts contingently receivable, those contingent amounts shall not be recognized as interest income in future periods before they become receivable—that is, they shall not be recognized as interest income before both the contingency has been removed and the interest has been earned.[24] Before recognizing those amounts as interest income, however, they shall be deducted from the recorded investment in the restructured receivable to the extent that contingent receipts included in "total future cash receipts specified by the new terms" avoided recognition of a loss at the time of restructuring (paragraph .032).

[24] *FASB Statement No. 5,* paragraph 17 [section 4311.17], (which continued without reconsideration certain provisions of *ARB No. 50,* "Contingencies"), states, in part: "Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization."

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.037 If amounts of future cash receipts must be estimated to apply the provisions of paragraphs .030-.032 because future interest receipts are expected to fluctuate—for example, the restructured terms may specify the stated interest rate to be the prime interest rate increased by a specified amount or proportion—estimates of the minimum total future receipts shall be based on the interest rate in effect at the time of restructuring. Fluctuations in the effective interest rate after the restructuring from changes in the prime rate or other causes shall be accounted for as changes in estimates in the periods the changes occur except that a creditor shall recognize a loss and reduce the recorded investment in a restructured receivable if the interest rate decreases to an extent that the minimum total future cash receipts determined using that interest rate fall below the recorded investment in the receivable at that time.

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

.039 A receivable from the sale of assets previously obtained in a troubled debt restructuring shall be accounted for according to *APB Opinion No. 21* [section 4111] regardless of whether the assets were obtained in satisfaction (full or partial) of a receivable to which that Opinion was not intended to apply. A difference, if any, between the amount of the new receivable and the carrying amount of the assets sold is a gain or loss on sale of assets.

Disclosure by Creditors

.040 A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about troubled debt restructurings as of the date of each balance sheet presented:

a. For outstanding receivables whose terms have been modified in troubled debt restructurings, by major category:[25] (i) the aggregate recorded investment; (ii) the gross interest income that would have been recorded in the period then ended if

[25] The appropriate major categories depend on various factors, including the industry or industries in which the creditor is involved. For example, for a commercial banking enterprise, at a minimum, the appropriate categories are investments in debt securities and loans. Information need not be disclosed, however, for non-interest-bearing trade receivables; loans to individuals for household, family, and other personal expenditures; and real estate loans secured by one-to-four family residential properties.

those receivables had been current in accordance with their original terms and had been outstanding throughout the period or since origination, if held for part of the period; and (iii) the amount of interest income on those receivables that was included in net income for the period. A receivable whose terms have been modified need not be included in that disclosure if, subsequent to restructuring, its effective interest rate (paragraph .030) has been equal to or greater than the rate that the creditor was willing to accept for a new receivable with comparable risk.

b. The amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructurings.

.041 A financial institution, or other creditor, may appropriately disclose the information prescribed by paragraph .040, by major category, for the aggregate of outstanding reduced-earning and nonearning receivables rather than separately for outstanding receivables whose terms have been modified in troubled debt restructurings.

Substitution or Addition of Debtors

.042 A troubled debt restructuring may involve substituting debt of another business enterprise, individual, or government unit[26] for that of the troubled debtor or adding another debtor (for example, as a joint debtor). That kind of restructuring should be accounted for according to its substance. For example, a restructuring in which, after the restructuring, the substitute or additional debtor controls, is controlled by, or is under common control[27] with the original debtor is an example of one that shall be accounted for by the creditor according to the provisions of paragraphs .030-.032. Those paragraphs shall also apply to a restructuring in which the substitute or additional debtor and original debtor are related after the restructuring by an agency, trust, or other

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[26] Government units include, but are not limited to, states, counties, townships, municipalities, school districts, authorities, and commissions. See page 4 of *AICPA Industry Audit Guide,* "Audits of State and Local Governmental Units."

[27] "Control" in this paragraph has the meaning described in paragraph 3(c) of *APB Opinion No. 18* [section 5131.03(c)], "The Equity Method of Accounting for Investments in Common Stock": "The usual condition for control is ownership of a majority (over 50%) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders or by court decree."

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relationship that in substance earmarks certain of the original debtor's funds or funds flows for the creditor although payments to the creditor may be made by the substitute or additional debtor. In contrast, a restructuring in which the substitute or additional debtor and the original debtor do not have any of the relationships described above after the restructuring shall be accounted for by the creditor according to the provisions of paragraphs .028 and .033.

Effective Date and Transition

.043 The preceding paragraphs of this Statement, other than paragraphs .039-.041, shall be effective for troubled debt restructurings consummated after December 31, 1977.[28] Earlier application is encouraged for those consummated on or before December 31, 1977 but during fiscal years for which annual financial statements have not previously been issued. The paragraphs shall not be applied to those consummated during fiscal years for which annual financial statements have previously been issued.

.044 Paragraph .039 shall be effective for receivables resulting from sales of assets after December 31, 1977 regardless of whether the provisions of this Statement were applied to the related troubled debt restructuring. Earlier application is encouraged for receivables from sales of assets on or before December 31, 1977 but during fiscal years for which annual financial statements have not previously been issued. It shall not be applied to those from sales of assets during fiscal years for which annual financial statements have previously been issued.

.045 The information prescribed by paragraphs .040 and .041 shall be disclosed in financial statements for fiscal years ending after December 15, 1977. Earlier application is encouraged in financial statements for fiscal years ending before December 16, 1977. For the purpose of applying paragraph .040, "receivables whose terms have been modified in troubled debt restructurings" shall encompass not only (a) receivables whose terms have been modified in troubled debt restructurings to which the other provisions of this Statement have been applied in accordance with paragraph .043 but also (b) those whose terms have been modified in earlier restructurings that constitute troubled debt restructurings (para-

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[28] For an enterprise having a fiscal year of 52 or 53 weeks ending in the last seven days in December or the first seven days in January, references to December 31, 1977 in paragraphs .043 and .044 shall mean the date in December 1977 or January 1978 on which the fiscal year ends.

graphs .002-.008) but have been excluded from its other provisions because of the timing of the restructurings.

The provisions of this Statement need not be applied to immaterial items.

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Appendix A

BACKGROUND INFORMATION

.046 There has been a substantial increase in recent years in the number of debtors that are unable to meet their obligations on outstanding debt because of financial difficulties. Sometimes the debtor and the creditor have restructured the debt to enable the debtor to avoid bankruptcy proceedings or other consequences of default, and the number of troubled debt restructurings receiving publicity has also increased. Although many of the most publicized troubled debt restructurings have involved debtors that are real estate companies or real estate investment trusts, debtors in other industries have also been involved in troubled debt restructurings.

.047 *APB Opinion No. 26* [section 5362], "Early Extinguishment of Debt," established the accounting by a debtor for debt extinguished before its scheduled maturity. A number of commentators have observed, however, that not all troubled debt restructurings are "extinguishments" as that term is used in *APB Opinion No. 26* [section 5362]. Also, since many troubled debt restructurings have occurred on or after the scheduled maturity of the debt, questions have arisen about accounting for debt restructurings that are not early extinguishments. It has been suggested that troubled debt restructurings should be considered separately from restructurings, including early extinguishments, that do not involve the economic or legal pressure to restructure on the creditor that characterizes troubled debt restructurings.

.048 Concern over the lack of guidance in the authoritative literature on accounting for troubled debt restructurings, accentuated by their increasing number, led to requests that the Financial Accounting Standards Board consider the matter. The Board submitted the question to the Screening Committee on Emerging Problems and weighed its recommendations in deciding to proceed with a project limited in scope to accounting and reporting by a debtor whose debt is restructured in a troubled loan situation. The Board issued an Exposure Draft of a Proposed Statement, "Restructuring of Debt in a Troubled Loan Situation," dated November 7, 1975, and held a public hearing on December 12, 1975. The Board received 63 written responses to the Exposure Draft and heard five oral presentations at the public hearing. A number of respondents objected to the accounting prescribed by the Exposure Draft, but they held divergent views about the appropriate accounting. Major issues of concern centered on (a) whether

certain kinds of troubled debt restructurings require reductions of carrying amounts of debt, (b) if they do, whether the effect of the reduction should be included in measuring current net income, be deferred, or be considered a contribution to capital, and (c) whether interest that is contingently payable on restructured debt should be recognized before it becomes payable.

.049 During the same period, uncertainties arose about the abilities of some state and local government units to pay their obligations when due. Some of those obligations have also been restructured, for example, by continuing the existing obligation for a designated period at a reduced interest rate or by substituting obligations with later maturities of the same or a related issuer. Questions about accounting and reporting by creditors for those restructured securities led various individuals and organizations to urge the Board to consider that matter.

.050 The Board considered (a) the lack of authoritative guidance and divergent views about accounting and reporting by debtors for troubled debt restructurings and by creditors for restructured securities of state and local government units and (b) the similarities of the issues for debtors and creditors and concluded that the accounting and reporting issues affecting both debtors and creditors should be considered in a single project. The Board therefore announced on January 7, 1976, that it had added to its agenda a project to determine accounting and reporting by both debtors and creditors. At the same time the Board announced that since the new project concerned accounting by both debtors and creditors, the Board would not issue a Statement covering the limited topic of the November 7, 1975 Exposure Draft.

.051 The Securities and Exchange Commission issued, also on January 7, 1976, *Accounting Series Release No. 188,* "Interpretive Statement by the Commission on Disclosure by Registrants of Holdings of Securities of New York City and Accounting for Securities Subject to Exchange Offer and Moratorium." The Commission did not require a particular accounting method because of the divergent views on accounting for the securities held and "the fact that the Financial Accounting Standards Board has agreed to undertake a study of the accounting problems . . . with the intention of developing standards which can be applied to year-end statements in 1976."

.052 The Board appointed a task force in January 1976 to provide counsel in preparing a Discussion Memorandum. Its sixteen members included individuals from academe, the financial com-

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munity, industry, law, and public accounting. The Board issued a Discussion Memorandum, "Accounting by Debtors and Creditors When Debt Is Restructured," dated May 11, 1976, comprehending accounting and reporting by debtors and creditors for "any change in the amount or timing of cash payments otherwise required under the terms of the debt at the date of restructuring." It received 894 written responses to the Discussion Memorandum and heard 37 oral presentations at a public hearing on July 27-30, 1976.

.053 In addition, the FASB staff reviewed the accounting and reporting practices of a number of debtors and creditors involved in troubled debt restructurings and interviewed a limited number of individuals who were directly associated with some of those restructurings.

.054 The Board issued an Exposure Draft of a proposed Statement on "Accounting by Debtors and Creditors for Troubled Debt Restructurings," dated December 30, 1976. It received 96 letters of comment on the Exposure Draft.

Appendix B

BASIS FOR CONCLUSIONS

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Appendix B

BASIS FOR CONCLUSIONS

.055 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others.

SCOPE OF THIS STATEMENT

.056 Paragraph .001 states that this Statement establishes standards of financial accounting and reporting by the debtor and by the creditor for a troubled debt restructuring. In contrast, the Discussion Memorandum comprehended all restructurings that changed "the amount or timing of cash payments otherwise required under the terms of the debt at the date of the restructuring." The broader scope of the Discussion Memorandum, which encompassed nontroubled as well as troubled debt restructurings, was due to several factors. The Board considered it necessary to obtain additional information about accounting practices and problems for both troubled and nontroubled debt restructurings. Some respondents to the November 7, 1975 Exposure Draft of a Proposed Statement, "Restructuring of Debt in a Troubled Loan Situation," expressed concern that to apply its guidelines for identifying troubled loan situations would require considerable judgment. Some Task Force members and other commentators advised the Board to comprehend all restructurings accomplished by exchanges of debt for debt or of equity securities for debt that may not be covered by *APB Opinion No. 26* [section 5362].[29]

.057 Most respondents to the Discussion Memorandum that commented on the matter, however, recommended that a Statement at this time should be limited to accounting for troubled debt restructurings. Numerous respondents indicated that restructurings of debt in nontroubled situations present no significant or unusual accounting problems that merit consideration or require new accounting and reporting standards. Many respondents contended that the kinds of major changes that might result from new standards on accounting for all restructurings should be deferred pending progress on the FASB's existing projects on accounting for interest costs and the conceptual framework for financial accounting and reporting. Some respondents argued that a useful distinction between troubled and nontroubled restructurings of debt can be made

[29] See paragraph .047 of this Statement.

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and that the need to use judgment in some circumstances should not be a deterrent to making that distinction in a Statement. A number of respondents to the Exposure Draft [30] made similar comments.

.058 The Board found persuasive the views described in the preceding paragraph and decided to limit the scope of this Statement to troubled debt restructurings. The Board also decided that conclusions in this Statement should not attempt to anticipate results of considering the issues in its Discussion Memorandum, "Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement," dated December 2, 1976. Rather, the Board believes that, to the extent possible, the accounting for troubled debt restructurings prescribed in this Statement should be consistent and compatible with the existing accounting framework.

.059 Paragraph .001 also states that the Statement does not establish standards of financial accounting and reporting for allowances for uncollectible amounts and does not prescribe or proscribe particular methods for estimating amounts of uncollectible receivables. Several respondents to the Exposure Draft urged the Board to adopt the method of accounting for uncollectible amounts based on the net realizable value of collateral property set forth in *Statement of Position 75-2,* "Accounting Practices of Real Estate Investment Trusts," issued June 27, 1975 by the Accounting Standards Division of the American Institute of Certified Public Accountants. Others noted potential conflicts between the Exposure Draft and the AICPA publication and requested clarification. Still others urged the Board to reject the method for estimating amounts of uncollectible receivables in *Statement of Position 75–2.*

.060 Since this Statement neither prescribes nor proscribes particular methods for estimating uncollectible amounts of receivables, it takes no position on whether the net realizable value of collateral is a proper basis for estimating allowances for uncollectible amounts of receivables. However, the accounting prescribed in this Statement for assets received in troubled debt restructurings differs from that in *Statement of Position 75–2,* for reasons given in paragraphs .065-.105, and the accounting prescribed in this Statement governs.

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[30] References to "Exposure Draft" in this Appendix are to "Accounting by Debtors and Creditors for Troubled Debt Restructurings," dated December 30, 1976, unless the reference specifically identifies the earlier Exposure Draft, "Restructuring of Debt in a Troubled Loan Situation," dated November 7, 1975.

.061 Paragraphs .002-.008 identify debt restructurings that fall within the scope of this Statement. This paragraph and the next are intended to clarify further the meaning of *troubled debt restructuring* for purposes of this Statement. The description of a troubled debt restructuring is based generally on that in the November 7, 1975 Exposure Draft, which many respondents to that Exposure Draft and the Discussion Memorandum found satisfactory. It focuses on the economic and legal considerations related to the debtor's financial difficulties that in effect compel the creditor to restructure a receivable in ways more favorable to the debtor than the creditor would otherwise consider. The creditor participates in a troubled debt restructuring because it no longer expects its investment in the receivable to earn the rate of return expected at the time of investment and may view loss of all or part of the investment to be likely unless the receivable is restructured. Thus, a troubled debt restructuring involves a receivable whose risk to the creditor has greatly increased since its acquisition, and if the creditor were not faced with the need to restructure to protect itself, it would require a much higher effective interest rate to invest in the same receivable currently. If the receivable has a market price, the effective interest rate based on that market price will have increased because of that increased risk to the creditor—that is, it will have increased more than market interest rates generally (or fallen less than market rates or increased while interest rates generally have fallen).

.062 Although the broad description of a troubled debt restructuring in paragraphs .002-.008 includes settlements of debt by transfers of assets and grants of equity interests in debtors, *troubled debt restructuring* refers in particular to modifications of terms intended to continue an existing debt by making the terms more favorable to the debtor to protect the creditor's investment. For purposes of this Statement, troubled debt restructurings do not include changes in terms resulting in an effective interest rate based on market price of the debt that is comparable to effective interest rates applicable to debt issued by nontroubled debtors, for example, a situation in which a debtor is able to exchange for its outstanding debt new marketable debt with an effective interest rate at or near the market interest rates for debt issued by nontroubled debtors generally. The fact that the debtor can obtain that interest rate only by including a "sweetener," such as a conversion privilege, does not make that transaction a troubled debt restructuring because (a) the debtor is sufficiently strong financially that the kind of economic compulsion on the creditor described earlier is not present, (b) the "sweetener" represents so drastic a change in the terms of the debt

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that the transaction is in substance the exchange of new debt for outstanding debt rather than merely a modification of terms to continue an existing debt, or (c) some combination of both factors.

.063 Some respondents to the Discussion Memorandum advocated that the scope of this Statement specifically exclude restructurings of receivables related to consumer finance activities or to all or certain residential properties. Their reasons focused primarily on the individual insignificance of those receivables in a creditor's financial position and on the cost involved to account for reductions in recorded investments in large numbers of receivables that may be restructured. The Board concluded that accounting for restructurings of those receivables in troubled situations should in general be the same as for other troubled debt restructurings. However, grouping like items or using statistical measures may be appropriate for receivables that are not individually material.

.064 Some respondents to the Exposure Draft suggested that the *time of a troubled debt restructuring* be clarified because several dates or events may be involved. The time may be significant in matters relating to recognizing gains or losses from restructuring or to the effective date of the Statement. Paragraph .006 specifies the time of a restructuring to be the date of consummation, that is, the time that assets are transferred, new terms become effective, and the like. A debtor should not recognize a gain on restructuring before consummation of the restructuring; a creditor should record receipt of an asset or equity interest at that date or should formally write down a restructured receivable, but may already have recognized a loss on restructuring through estimated uncollectible amounts.

DIVERGENT VIEWS OF TROUBLED DEBT RESTRUCTURINGS

.065 Respondents to the Discussion Memorandum expressed divergent views about the substance of various types of troubled debt restructurings and appropriate accounting for them within the existing accounting framework. Those views fall generally into three categories:

a. All troubled debt restructurings constitute events that are part of continuing efforts by creditors to recover amounts invested and obtain a return on investment despite debtors' financial difficulties; therefore, troubled debt restructurings may require certain disclosures, but usually do not require changes in carrying amounts of payables or recorded investments in receivables or recognition of gains or losses.

b. All debt restructurings, troubled and nontroubled, constitute transactions whose financial effect on assets or liabilities (receivables or payables) should be recognized, including recognition of gains or losses.

c. Accounting for a troubled debt restructuring depends on the characteristics of the restructuring. Some troubled debt restructurings constitute transactions requiring recognition of changes in receivables or payables and related gains or losses; other troubled debt restructurings do not.

Recognition of Changes Not Appropriate

.066 Respondents who contended that troubled debt restructurings constitute events for which recognition of changes in assets or liabilities is usually not appropriate within the existing accounting framework generally focused on accounting by creditors. They reasoned that a troubled debt restructuring commonly involves a concession granted unilaterally by the creditor to increase its prospects of recovering the amount invested. The debtor is usually a passive beneficiary of the effects of the restructuring. Troubled debt restructurings typically result from the debtor's financial difficulties that existed before restructuring, and in the existing accounting framework the creditor should have considered the debtor's financial difficulties in estimating an allowance for uncollectible amounts regardless of whether those difficulties were likely to culminate in a restructuring. According to those respondents, the restructuring event in itself has no accounting significance except to sometimes provide more definitive evidence of the effect of the debtor's financial difficulties on the creditor's ability to recover the recorded investment in the receivable.

.067 According to that view, the creditor should record no change in a receivable restructured in a troubled debt restructuring and no gain or loss whether the restructuring involves (i) transfer of receivables, real estate, or other noncash assets from the debtor to the creditor to satisfy the receivable, (ii) grant to the creditor of an equity interest in the debtor to satisfy the receivable, (iii) modification of the terms of the receivable, or (iv) some combination of transfer of assets or grant of equity interests (or both) and modification of terms. The normal, expected course of events in a creditor's activities is to invest cash, earn interest on the cash invested, and eventually recover the cash. Although a creditor initiates or agrees to a restructuring to protect the amount invested, not to acquire noncash assets, the creditor may accept noncash assets (including an equity interest) as a necessary intermediate step. The creditor previously held a claim on the debtor's assets, either through a

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receivable secured by specific collateral or through an unsecured general claim against the debtor's assets. Accepting noncash assets in a restructuring represents the exercise of that claim; the assets stand in the place of the receivable. According to that view, the creditor's recorded investment in the receivable should become the recorded investment in the surrogate assets obtained. Then, since whether the creditor recovers that investment depends on the cash received for the assets that replaced the receivable, recoverability of that recorded investment as a result of obtaining the surrogate assets should be assessed. An expected failure, if any, to recover all of the recorded investment should be recognized as a loss by the creditor to the extent not previously recognized. However, transfer of the assets to the creditor should not precipitate recognition of a loss that was not inherent in the receivable before the restructuring; at most, the transfer provides evidence of the existence and amount of a loss.

Recognition of Changes Appropriate for All Debt Restructurings

.068 Some respondents advocated for virtually all debt restructurings, troubled and nontroubled, the accounting normally required in the existing accounting framework for initial recognition of assets and liabilities. They reasoned that each restructuring is an exchange resulting in a new asset for the creditor or liability for the debtor in place of the old one. According to that view, the presence or absence of financial difficulties does not affect the appropriate accounting for a restructuring; at most, a debtor's financial difficulties may affect the terms of the exchange. Those respondents contended that all assets and liabilities exchanged in debt restructurings should be measured at their fair values at the time of the restructuring by both debtors and creditors. They considered continued use of recorded amounts derived from previous exchange transactions to be inappropriate for restructured receivables and payables because it ignores a current exchange transaction and may ignore gains or losses that have occurred and should be recognized.

Accounting Depends on Circumstances

.069 Some respondents contended that the controlling criterion in determining appropriate accounting for a debt restructuring within the existing accounting framework is whether the restructuring involves transfer of resources, obligations, or both between debtor and creditor. According to that view, a troubled debt restructuring

involving transfer of resources, obligations, or both should be accounted for the same as other transfers of resources and obligations in the existing accounting framework and may involve recognizing a gain or loss. A troubled debt restructuring involving no transfer of resources or obligations requires no accounting for changes in assets or liabilities, except to recognize losses in accordance with *FASB Statement No. 5* [section 4311].

.070 Some respondents distinguished debt restructurings involving transfers of resources, obligations, or both from those involving no transfers on the basis of whether the debtor transferred assets or granted an equity interest to the creditor to satisfy the debt or the restructuring involved modification of terms only. Other respondents classified modifications of terms involving reduction of face amount of the debt with transfers of assets or grants of equity interests (discussed further in paragraphs .106-.155).

Board Conclusions about Recognizing Changes in Assets or Liabilities

.071 *APB Statement No. 4* [sections 1021-1029], "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," describes relevant parts of the existing accounting framework. That Statement defines "economic resources" as "the scarce means (limited in supply relative to desired uses) available for carrying on economic activities" and identifies "claims to receive money" as an economic resource. It defines "economic obligations" as "present responsibilities to transfer economic resources or provide services to other entities in the future" and identifies "obligations to pay money" as an economic obligation. It also states that "events that change resources, obligations, and residual interest are the basis for the basic elements of results of operations . . . and other changes in financial position with which financial accounting is concerned." (See *APB Statement No. 4,* paragraphs 57, 58, and 61 [sections 1023.18-.19 and 1023.22].)

.072 According to *APB Statement No. 4* [sections 1021-1029], almost all of the events that in the existing accounting framework normally change assets and liabilities and also affect net income for the period of change are either "exchanges" or "nonreciprocal transfers," the two classes that comprise "transfers of resources or obligations to or from other entities." The other classes of events—"external events other than transfers of resources or obligations to or from other entities" (price changes, interest rate changes, technological changes, vandalism, etc.) and "internal events" (production and casualties)—result in

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revenues or gains only through "exceptions" and result in expenses or losses only because some produce losses by definition or by applying the "modifying convention" of conservatism. (See *APB Statement No. 4,* paragraphs 62 and 180-187 [sections 1023.23 and 1027.06-.13].)

.073 An exchange is a reciprocal transfer between the enterprise and another entity in which "the enterprise either sacrifices resources or incurs obligations in order to obtain other resources or satisfy other obligations." "Exchanges between the enterprise and other entities (enterprises or individuals) are generally recorded in financial accounting when the transfer of resources or obligations takes place or services are provided." Nonreciprocal transfers are "transfers in one direction of resources or obligations, either from the enterprise to other entities or from other entities to the enterprise." In nonreciprocal transfers between the enterprise and entities other than owners, "one of the two entities is often passive, a mere beneficiary or victim of the other's actions." Nonreciprocal transfers between the enterprise and entities other than owners "are recorded when assets are acquired (except that some noncash assets received as gifts are not recorded), when assets are disposed of or their loss is discovered, or when liabilities come into existence or are discovered." (See *APB Statement No. 4,* paragraphs 62, 181, and 182 [sections 1023.23 and 1027.07-.08].)

.074 The Board rejected the view that virtually all troubled debt restructurings have the same substance in the existing accounting framework. It therefore rejected both the view that accounting for all troubled debt restructurings should involve recognition of changes in assets or liabilities and perhaps gains and losses and the view that no troubled debt restructurings should require recognition of changes in assets or liabilities or gains or losses.

.075 The Board concluded that a troubled debt restructuring that involves transfer of resources or obligations requires accounting for the resources or obligations transferred whether that restructuring involves an exchange transaction or a nonreciprocal transfer. Both kinds of transfers are accounted for in the existing accounting framework on essentially the same basis (exchange price received or paid or fair value received or given). In this Statement, therefore, the Board found it unnecessary to decide whether the transfer of resources and obligations in various types of troubled debt restructurings is reciprocal (an exchange) or nonreciprocal as those terms are used in paragraph 62 of *APB Statement No. 4* [section 1023.23].

.076 The Board also concluded that a troubled debt restructuring that does not involve a transfer of resources or obligations is a

continuation of an existing debt. It is neither an event that results in a new asset or liability for accounting purposes nor an event that requires a new measurement of an existing asset or liability.

.077 The Board noted that guidance regarding the types of troubled debt restructurings that involve transfers of resources, obligations, or both is sparse in existing accounting pronouncements, and various views exist. The Board concluded that to the extent a troubled debt restructuring involves (i) transfer of receivables, real estate, or other assets from debtor to creditor to satisfy debt or (ii) grant to the creditor of an equity interest in the debtor to satisfy debt (or a combination of both), a transfer of resources or obligations has occurred that in the existing accounting framework should be accounted for at fair value. The debtor has given up assets or granted an equity interest to settle a payable, and the creditor has received the assets or equity interest in satisfaction of a receivable. In contrast, to the extent a troubled debt restructuring involves only modification of terms of continuing debt, no transfer of resources or obligations has occurred. The substance of troubled debt restructurings involving modifications of continuing debt is discussed in paragraphs .106-.155.

.078 Several respondents to the Exposure Draft disagreed with the Board's distinction between troubled debt restructurings involving transfers of assets or grants of equity interests in debtors and those involving only modifications of terms. Some respondents wished to have fewer kinds of troubled debt restructurings accounted for as transactions between debtors and creditors and thus disagreed with the Exposure Draft's conclusions on accounting for transfers of assets; their views are noted in the next section. Others wished to account for more kinds of troubled debt restructurings as transactions between debtors and creditors and thus disagreed with the Exposure Draft's conclusions on accounting for modifications of terms; their views are noted in paragraphs .150-.153.

ACCOUNTING FOR RESTRUCTURINGS INVOLVING TRANSFERS

Accounting by Debtors and Creditors for Transfer of Assets

Concept of Fair Value

.079 Some respondents to the Exposure Draft continued to argue that all troubled debt restructurings should be accounted for as modifications of terms of debt and that none should be accounted for as transfers of assets (paragraphs .066 and .067). Others ac-

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cepted the need to account for some troubled debt restructurings as asset transfers but held that obtaining assets through foreclosure or repossession under terms included in lending agreements should be distinguished from obtaining assets in exchange for cash or in other "asset swaps." They contended that (a) only the form of the asset is changed by foreclosure or repossession, (b) the substance of a secured loan is that the lender may choose either to postpone receipt of cash or take the asset to optimize cash receipts and recovery of its investment, and (c) foreclosure or repossession is not the completion of a lending transaction but merely a step in the transaction that begins with lending cash and ends with collecting cash.

.080 The Board rejected those arguments for the reasons given in paragraphs .071-.077, emphasizing that an event in which (a) an asset is transferred between debtor and creditor, (b) the creditor relinquishes all or part of its claim against the debtor, and (c) the debtor is absolved of all or part of its obligation to the creditor is the kind of event that is the basis of accounting under the existing transaction-based accounting framework. To fail to recognize an event that fits the usual description of a transaction and to recognize only the lending and collection of cash as transactions would significantly change the existing accounting framework.

.081 Use of the fair value of an asset transferred to measure the debtor's gain on restructuring and gain or loss on the asset's disposal or the creditor's cost of acquisition is not adopting some kind of "current value accounting." On the contrary, that use of fair value is common practice within the existing accounting framework. Paragraph .013 of this Statement explains briefly the meaning of *fair value* and refers to *APB Opinions No. 16* [section 1091], *No. 21* [section 4111], and *No. 29* [section 1041], which use *fair value* in the same way and provide guidance about determining fair values within the existing accounting framework. The term *fair value* is used in essentially the same way as *market value* was used in the Discussion Memorandum to denote a possible attribute to be measured at the time a debt is restructured. *Fair value* is defined in paragraph 181 of *APB Statement No. 4* [section 1027.07] as "the approximation of exchange price in transfers in which money or money claims are not involved." Although a "money claim" is necessarily involved in transferring assets to settle a payable in a troubled debt restructuring, the troubled circumstances in which the transfer occurs make it obvious that the amount of the "money claim" does not establish an exchange price. Determining fair value of the assets transferred in a troubled debt restructuring is usually necessary to approximate an exchange price for the

same reasons that determining fair value is necessary to account for transfers of assets in nonmonetary transactions (*APB Opinion No. 29* [section 1041]).

.082 That point is emphasized in this Appendix because some respondents to the Exposure Draft apparently misunderstood the concept of fair value (paragraph 11 of the Exposure Draft and paragraph .013 of this Statement) and the discounting of expected cash flows specified in those paragraphs. Paragraph .013 permits discounting of expected cash flows from an asset transferred or received in a troubled debt restructuring to be used to estimate fair value only if no market prices are available either for the asset or for similar assets. The sole purpose of discounting cash flows in that paragraph is to estimate a current market price as if the asset were being sold by the debtor to the creditor for cash. That estimated market price provides the equivalent of a sale price on which the debtor can base measurement of a gain on restructuring and a gain or loss on disposal of the asset and the equivalent of a purchase price on which the creditor can measure the acquisition cost of the asset. To approximate a market price, the estimate of fair value should use cash flows and discounting in the same way the marketplace does to set prices—in essence, the marketplace discounts expected future cash flows from a particular asset "at a rate commensurate with the risk involved" in holding the asset. An individual assessment of expected cash flows and risk may differ from what the marketplace's assessment would be, but the procedure is the same.

.083 In contrast to the purpose of paragraph .013, *AICPA Statement of Position No. 75-2* [31] is concerned with different measures —net realizable value to a creditor of a receivable secured by real property and net realizable value of repossessed or foreclosed property. Its method of accounting for assets obtained by foreclosure or repossession thus differs from the method specified in this Statement. It proposes discounting expected cash flows at a rate based on the creditor's "cost of money" to measure the "holding cost" of the asset until its realizable value is collected in cash. The concept of fair value in paragraph .013 does not involve questions of whether interest is a "holding cost" or "period cost" because it is concerned with estimating market price, not net realizable value, however defined. Accounting for transfers of assets in troubled debt restructurings and for the assets after transfer is, of course, governed by this Statement.

.084 Several respondents to the Exposure Draft suggested that the Statement should explicitly state that troubled debt restructurings

[31] See paragraphs .059 and .060 of this Statement.

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that are in substance transfers of assets should be accounted for according to that substance. The Board agreed that a restructuring may be in substance a foreclosure, repossession, or other transfer of assets even though formal foreclosure or repossession proceedings are not involved. Thus, the Statement requires accounting for a transfer of assets if, for example, the creditor obtains control or ownership (or substantially all of the benefits and risks incident to ownership) of one or more assets of the debtor and the debtor is wholly or partially relieved of the obligations under the debt, or if both the debt and one or more assets of the debtor are transferred to another debtor that is controlled by the creditor.

Debtor's Recognition of Gain or Loss

.085 Responses to the November 7, 1975 Exposure Draft, the May 11, 1976 Discussion Memorandum, and the Exposure Draft included two general procedures for a debtor to account for a gain or loss from a troubled debt restructuring involving a transfer of assets to settle a payable:

a. The debtor recognizes a difference, if any, between the carrying amount of assets transferred and the carrying amount of the payable settled as a gain on restructuring of a payable.

b. The debtor (1) recognizes a difference, if any, between the fair value and carrying amount of assets transferred as a gain or loss on transfer of assets and (2) recognizes a difference, if any, between the fair value of assets transferred and the carrying amount of the payable settled, as a gain on restructuring of a payable.

.086 Some respondents contended that debtors should not recognize the difference between the carrying amount and fair value of assets transferred to settle a payable as a gain or loss on assets. Instead, the net difference, if any, between the carrying amount of assets transferred and the carrying amount of a payable settled should be recognized as a gain or loss on restructuring of a payable. They argued that to measure the fair value of assets transferred would be costly and subjective in certain circumstances and that distinctions in the debtor's income statement between a gain or loss on disposition of assets and a gain on settlement of payables in the same troubled debt restructuring would probably not be helpful and might be arbitrary.

.087 Other respondents who addressed the question emphasized the desirability of being able to assess separately the debtor's

performance with respect to the transferred assets. They suggested that measuring the fair values of the transferred assets is essential to that assessment and conveys significant information that is obscured if fair values are not measured. For example, the fair values of some assets transferred (such as real estate) may often exceed their carrying amounts, while the fair values of other assets transferred (such as receivables) may sometimes be less than their face amounts. In the existing accounting framework, the first kind of difference is not recognized before disposal of the asset, but the second kind of difference is likely to have been recognized before restructuring by some debtors but not recognized by others for various reasons. Failure to include a gain or loss for the difference between the fair values and carrying amounts of assets transferred in troubled debt restructurings is likely to obscure differences and similarities between restructurings, according to that view, and respondents who advocated separate recognition of a debtor's gains or losses on assets transferred and gains on restructuring argued that separate recognition is required to provide consistent information about a single debtor for different periods and comparable information about different debtors for the same periods. The need for separate recognition is accentuated if gains and losses on transfer of assets are classed differently from gains on restructuring in the debtor's income statement (that is, if the latter are classified as extraordinary items).

.088 The Board concluded that the fair value of the assets transferred in a troubled debt restructuring constitutes the best measure of the debtor's sacrifice to settle the payable and therefore that the fair value of assets transferred should be used to measure the gain on restructuring of the payable. In the existing accounting framework, gains, and losses on certain kinds of noncurrent assets, are usually recognized on assets only when the assets are sold or otherwise disposed of. For many assets, that gain or loss on sale or disposal is the only indication of whether the enterprise did well or poorly by having the asset. That indication is lost if the gain or loss on disposition is buried in a gain on restructuring of troubled debt, and the effect of the restructuring itself is also obscured. Further, unless fair value of the asset transferred is used to account for the transaction, the proportion of a payable settled by the transfer can usually be determined only by arbitrary and complicated allocations if the transfer settles only part of the payable and the terms are modified on the remainder (paragraph .019).

.089 Since a gain or loss recognized by a debtor on the assets transferred to settle a payable in a troubled debt restructuring

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is closely related to a gain recognized by a debtor on restructuring of a payable, the Board concluded that the aggregate amount of each should be disclosed for restructurings that have occurred during a period for which financial statements are presented (paragraph .025).

Creditor's Subsequent Accounting

.090 The Board considered two proposals for a creditor's accounting for assets received in full satisfaction of a receivable in a troubled debt restructuring: (a) the creditor accounts for the assets received at their fair value and recognizes as a loss a difference, if any, between the total fair value of assets received and the recorded investment in the receivable satisfied or (b) the creditor accounts for the assets received at the recorded investment in the receivable satisfied and recognizes no loss. Those alternatives are described in paragraphs .065-.070, and the Board's reasons for adopting the first proposal are given in paragraphs .071-.078.

.091 Several respondents to the Exposure Draft requested guidance on a creditor's accounting after a troubled debt restructuring for assets received in the restructuring. Some asked the Board to require or permit creditors to accrue interest on all assets acquired through repossession or foreclosure. In response, paragraph .029 states that "after a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash." The fair value at the time of transfer of an asset transferred to a creditor in a troubled debt restructuring is a measure of its cost to the creditor and generally remains its carrying amount (except for depreciation or amortization) until sale or other dispositon if the asset is inventory, land, building, equipment, or other nonmonetary asset. That is, under the present accounting framework, interest is accrued only on some receivables and other monetary assets. Except for the effects of a few specialized rules that permit interest cost to be added to the cost of some assets under construction, etc., interest is not accrued on nonmonetary assets. That framework governs accounting for assets acquired in a troubled debt restructuring. The method of accounting for assets received through foreclosure, repossession, or other asset transfer to satisfy a receivable proposed by *Statement of Position 75–2* is not compatible with the accounting specified in this Statement.

Debtor's Accounting for Grant of Equity Interest

.092 The Board considered three proposals for a debtor's accounting for an equity interest granted to a creditor to settle a payable in a troubled debt restructuring:

a. The debtor directly increases its owners' equity by the fair value of the equity interest granted[32] and recognizes the difference between that fair value and the carrying amount of the payable settled as a gain included in measuring net income.

b. Same as (a) except that the resulting gain is included directly in the owners' equity of the debtor.

c. The debtor directly increases its owners' equity by the carrying amount of the payable settled, recognizing no gain.

.093 Respondents favoring use of fair value to record a grant of an equity interest contended that the increase in the owners' equity of the debtor as a result of a troubled debt restructuring should be measured by the consideration received for the equity interest granted, not by the carrying amount of the payable settled because that carrying amount has no current economic significance. They also contended that a separate measure of a gain on restructuring of payables provides useful information.

.094 Among those who advocated use of fair value to record an equity interest granted to settle debt in a troubled debt restructuring and recognition of a resulting gain on restructuring, some advocated including that gain in measuring net income and others advocated including it directly in the debtor's equity accounts. Those favoring inclusion in net income argued that all gains from troubled debt restructurings are components of net income whether they arise from transfer of assets or grant of equity interests. Those favoring direct inclusion in owners' equity argued that, to the extent an equity interest is involved, the restructuring is a capital transaction and gains resulting from capital transactions should be recognized as direct increases in paid-in or contributed owners' equity rather than as components of net income.

.095 Those who advocated that the debtor's increase in equity for an equity interest granted should be the carrying amount of

[32] "Fair value" in this context normally means the fair value of the liability satisfied or the fair value of the equity interest granted, whichever is the more clearly evident (*APB Opinion No. 16,* paragraph 67 [section 1091.67], and *APB Statement No. 4,* paragraph 182 [section 1027.08]).

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the debt settled also argued that granting an equity interest is essentially a capital transaction to which the notion of a gain does not apply. That solution was proposed in the November 7, 1975 Exposure Draft. Advocates of that view noted that paragraph 187 of *APB Statement No. 4* [section 1027.13] states that, among other sources, increases in owners' equity arise from investments in an enterprise by its owners. According to that view, a creditor that accepts an equity interest in the debtor in satisfaction of a receivable becomes an owner; the debtor's measure of the owners' investment is the carrying amount of the payable settled.

.096 After considering the comments received in response to the November 7, 1975 Exposure Draft, the May 11, 1976 Discussion Memorandum, and the Exposure Draft, the Board concluded that a debtor should record an equity interest in the debtor granted to a creditor to settle a payable in a troubled debt restructuring at its fair value, and the difference between that fair value and the carrying amount of the payable settled should be recognized as a gain in measuring net income. The Board recognizes that, for some debtors involved in troubled debt restructurings, estimating either the fair value of the equity interest granted or the fair value of the payable settled may be difficult. That estimate is necessary, however, to measure separately the consideration received for the equity interest and the gain on restructuring. To include the gain on restructuring in contributed equity would violate a clear principle for accounting for issues of stock—capital stock issued is recorded at the fair value of the consideration received (*APB Statement No. 4,* paragraph 182 [section 1027.08]). The consideration received for the stock issued in that kind of troubled debt restructuring is cancellation of the payable (or part of it), but the fair value of the consideration received is not measured by the carrying amount of the payable. Whether the consideration received is measured by the fair value of the stock issued or the fair value of the payable cancelled, the consideration is less than the carrying amount of the payable. To record the stock issued at the carrying amount of the payable thus results in recording the stock at an amount in excess of the consideration received; to include the gain in restructuring in contributed equity instead of net income gives the same result.

.097 To recognize a gain on restructuring acknowledges that the creditor accepted something less than the carrying amount of the payable to settle it. Since that is the essential result whether the restructuring is in the form of a transfer of assets from debtor to creditor or the form of a grant to the creditor of an equity inter-

est in the debtor, the Board believes that essentially the same accounting applies in the existing accounting framework to both kinds of restructurings. Although the creditor becomes an owner of the debtor to the extent that the creditor accepts an equity interest in the debtor, that is a consequence of the kind of consideration used to settle a payable in a restructuring. The restructuring itself is an agreement between a debtor and a creditor, and the gain to the debtor results because the creditor accepted less consideration than the carrying amount of the debt.

Classification of Debtor's Gain on Restructuring

.098 Alternatives considered by the Board for classifying gain on a troubled debt restructuring in the debtor's financial statements were that the gain is: (a) always included in measuring net income in accordance with *APB Opinion No. 30* [section 2012], (b) always included in measuring net income as an extraordinary item, and (c) always included as a direct addition to paid-in capital. Most respondents addressing the question recommended classifying a gain on restructuring debt as an extraordinary item, primarily because they perceived it to be similar to gains or losses on extinguishment of debt that, according to *FASB Statement No. 4* [section 2013], shall be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. Some respondents recommended classifying the gain as a direct increase in paid-in capital, contending that since the gain results from a unilateral action by the creditor, the debtor has in effect received a contribution to equity from the creditor.

.099 The Board concluded that a gain on restructuring (net of related income tax effect), if material, should always be classified as an extraordinary item in measuring the debtor's net income. The Board recognized that to apply the criteria in *APB Opinion No. 30* [section 2012] to a particular debtor's gain on restructuring would not necessarily result in its classification as an extraordinary item. The Board concluded, however, that a gain on restructuring of a payable in a troubled debt restructuring is indistinguishable from a gain or loss on other extinguishments of debt, and the same classification in financial statements is appropriate. Since *FASB Statement No. 4* [section 2013] classifies a gain or loss on extinguishment of debt as an extraordinary item, the classification is appropriate for a gain on restructuring of a payable.

.100 Some respondents suggested that "legal fees and other direct costs that a debtor incurs in granting an equity interest

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to a creditor in a troubled debt restructuring" (paragraph .024) always be included as extraordinary items whether or not the debtor recognizes a gain on restructuring. Issuing equity interests is not an extraordinary event for a business enterprise, however, and related costs are not extraordinary items under any existing authoritative literature. Deducting those costs from the proceeds of issue has been customary practice, and this Statement does not change that custom. But only costs of issuing the equity interest may be accounted for that way. All other direct costs of a troubled debt restructuring are expenses of the period of restructuring but shall be deducted from a gain, if any, on restructuring.

Creditor's Accounting for Loss on Restructuring

.101 Some respondents to the Discussion Memorandum, especially financial institutions, indicated that they hold and manage broad groups of earning assets (primarily loans and investments) as portfolios rather than as individual assets. According to them, their primary consideration in making a new loan or investment is to recover the amount invested, and the rate of return on the amount invested is a secondary consideration. Although one objective is to obtain an appropriate rate of return for the particular credit risk, changes in market conditions and general economic conditions as well as changes affecting the individual asset or debtor may cause the actual return from a loan or investment to vary from that originally anticipated. Therefore, the objective is to maintain a portfolio with an average yield that provides an adequate margin over the cost of funds and that has risk, maturity, marketability, and liquidity characteristics that are appropriate for the particular institution. To achieve that objective, the contractual rate of return required on individual loans and investments must include a factor to offset the probability that some of them will become nonearning assets, some will ultimately recover amounts invested only with difficulty, and some will involve loss of at least a portion of the amounts invested.

.102 The financial difficulties of a debtor that lead to a troubled debt restructuring usually require the creditor to consider those difficulties carefully in determining whether to recognize a loss on the existing receivable. Typically, before restructuring occurs, the creditor has determined the need for a related allowance for uncollectible amounts in light of those difficulties. An allowance for uncollectible amounts may have been based on individual receivables, on groups of similar receivables without necessarily attempting to identify particular receivables that may prove un-

collectible, or both. The creditor typically has numerous lending transactions and expects loan losses to recur as a consequence of customary and continuing business activities. Almost all respondents who commented on the classification of a creditor's loss on restructuring recommended that the loss be accounted for in a manner consistent with the enterprise's method of accounting for other losses related to its receivables. Usually that involves recognizing specific losses as they are identified and periodically adjusting the allowance for uncollectible amounts based on an assessment of its adequacy for losses not yet specifically identified. Respondents recommended that the net effect of recognizing specific losses and adjusting the valuation allowance be included in measuring net income in accordance with the provisions of *APB Opinion No. 30* [section 2012].

.103 The Board considered the varied frequency and significance for creditors of troubled debt restructurings in the light of the discussion in *APB Opinion No. 30* [section 2012], and agreed that (a) a creditor should account for a loss from a troubled debt restructuring in the same manner as a creditor's other losses on receivables (that is, as deductions in measuring net income or as reductions of an allowance for uncollectible amounts), and (b) *APB Opinion No. 30* [section 2012] should apply to losses on restructuring that are included in measuring net income.

Creditor's Sale of Assets Received in Restructuring

.104 A creditor whose customary business activities include lending may sell an asset that was previously acquired in a troubled debt restructuring. The consideration received in that sale may be represented, in whole or in part, by a receivable. The Board considered whether a receivable received in that way is exempt from the provisions of *APB Opinion No. 21* because paragraph 3(d) of that Opinion [section 4111.03(d)] states that, except for one paragraph, the Opinion does not apply to several kinds of receivables or payables or activities, including "the customary cash lending activities and demand or savings deposit activities of financial institutions whose primary business is lending money." Some respondents to the Exposure Draft held that acquiring and disposing of those assets is part of "the customary cash lending activities" of certain financial institutions.

.105 The "lending activities" referred to in paragraph 3(d) of *APB Opinion No. 21* [section 4111.03(d)] are modified by the words "customary" and "cash," and the Board concluded that the sale of an asset, such as real estate, by a financial institution is distinguishable from its customary cash lending activities. The view that the customary cash lending activities of a finan-

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cial institution include repossession or foreclosure and resale of assets is part of the argument that repossessions and foreclosures are not transactions to be accounted for but merely changes in the form of the asset (paragraphs .066, .067, and .079-.084). The Board rejected that contention and also rejected this part of it. *APB Opinion No. 21* [section 4111] focuses primarily on the possible misstatement of the exchange price (sale price or purchase price) in an exchange of a noncash asset for a receivable or payable, with consequent misstatement in the period of the transaction of gain or loss on sale or acquisition cost and misstatement in later periods of interest income or interest expense. The resale of repossessed or foreclosed assets is that kind of transaction and involves the same questions. Accordingly, the Board concluded that a receivable resulting from sale of an asset received in a troubled debt restructuring is covered by that Opinion, including paragraph 12, which prescribes the measurement of a note (receivable) exchanged "for property, goods, or service in a bargained transaction entered into at arm's length."

ACCOUNTING FOR RESTRUCTURINGS INVOLVING MODIFICATION OF TERMS

Background Information

.106 A creditor holds a receivable with the expectation that the future cash receipts, both those designated as interest and those designated as face amount, specified by the terms of the agreement will provide a return of the creditor's investment in that receivable and a return on the investment (interest income).[33] That essential nature of a creditor's investment in a receivable is the same whether the creditor invested cash (for example, a cash loan to a debtor or a cash purchase of debt securities) or exchanged assets or services (for example, a sale of the creditor's services, product, or other assets) for the receivable.

.107 Similarly, a debtor expects the future cash payments specified by the terms of a payable to include a cost (interest expense) for the privilege of deferring repayment of funds borrowed or deferring payment for goods or services acquired. The essential nature of a debtor's payable is the same whether the debtor received cash in exchange for the payable (for example, a cash loan

[33] The terms of some short-term receivables and payables (for example, trade accounts receivable or payable) may not be expected to result in interest income or interest expense to the creditor or debtor except as it may be implicit in the transaction (for example, implicit in the price of a product sold or purchased on account).

or the issue of debt securities for cash) or received other assets or services (for example, a purchase of services, materials, or other assets from the creditor).

.108 The difference between the amount a creditor invests in a receivable and the amount it receives from the debtor's payments of interest and face amount is the return on the investment (interest income) for the entire period the receivable is held. Similarly, the difference between the amount a debtor receives and the amount it pays for interest and face amount is the cost of deferring payment (interest expense) for the entire period the payable is outstanding. The question that must be answered to account for a debt (a receivable or payable) and related interest is how that total interest income or expense is to be allocated to the accounting periods comprising the entire period that the receivable is held or the payable is outstanding.

.109 That allocation of interest income or expense to periods is normally accomplished in present accounting practice by the interest method, which measures the interest income or expense of each period by applying the effective interest rate implicit in the debt to the amount of the debt at the beginning of the period, assuming that all cash receipts or payments will occur as specified in the agreement. The effective interest rate implicit in the debt may be the same as or different from the interest rate stated in the agreement (the stated interest rate). The effective and stated rates are the same if the amount invested or borrowed equals the face amount; the rates differ if the amount invested or borrowed is greater or less than the face amount.

.110 Thus, the recorded investment in a receivable or the carrying amount of a payable, both at the time of the originating transaction and at the beginning of each period comprising the entire period a receivable is held or a payable is outstanding, is the sum of the present values of (a) the amounts of periodic future cash receipts or payments that are designated as interest and (b) the face amount of cash due at maturity, both discounted at the effective interest rate implicit in the debt. If the effective interest rate differs from the stated interest rate, the recorded investment in the receivable or carrying amount of the payable in financial statements is the face amount plus unamortized premium or less unamortized discount, and that amount is used to measure the interest income or expense, as described in the preceding paragraph.

.111 Numerous references to and descriptions of the concepts and procedures referred to in paragraphs .108-.110 are found in the pronouncements of the Accounting Principles Board and

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the Financial Accounting Standards Board, for example, on accounting for leases (*FASB Statement No. 13* [section 4053]); accounting for the cost of pension plans (*APB Opinion No. 8* [section 4063]); accounting for interest on receivables and payables (*APB Opinions No. 12* [section 5361] *and No. 21* [section 4111]); accounting for early extinguishment of debt (*APB Opinion No. 26* [section 5362]); recording receivables and payables of a company acquired in a business combination (*APB Opinion No. 16,* paragraphs 87-89 [section 1091.87-.89]); and translating receivables and payables denominated in a foreign currency (*FASB Statement No. 8,* paragraph 39 [section 1083.039]).

.112 Pronouncements of the Accounting Principles Board also include several specific statements of broad principle. They include: "The general principles to apply the historical-cost basis of accounting to an acquisition of an asset depend on the nature of the transaction: . . . b. An asset acquired by incurring liabilities is recorded at cost—that is, at the present value of the amounts to be paid" (*APB Opinion No. 16,* paragraph 67 [section 1091.67]); "Conceptually, a liability is measured at the amount of cash to be paid discounted to the time the liability is incurred" (*APB Statement No. 4,* paragraph 181 [M-1C] [section 1027.07]); and ". . . upon issuance, a bond is valued at (1) the present value of the future coupon interest payments *plus* (2) the present value of the future principal payments (face amount). . . . discounted at the prevailing market rate of interest . . . at the date of issuance of the debt" and ". . . the difference between the present value and the face amount should be treated as discount or premium and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the 'interest' method described in and supported by paragraphs 16 and 17 of *APB Opinion No. 12* [section 5361.01-.02]" (*APB Opinion No. 21,* paragraphs 18 [Appendix] and 15 [sections 4111A.01 and 4111.14]).

Kinds of Modifications and Accounting Issues

.113 Agreements between a creditor and a debtor that modify the terms of an existing debt may affect (i) only the *timing* of future cash receipts or payments specified by the agreement—the timing of periodic interest, the maturity date, or both, (ii) only the *amounts* of cash to be received or paid—the amounts of interest, face amount, or both, or (iii) *both* timing and amounts of cash to be received or paid.

.114 Two major issues arise in accounting for an existing debt whose terms are modified in a troubled debt restructuring. One issue involves whether to: (a) continue the same recorded invest-

ment for the receivable or carrying amount for the payable and recognize the effects of the new terms prospectively as reduced interest income or expense or (b) recognize a loss or gain by changing the recorded amount. The interest method (paragraph .109) is used in both (a) and (b) to allocate interest income or expense to periods between restructuring and maturity, but in general, the implicit annual interest rate will be higher, and the resulting interest income or expense will be larger in each of the remaining periods, if a loss (creditor) or gain (debtor) is recognized at the time of a troubled debt restructuring, as in (b), than if the effects of the new terms are recognized prospectively, as in (a).

.115 The other issue involves two related questions: Should the same accounting (either (a) or (b) in paragraph .114) apply both to modifications of *timing* and to modifications of *amounts* to be received or paid under the agreement? And should the same accounting apply both to modifications of *interest* and to modifications of *face amount*? The following paragraphs explain and illustrate those issues and summarize the arguments advanced for various proposed solutions.

.116 Modifications of terms that affect only the *timing* of amounts to be received or paid do not change the total amount to be received or paid. However, changes in timing of the amounts to be received or paid on a debt change its present value determined by discounting at the prerestructuring effective interest rate or a current market interest rate or change the effective interest rate needed to discount the amounts to the prerestructuring present value (recorded investment in receivable or carrying amount of payable) or market value. Modifications that affect only the *amount* of interest or face amount (or both unless they are exactly offsetting) to be received or paid change total amounts as well as present values, effective interest rates, or both. Modifications of *both timing and amount* to be received or paid combine those effects. A hypothetical case illustrates those kinds of modifications and their effects.

.117 A creditor holds a receivable calling for receipt of $100 at the end of each year for five more years and receipt of the $1,000 face amount at the end of those five years. The stated interest rate is 10 percent, compounded annually. The recorded investment in the receivable is $1,000, and the effective annual interest rate implicit in the investment is also 10 percent. If all amounts are received as agreed, the creditor will receive total interest income of $500—the difference between the total amount to be received ($1,500) and the recorded investment in the receivable ($1,000)—

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and the effective interest rate on the $1,000 investment will be 10 percent. However, the terms of the receivable are to be modified in a troubled debt restructuring. The four modifications that follow are examples of the three kinds of modifications described in paragraphs .113 and .116 (change in amount of interest and change in face amount are both illustrated; change in timing of face amount raises no issues different from change in timing of interest and is not illustrated):

1. *Timing of interest only*—Terms modified to defer collection of interest until the receivable matures (a single collection of $500 at the end of five years is substituted for five annual collections of $100).

2. *Amount of interest only*—Terms modified to leave unchanged the timing of interest and the timing and amount of the face amount but reduce the annual interest from $100 to $60.

3. *Amount of face amount only*—Terms modified to leave unchanged the amounts and timing of interest but reduce the face amount to $800 due at the end of five years.

4. *Both timing of interest and amount of face amount*—Terms modified to defer collection of interest until the receivable matures and reduce the face amount to $800 (modifications 1 and 3 combined).

.118 The following chart lists several factual observations that can be made about the effects on the creditor's receivable of each of those restructurings. In general, the same observations apply to the debtor's payable.

	Before Modification
Observation:	
a. Amount by which total cash receipts specified by the terms exceed recorded investment in the receivable:	
Interest	$ 500
Face amount	1,000
Total cash receipts	$1,500
Recorded investment	1,000
Excess of specified cash receipts over recorded investment	$ 500
b. Effective interest rate on the recorded investment ($1,000)	10.0%
c. Present value of the total cash receipts discounted at the prerestructuring effective interest rate (10%)	$1,000
d. Present value of the total cash receipts discounted at the current market interest rate (assumed to be 12%)	$ 928
e. Face amount specified by the terms	$1,000

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Modification 1 (Timing Only)	Modification 2 (Amount of Interest Only)	Modification 3 (Amount of Face Amount Only)	Modification 4 (Timing and Amount)
$ 500	$ 300	$ 500	$ 500
1,000	1,000	800	800
$1,500	$1,300	$1,300	$1,300
1,000	1,000	1,000	1,000
$ 500	$ 300	$ 300	$ 300
8.5%	6.0%	6.5%	5.4%
$ 931	$ 848	$ 876	$ 807
$ 851	$ 784	$ 814	$ 738
$1,000	$1,000	$ 800	$ 800

Alternatives Considered

.119 Proposals for accounting for troubled debt restructurings tend to focus on the various observations (paragraph .118) about the effects of modifying the terms of a debt.

a. Some respondents focused on the effect of a troubled debt restructuring on the effective interest rate (observation (b)). They would not reduce the recorded investment in a receivable or carrying amount of a payable and recognize a loss (creditor) or gain (debtor) as long as the new terms did not result in a negative effective interest rate on the recorded investment or carrying amount—that is, as long as the total future cash receipts or

payments specified by the new terms (including both amounts designated as interest and the amount designated as face amount) at least equaled the recorded investment or carrying amount (observation (a)). Thus, they would recognize no loss or gain for any of the four modifications in the illustration in paragraphs .117 and .118.

b. Some respondents focused on the effect of a troubled debt restructuring on the face amount of the debt (observation (e)). They would not reduce the recorded investment in a receivable or carrying amount of a payable as long as the restructuring modified only the timing or amount of designated interest or the timing of the designated face amount, but would recognize a loss (creditor) or gain (debtor) if restructuring reduced the face amount of the debt. Thus, they would recognize a loss or gain for modifications 3 and 4 in the illustration.

c. Some respondents focused on the effect of a troubled debt restructuring on the present value of the debt discounted at the effective interest rate before restructuring (observation (c)). They would reduce the recorded investment in a receivable or carrying amount of a payable to the present value of the total future cash receipts or payments under the new terms discounted at the prerestructuring effective interest rate and recognize a loss (creditor) or gain (debtor) equal to the reduction. Thus, they would recognize a loss or gain for each of the modifications in the illustration.

d. Some respondents focused on the fair or market value of the debt after a troubled debt restructuring. They would account for each restructuring as an exchange of debt, recording a new receivable or payable at its fair or market value and recognizing a loss (creditor) or gain (debtor) for the difference between that fair or market value and the recorded investment or carrying amount of the receivable or payable replaced. Thus, they would recognize a loss or gain for each of the modifications in the illustration.

The following paragraphs summarize those four views and their variations.

Change in Effective Rate View

.120 Some respondents emphasized that, in the absence of a transfer of resources or obligations, the existing accounting framework does not require losses to be recognized or permit gains to be

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recognized because of events that affect only future profitability of an investment but do not affect the recoverability of the investment itself. They contended that applying that principle to troubled debt restructurings means that no loss or gain should be recognized on a debt because of modification of terms of debt unless part of the recorded investment in a receivable is not recoverable or part of the carrying amount of a payable will not be paid under the new terms. In their view, a creditor should recognize a loss to the extent that the total future cash receipts specified by the new terms is less than the recorded investment in the receivable, and a debtor should recognize a gain to the extent that the total future cash payments specified by the new terms is less than the carrying amount of the payable.

.121 According to that view, if the recorded investment in a receivable is recoverable or the carrying amount of a payable is to be paid under the new terms,[34] interest income or expense is allocated to the periods between restructuring and maturity of the debt by using the reduced effective interest rate that is implicit in the difference between the recorded investment or carrying amount before (and after) restructuring and the future cash receipts or payments specified by the new terms. If a loss or gain is recognized at the time of restructuring, the recorded investment or carrying amount equals the total future cash receipts or payments, and no interest income or expense is allocated to the remaining periods between restructuring and maturity.

.122 Some of those respondents contended that the amount invested by a creditor in a receivable has some of the characteristics of, and is analogous to, an investment in plant, property, intangibles, and similar assets sometimes called "capital assets." According to that analogy, modifying the terms of receivables in troubled debt restructurings is similar to modifying selling prices of products produced by those capital assets; the modifications affect the profitability of those assets but are not recorded in the existing accounting framework unless they result in an inability to recover the investment in the assets. That capital asset analogy leads its proponents to accounting for troubled debt restructurings that is essentially the same as that described in paragraphs .120 and .121.

.123 Certain respondents who supported the views described in paragraphs .120-.122 argued that the resulting accounting not only is required by the existing accounting framework but also accur-

[34] The likelihood of collection of the amounts specified by the new terms of a receivable should, of course, be assessed in determining allowances for estimated uncollectible amounts.

ately describes a troubled debt restructuring involving only modification of terms. They held that, unless the effective interest rate on a debt becomes negative in a troubled debt restructuring, the essential effect of modifying terms is to reduce the effective interest rate on the debt—that is, to decrease the effective rate of return to the creditor and to decrease the effective cost to the debtor of deferring payment. For example, some responding financial analysts argued that to disclose the creditor's new effective interest rate on restructured receivables would be more useful for their purposes than for the creditor to report a loss on restructuring and then show those receivables to be earning the prerestructuring interest rate, the current market interest rate, or some other rate higher than the effective rate on the recorded investment in a receivable before restructuring.

.124 According to respondents who emphasized the effect of a troubled debt restructuring on the effective interest rate, there is no economic basis for distinguishing modifications of future cash receipts or payments designated as interest from modifications of future cash receipts or payments designated as face amount. They argued that a creditor in a troubled debt restructuring attempts first to assure recovery of its investment (which is represented in its financial statements by the recorded investment in the receivable) and then to obtain the highest interest income commensurate with the situation. Whether the amounts to be received under the new terms are designated as receipts of interest or receipt of face amount is a minor consideration; the significant question is whether the new terms allow the creditor to recover its investment.

.125 According to that view, since numerous combinations of receipts or payments designated as interest and face amount can be structured to produce a particular present value or effective interest rate, to base accounting on that distinction is likely to result in questionable, if not indefensible, financial reporting. The creditor in a troubled debt restructuring may have considerable flexibility in designating a proportion of the future receipts or payments under the new terms as interest and designating another proportion as face amount. If those designations were to dictate the accounting, a creditor desiring to recognize a loss on restructuring and to recognize higher interest income for later periods could restructure terms in one way, while a creditor desiring to avoid recognizing a loss on restructuring and to recognize lower interest income for later periods could restructure the terms in another way, even though the underlying cash receipts specified by the new terms were the same, both in timing and amount, for both creditors. A creditor desiring to recognize a gain on restructuring could conceivably in-

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crease the amount designated as face amount to an amount higher than the present recorded investment and reduce the amounts designated as receipt of interest; a debtor might agree to that arrangement if it were financially troubled at the time of restructuring but expected to be able to pay the higher face amount later.

Change in Face Amount View

.126 Some respondents distinguished modifications of face amounts from modifications affecting only amounts or timing of receipts or payments designated as interest or timing of the maturity date. They would neither reduce recorded investment in a receivable or carrying amount of a payable nor recognize loss or gain in a troubled debt restructuring if a modification of terms of a debt changed only the *amounts or timing* of receipts or payments designated as interest or changed the *timing* of receipts or payments designated as face amount. They held, however, that if a troubled debt restructuring *reduces the face amount* of a debt, the creditor should recognize a loss, and the debtor should recognize a gain.[35]

.127 To record a modification of terms involving reduction of face amount of a debt, proponents of that view would reduce the recorded investment in the receivable or carrying amount of the payable by the same proportion as the reduction of the face amount and recognize a loss (creditor) or gain (debtor) for that amount. If the restructuring changed the effective interest rate on the remaining recorded investment or carrying amount, they would allocate interest income or expense to the remaining periods between restructuring and maturity using that new effective interest rate. That rate would be implicit in the difference between the new recorded investment in the receivable or carrying amount of the payable and the future cash receipts or payments specified by the new terms. That rate would be higher for a debt whose face amount had been reduced, and would therefore result in more interest income or expense for those periods, than the rate described in paragraph .121.

.128 Respondents who distinguished between modifications of terms that change the face amount of a debt and other kinds of modifications generally agreed with the view expressed in paragraphs .120 and .122 that the existing accounting framework does not recognize losses or gains from events that change the profitability of existing assets but requires a loss to be recognized if the event causes part or all of an investment in an asset to become un-

[35] Some proponents of this view opposed recognizing gains from troubled debt restructurings not involving transfers of assets or grants of equity interests.

recoverable. Those respondents gave several reasons for concluding that reduction of face amount of a debt in a troubled debt restructuring requires proportionate reduction of the recorded investment in the receivable or carrying amount of the payable and recognition of a resulting loss or gain.

.129 Some respondents who favored accounting based on a distinction between modifications of face amount and other modifications argued that to the extent that the face amount of a debt is reduced, the debtor-creditor relationship has been terminated, and the accounting should recognize that termination. In other words, the face amount adjusted by a premium or discount, if any, measured in the market at the time a receivable or payable was created is recognized in the existing accounting framework as an asset for the creditor or liability for the debtor; reducing that face amount therefore reduces an asset or liability proportionately, and the reduction must be recognized. In their view, to the extent the face amount is reduced, a transfer of resources or obligations occurs.

.130 Some respondents described the analogy between a creditor's investment in a receivable and an investment in "capital assets" that is noted in paragraph .122 and contended that reductions of face amounts of receivables in troubled debt restructurings are analogous to events that reduce the amount, rather than the future profitability, of capital assets. Both they and the respondents whose view is described in the preceding paragraph held that the act of reducing the face amount showed that the creditor and debtor agreed that the receivable and payable had been decreased.

.131 Some respondents contended in effect that accounting for receivables and payables in the existing accounting framework is based on the face amount of a receivable or payable, or perhaps on the face amount plus a premium or minus a discount at the date of acquisition or issue, and a change in the face amount is a change in an asset (receivable) or liability (payable). They implicitly assumed or concluded that the present value concepts described in the pronouncements noted in paragraphs .111 and .112 did not apply to receivables or payables involved in troubled debt restructurings. Thus, they contended that the distinction between the face amount due at maturity and the amounts designated as interest to be received or paid periodically until maturity is vital in determining proper accounting for a troubled debt restructuring. According to that view, the face amount due at maturity (sometimes referred to as the "principal") is the basis of the recorded investment in a receivable or carrying amount of a payable; that investment or carrying amount does not include the present

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value of future receipts or payments designated as interest. That is, a creditor or debtor records the face amount (perhaps increased by premium or decreased by discount) when a receivable is obtained or a payable is incurred, and no value is ascribed in the accounts to rights to receive or obligations to pay amounts designated as interest; rather, cash receipts or payments designated as interest are recognized in the accounts only as they become receivable or payable in future periods. Some respondents holding that view added that to record a loss (creditor) or gain (debtor) because future cash receipts or payments designated as interest are modified in a troubled debt restructuring would represent abandonment of the existing historical cost framework and constitute piecemeal implementation of current value accounting.

.132 Several respondents who supported the views described in paragraphs .126-.131 held that the accounting required by those views is presently used, at least by some financial institutions. Some banker respondents indicated that troubled debt restructurings involving reductions in face amount or "principal" are exceedingly rare, but that most bankers would probably recognize a loss of "principal" in recording one in which their institution was the creditor.

.133 Differences between the view that focuses on the effect of a troubled debt restructuring on face amount (paragraphs .126-.132) and the view that focuses on its effect on the effective interest rate (paragraphs .120-.125) pertain wholly to troubled debt restructurings that reduce the amount designated as face amount. Both views lead to the same accounting for troubled debt restructurings involving other kinds of modification of terms.

Present Value at Prerestructuring Rate View

.134 Some respondents contended that accounting for troubled debt restructurings should recognize the revised pattern of cash receipts or payments under the new terms of the restructured debt. That is, they would continue to use the effective interest rate established when the receivable was acquired or payable was incurred and would reduce the recorded investment or carrying amount to the present value of the future cash receipts or payments specified by the new terms.

.135 Those respondents in effect supported the accounting proposed in the FASB Exposure Draft, "Restructuring of Debt in a Troubled Loan Situation" (November 7, 1975): a debtor should account for a troubled debt restructuring that involves modification of terms of debt by adjusting the carrying amount of the payable

to the present value of the cash payments (both those designated as interest and those designated as face amount) required of the debtor after restructuring, discounted at the prerestructuring effective interest rate, and recognizing a gain on restructuring of the payable equal to the difference, if any, between that present value and the carrying amount of the payable before restructuring (paragraph 6 of that Exposure Draft). Since a troubled debt restructuring almost invariably involves stretching out or deferring the debtor's payments, and may involve reducing amounts due as well, the present value of a restructured payable is almost invariably less than its carrying amount (both are determined by discounting at the same interest rate); a debtor would thus normally recognize a gain on the restructuring. The November 7, 1975 Exposure Draft dealt only with accounting by debtors, but if the counterpart accounting were adopted by creditors, the creditor would normally recognize a loss equal to the difference between its recorded investment in the receivable before restructuring and the present value at the prerestructuring effective interest rate. Interest expense or income in future periods would continue to be based on the prerestructuring interest rate.

.136 Some respondents who held the view described in paragraphs .134 and .135 agreed with the view in paragraphs .124 and .125 that no economic basis exists for distinguishing between modifications of face amounts and other kinds of modifications. The major difference between the two views is that the accounting for one view (paragraphs .134 and .135) retains the same effective interest rate as before restructuring and changes the present value of the future cash receipts or payments specified by the new terms, while the other view (paragraphs .124 and .125) retains the same present value as before restructuring (the recorded investment in a receivable or carrying amount of a payable)[36] and changes the effective interest rate for the periods remaining between restructuring and maturity.

Fair Value View

.137 Some respondents contended that modifying terms in a troubled debt restructuring results in an exchange of new debt for the previous debt. The new debt should be recorded at its fair value—usually the present value of the future cash receipts or payments specified by the new terms (whether designated as interest or face amount) discounted at the current market rate of interest for receivables or payables with similar terms and risk

[36] Unless the restructuring causes the effective interest rate to fall below zero.

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characteristics. Those respondents contended that every debt restructuring is an exchange transaction (paragraph .068), and they would recognize a loss (creditor) and gain (debtor) to the extent of the difference between the recorded investment in the receivable or carrying amount of the payable before restructuring and the fair value of the receivable or payable after restructuring. Interest income and expense in future periods would be based on the market rate of interest at the time of restructuring.

.138 Respondents who supported the view just described agreed that designations of amounts as face amount or interest should not determine whether a loss or gain should be recognized (paragraphs .124 and .125) because only the amounts and timing of cash receipts or payments, and not their names, affect the present value of a receivable or payable. They disagreed with other respondents by contending that the current market interest rate—which gives the fair value of a receivable or payable—should be used because an exchange transaction had occurred.[37]

.139 Some of the responding financial analysts indicated a preference for accounting that does not use a current interest rate to determine whether a creditor should recognize a loss in a troubled debt restructuring involving modification of terms. According to them, to use a current interest rate to discount future cash receipts only for receivables that have been restructured would not result in meaningful information about the earning potential of a creditor's entire loan or investment portfolio and might be confusing because receivables that were not restructured would continue to reflect the various historical interest rates at the time of each investment.

Conclusions on Modification of Terms

.140 After considering the information received in connection with (i) the Exposure Draft, "Restructuring of Debt in a Troubled Loan Situation" (November 7, 1975), and the public hearing based on it (paragraph .048), (ii) the Discussion Memorandum, "Accounting By Debtors and Creditors When Debt Is Restructured" (May 11, 1976), and the public hearing based on it (paragraph .052), and (iii) the Exposure Draft, the Board concluded that the substance of all modifications of a debt in a troubled debt restructuring is essentially the same whether they are modifications of

[37] Some respondents contended that the fair value of the receivable or payable after restructuring should be measured by discounting the future cash flows specified by the new terms at the cost of capital to the creditor or debtor, as appropriate.

timing, modifications of amounts designated as interest, or modifications of amounts designated as face amounts. All of those kinds of modifications affect future cash receipts or payments and therefore affect (a) the creditor's total return on the receivable, its effective interest rate, or both and (b) the debtor's total cost on the payable, its effective interest rate, or both. The Board believes that accounting for restructured debt should be based on the substance of the modifications—the effect on cash flows—not on the labels chosen to describe those cash flows.

.141 The Board thus rejected views that modifications involving changes in face amounts should be distinguished from and accounted for differently from modifications involving amounts of future cash receipts or payments designated as interest and modifications involving timing of future cash receipts or payments. The major reason for that rejection is given in the preceding paragraph: the substance of a troubled debt restructuring lies in its effect on the *timing and amounts* of cash receipts or payments due in the future. Whether an amount due at a particular time is described as face amount or interest is of no consequence to either the present value of the receivable or payable or its effective interest rate.

.142 The Board considered the views described in paragraphs .129-.132 and rejected them to the extent they conflict with the Board's conclusions. In the Board's view, a debtor-creditor relationship is described by the entire agreement between the debtor and creditor and not merely by the face amount of the debt. Changes in that relationship therefore encompass changes in timing and changes in amounts designated as interest as well as changes in an amount designated as face amount. The same reasoning applies to the analogy between debt and investment in "capital assets." A reduction in a troubled debt restructuring of an amount designated as face amount is not, in the Board's view, analogous to the loss or destruction of a portion of a capital asset. Indeed, the economic impact of reducing an amount designated as face amount is essentially the same as that of reducing by the same amount an amount designated as interest that is due at the same time. Thus, although an analogy between investment in a receivable and investment in a capital asset may have merit, an analogy between an amount designated as the face amount of a receivable and the physical entirety of a capital asset does not.

.143 The Board also rejected the view that accounting is based on the face amount or "principal" in the existing accounting framework. That view is not consistent with the weight of the pro-

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nouncements noted in paragraphs .111 and .112 to the effect that the recorded investment in a receivable or carrying amount of a payable is the present value of the future cash receipts or payments specified by the terms of the debt discounted at the effective interest rate that is implicit in the debt at its inception. That accounting explicitly excludes from the recorded investment in a receivable or carrying amount of a payable the interest income or expense to be recognized in future periods. The interest method recognizes that interest income or expense as a constant percent (the effective interest rate) of the recorded investment or carrying amount at the beginning of each future period as the interest income or expense becomes receivable or payable. The method is not a "current value method" as that term is generally used in the accounting literature, unless the effective interest rate used to determine present value and interest income or expense each period is the current market interest rate for the period.

.144 The Board noted the argument that current practice in some financial institutions is to record losses based on reductions in troubled debt restructurings of amounts designated as face amount. The Board also noted that several respondents indicated that modifications of terms of that kind almost never occur. Presumably, a creditor would generally prefer to alleviate the debtor's cash difficulties by deferring payment of the amount designated as face amount rather than by reducing it because deferring payment preserves a creditor's maximum claim in the event of the debtor's bankruptcy. The Board decided that accounting for reductions in troubled debt restructurings of amounts designated as face amounts, although occurring only rarely, should be made consistent with accounting for other modifications of future cash receipts or payments in troubled debt restructurings and with the accounting pronouncements referred to in paragraphs .111 and .112.

.145 The Board also considered the views described in paragraphs .134-.139 and rejected them to the extent they conflict with the Board's conclusions. The Board concluded that since a troubled debt restructuring involving modification of terms of debt does not involve transfers of resources or obligations (paragraph .077), restructured debt should continue to be accounted for in the existing accounting framework, on the basis of the recorded investment in the receivable or carrying amount of the payable before the restructuring. The effective interest rate on that debt should be determined by the relation of the recorded investment in the receivable or carrying amount of the payable and the future cash receipts or payments specified by the new terms of the debt.

.146 To introduce the current market interest rate to provide a new measure of the recorded investment in a restructured receivable or carrying amount of a restructured payable is inappropriate in the existing accounting framework in the absence of a transfer of resources or obligations, that is, if only the terms of a debt are modified in a troubled debt restructuring. Moreover, since the new terms are not negotiated on the basis of the current market rates of interest, there is little or no reason to believe that a current market rate of interest applied to the restructured debt reflects the effective return to the creditor or the effective cost to the debtor. On the contrary, the circumstances of a troubled debt restructuring give every reason to believe that, except by coincidence, it does not. Similarly, there is little or no reason to believe that a restructured debt continues to earn or cost the same effective interest rate as before the restructuring. The restructuring reflected the creditor's recognition that its investment in the receivable no longer could earn that rate and that a lower effective rate was inevitable. In other words, the effect of the restructuring was to decrease the effective interest rate on a continuing debt, and the accounting should show that result.

.147 The Board found persuasive the arguments that a creditor in a troubled debt restructuring is interested in protecting its unrecovered investment (represented in the accounts by the recorded investment in the receivable) and, if possible, obtaining a return. To the creditor, therefore, the effect of a restructuring that provides for recovery of the investment is to reduce the rate of return (the effective interest rate) between the restructuring and maturity. Similarly, the effect of that kind of restructuring to the debtor is to reduce the cost of credit (the effective interest rate) between the restructuring and maturity.

.148 Thus, the Board concluded that no loss (creditor) or gain (debtor) should be recognized in a troubled debt restructuring if the total future cash receipts or payments (whether designated as interest or face amount) specified by the new terms at least equals the recorded investment or carrying amount of the debt before the restructuring. The creditor should reduce the recorded investment in the receivable and recognize a loss and the debtor should reduce the carrying amount of the payable and recognize a gain to the extent that the recorded investment or carrying amount exceeds the total cash receipts or payments specified by the new terms. Some respondents to the Exposure Draft apparently misunderstood the reason for using *total* future cash receipts or payments to compare with the recorded investment in a receivable or the carrying amount of a payable to determine whether to recognize

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a loss or gain on restructuring. Some wondered if the failure to discount the future cash flows implied changes in pronouncements that require discounting or de-emphasis or abandonment by the Board of discounting methods. On the contrary, the Statement is based solidly on the need to consider the effect of interest. Indeed, the Board's conclusion is that a troubled debt restructuring affects primarily the effective interest rate and results in no loss or gain as long as the effective rate does not fall below zero. It requires recognition of a loss to prevent the effective rate from falling below zero. The effective interest rate inherent in the unrecovered receivable or unpaid payable and the cash flows specified by the modified terms is then used to recognize interest income or interest expense between restructuring and maturity.

.149 The Board also concluded that the fair values of assets transferred or equity interest granted in partial settlement of debt in a troubled debt restructuring should be accounted for the same as a partial cash payment. The recorded investment in the receivable or carrying amount of the payable should be reduced by the amount of cash or fair value transferred, and the remaining receivable or payable should be accounted for the same as a modification of terms. That accounting avoids basing losses or gains on restructuring on arbitrary allocations otherwise required to determine the amount of a receivable satisfied or payable settled by transfer of assets or grant of an equity interest.

.150 Several respondents to the Exposure Draft disagreed with its proposed conclusions on accounting for modifications of terms in troubled debt restructurings. One group, which favored accounting for all troubled debt restructurings at fair value as exchanges of debt, criticized the Exposure Draft for failing to recognize losses and gains from decreases in present values of receivables and payables, for being inconsistent with *APB Opinions No. 21* [section 4111] and *No. 26* [section 5362], and for elevating form over substance. Another group, which agreed with the Exposure Draft except for restructurings in which face amounts of receivables are reduced, criticized it for failing to recognize losses and gains from decreases in face amounts, for changing existing practice, and for elevating form over substance. Both views are discussed individually in earlier paragraphs (.126-.139) and are there shown to be virtually opposite views to each other, but they have some similarities when compared to the accounting in the Exposure Draft and this Statement.

.151 For example, both criticisms of the Exposure Draft noted in the preceding paragraph result from rejection of fundamental

conclusions in the Exposure Draft. Thus, respondents who favor accounting for all troubled debt restructurings as exchanges of debt disagreed with the conclusions that "a troubled debt restructuring that does not involve a transfer of resources or obligations is a continuation of an existing debt" and "to the extent that a troubled debt restructuring involves only a modification of terms of continuing debt, no transfer of resources or obligations has occurred (paragraphs .076 and .077). Respondents with that view presumably saw troubled debt restructurings as of the same essence as exchanges covered by *APB Opinions No. 21* [section 4111] and *No. 26* [section 5362] and found the Exposure Draft inconsistent with those Opinions. If, however, the conclusions quoted earlier in this paragraph are accepted, modifications of terms of continuing debt are different in substance from exchanges of resources or obligations, and the Exposure Draft is consistent with the Opinions.

.152 Similarly, some respondents who favor recognizing losses and gains from reducing face amounts in troubled debt restructurings disagreed with the conclusion that "the substance of all modifications of a debt in a troubled debt restructuring is essentially the same whether they are modifications of timing, modifications of amounts designated as interest, or modifications of amounts designated as face amounts" (paragraph .140). That is, they think that financial institutions' customary distinctions between principal and interest have more substance than the effects of modifications on future cash flows, although they admit that changes in practice would be minimal because few troubled debt restructurings involve changes in face amounts (paragraph .144).

.153 The fact that elevating form over substance is a criticism common to the arguments of respondents who fundamentally disagreed with the Exposure Draft emphasizes that various views on proper accounting depend on varying perceptions of the substance of modification of terms in a troubled debt restructuring. The preceding paragraphs note three different views of that substance: the view on which the Exposure Draft and this Statement are based and two other views that differ significantly not only from the view adopted but from each other. The Board carefully analyzed all three views before issuing the Exposure Draft and decided on one of them for the reasons stated in paragraphs .106-.152.

.154 Some respondents who agreed generally with the accounting for modifications of terms specified in the Exposure Draft and some who preferred to recognize debtors' gains and creditors' losses from decreases in face amounts expressed concern that a debtor's prepayment may result in recognizing a creditor's loss in the

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wrong period (they are silent about a debtor's gain). That is, if a debtor may prepay a reduced face amount without penalty, total future cash receipts may actually be less than the recorded investment in the receivable even though the total future amounts specified by the restructured terms are at least equal to the recorded investment, and no loss is recognized by the creditor at the time of restructuring under paragraph .016. The loss would be recorded in the period of prepayment rather than the period of restructuring. They propose that a creditor be required to recognize a loss on restructuring in the period of restructuing to the extent that a reduction of face amount is not protected by a prepayment penalty.

.155 This Statement does not include that kind of test based on prepayment penalties. The proposed test rests on the assumption that a loss resulting from prepayment necessarily is a loss on restructuring, and that presumption is questionable. At the time of restructuring, the most probable estimate of future cash receipts is usually that the debtor will not prepay, even if there is no prepayment penalty, because (a) prepayment of a debt with a relatively low effective interest rate is to the creditor's advantage, not the debtor's, (b) initiative for prepayment lies wholly with the debtor, and (c) the debtor is clearly unable to prepay at the time of a troubled debt restructuring and may never be able to prepay. If that most probable estimate later proves incorrect, and the debtor does prepay, a change of estimate should be recorded in the period of prepayment.

CREDITOR'S ACCOUNTING FOR SUBSTITUTION OR ADDITION OF DEBTORS

.156 A change between the Exposure Draft and this Statement is that the Exposure Draft dealt with substitutions of debtors only if the debtors were government units. Several respondents to the Exposure Draft suggested that the principles developed there applied to substitutions or additions of nongovernment debtors as well.

.157 The general principle developed in earlier paragraphs is that the accounting for a troubled debt restructuring depends on its substance. The issues raised if a creditor in a troubled debt restructuring accepts, or is required to accept, a new receivable from a different debtor to replace an existing receivable from a debtor experiencing financial difficulties pertains to the circumstances, if any, in which the substitution or addition is in substance similar to a transfer of assets to satisfy a receivable and the circumstances, if any, in which that kind of restructuring is in substance similar to a modification of terms only.

.158 One view expressed by respondents was that the substitution of a receivable from a different debtor for an existing receivable or the addition of another debtor is always a transaction requiring accounting by the creditor for a new asset at its fair value, recognizing gain or loss to the extent that the fair value of the new asset differs from the recorded investment in the receivable it replaces. To some proponents, that view holds regardless of the relationship between the original debtor and the new debtor.

.159 Another view expressed was that the kind of substitution involved in each restructuring must be considered, and the accounting depends on the relationship between the original and new debtors and between the original and new terms.

.160 The Board rejected the view that the substitution or addition of a new debtor is always a transaction requiring recognition of a new asset by the creditor. In some troubled debt restructurings, the substitution or addition may be primarily a matter of form while the underlying debtor-creditor relationship, though modified, essentially continues. For example, to enhance the likelihood that the modified terms of a troubled debt restructuring will be fulfilled, a new legal entity may be created to serve as a custodian or trustee to collect designated revenues and disburse the cash received in accordance with the new debt agreement. The role of that new unit may be similar to that of a sinking fund trustee in an untroubled debt situation. The source of the funds required to fulfill the agreement may be the same, but some or all of those funds may be earmarked to meet specific obligations under the agreement. Similarly, if the new debtor controls, is controlled by, or is under common control with the original debtor, the substance of the relationship is not changed. Each troubled debt restructuring involving a substitution or addition of a debtor should be carefully examined to determine whether the substitution or addition is primarily a matter of form to facilitate compliance with modified terms or primarily a matter of substance.

.161 The Board considers the exchanges of bonds of the Municipal Assistance Corporation (Corporation) for notes of the City of New York (City) described in recent exchange offers[38] to be examples of troubled debt restructurings whose substance to creditors for accounting purposes is a modification of the terms of an existing receivable rather than an acquisition of a new asset (receivable). According to those exchange offers:

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[38] Municipal Assistance Corporation for the City of New York, "Exchange Offer[s] to Holders of Certain Short-Term Notes of the City of New York," November 26, 1975, May 21, 1976, and March 22, 1977.

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> The Corporation . . . was created in June 1975 . . . for the purposes of assisting the City in providing essential services to its inhabitants without interruption and in creating investor confidence in the soundness of the obligations of the City. To carry out such purposes, the Corporation is empowered, among other things, to issue and sell bonds and notes and to pay or lend funds received from such sale to the City and to exchange the Corporation's obligations for obligations of the City.[39]

The Board's understanding is that: (a) the Corporation receives its funds to meet debt service requirements and operating expenses from tax allocations from New York State's collections of Sales Taxes imposed by the State within the City, Stock Transfer Taxes, and Per Capita Aid (revenue sources previously available to the City); (b) Tax and Per Capita Aid amounts not allocated to the Corporation for its requirements are available to the City under the terms of the applicable statutes; and (c) the primary purpose in creating the Corporation was to enhance the likelihood that the City's debt will be paid, not to introduce new economic resources and activities.

RELATED MATTERS

.162 Several respondents commenting on accounting for contingent future cash payments or receipts indicated a need for some clarification of the accounting described in the Exposure Draft. Accounting for contingent payments or receipts is complicated because it involves four separate situations—(1) accounting by the debtor at the time of restructuring, (2) accounting by the debtor after the time of restructuring, (3) accounting by the creditor at the time of restructuring, and (4) accounting by the creditor after the time of restructuring. It is further complicated because the view of both debtor and creditor shifts between "gain" contingencies and "loss" contingencies as the accounting shifts from the time of restructuring to after the time of restructuring. The accounting in the Exposure Draft and this Statement is governed by the following general principles:

a. Paragraph 17 (gain contingencies) of *FASB Statement No. 5* [section 4311.17] governs a debtor's accounting for contingent cash payments at the time of restructuring (paragraph .018) and a creditor's accounting for contingent cash receipts after the time of restructuring (paragraph .036). Since gain contingencies are not recognized until a gain is realized, (1) a *debtor* should not recognize a gain at the

[39] Municipal Assistance Corporation for the City of New York, "Exchange Offer to Holders of Certain Short-Term Notes of the City of New York," November 26, 1975, p. 15.

time of restructuring that may be offset by future contingent payments, which is equivalent to assuming that contingent future payments will be paid, and (2) a *creditor* should not recognize contingent cash receipts as interest income until they become unconditionally receivable, that is, until both the contingency has been removed and the interest has been earned.

b. Paragraph 8 (loss contingencies) of *FASB Statement No. 5* [section 4311.08] governs a debtor's accounting for contingent cash payments after the time of restructuring (paragraph .022) and a creditor's accounting for contingent cash receipts at the time of restructuring (paragraph .032). Since two conditions must be met to recognize an estimated loss, (1) a *debtor* should recognize an interest expense and payable for contingent payments when it is probable that a liability has been incurred and the amount can be reasonably estimated, and (2) a *creditor* should recognize a loss unless offsetting contingent cash receipts are probable and the amount can be reasonably estimated. Contingent cash receipts are unlikely to be probable at the time of restructuring.

.163 The principles described in the preceding paragraph also apply to other situations in which future cash payments or receipts must be estimated to apply the provisions of the Statement, for example, future interest payments or receipts that are expected to fluctuate because they are based on the prime interest rate or indeterminate total interest payments or receipts because the debt is payable or collectible on demand or becomes payable or collectible on demand after a specified period (paragraphs .018 and .032).

DISCLOSURE

Disclosure by Debtors

.164 Most respondents to the Discussion Memorandum commenting on disclosure by debtors for restructurings advocated essentially the disclosure prescribed for gains or losses from extinguishment of debt in *FASB Statement No. 4* [section 2013]. Paragraph .099 gives the Board's reasons for adopting for gains on troubled debt restructurings the guidelines for income statement classification prescribed in that Statement for gains from extinguishment of debt. Since troubled debt restructurings for which gains are recognized and extinguishments of debts thus use the same guidelines for income statement

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classification and are similar for disclosure purposes, the Board concluded that the kind of information prescribed in paragraph 9 of *FASB Statement No. 4* [section 2013.09] is generally appropriate for disclosing troubled debt restructurings involving recognition of gains. Since some of those restructurings involve transfers of assets to creditors to settle payables, the Board believes that it is appropriate also to disclose the aggregate net gain or loss recognized on transfers of assets. However, since several respondents to the Exposure Draft indicated that problems would arise in attempting to determine when a debtor's current difficulties began and perhaps in obtaining amounts of earlier losses, this Statement omits a requirement in the Exposure Draft to disclose also "the aggregate loss, if any, recognized on those assets in earlier periods in connection with the debtor's current financial difficulties."

.165 Restructurings not involving recognition of gain or loss at the time of restructuring usually modify the timing, amounts, or both, of interest or face amount the debtor is to pay under the debt's terms (paragraphs .016-.018). In the Board's view, the principal changes in terms should be disclosed to permit an understanding of the financial effects of those modifications.

.166 Paragraph .026, specifying disclosure of the extent to which inclusion of contingent future cash receipts prevented recognizing a gain on restructuring was added in response to suggestions by respondents to the Exposure Draft. The Board agreed that information would be useful in assessing the relation between future cash payments and future interest expenses of the debtor.

Disclosure by Creditors

.167 Most banking and other financial institutions responding to the Discussion Memorandum that commented on disclosure by creditors argued against separate disclosures about restructured receivables. They emphasized that to be the most meaningful to financial statement users information about receivables should disclose the interest rate characteristics of each broad group of earning assets (primarily loan or investment portfolios), by major category. They argued that information limited to receivables that have been restructured would not only be less meaningful than information about entire portfolios of receivables but also could be confusing because the same information is also needed about other receivables, particularly those that are earning no return but have not been restructured (nonearning receivables). Several of those institutions referred to the requirements of the Securities and Exchange Commission and of the banking regulatory agencies,

which recently became effective, both concerning disclosure about categories of loan and investment portfolios—including their maturities, interest rates, and nonearning loans and investments—and the allowance for uncollectible amounts. They indicated that those requirements provide adequate information about the financial effects of restructurings, troubled or nontroubled. Financial analysts responding also recommended disclosure focusing on the characteristics of each broad group of earning assets. They expressed a desire for information about past and expected yields of entire portfolios, by major category, to enable them to make informed judgments about recent and prospective earnings performance.

.168 Some respondents to the Discussion Memorandum that are not financial institutions recommended that the Board require information to be disclosed about each significant troubled debt restructuring in the period that it occurs, primarily the terms of the restructuring, gain or loss recognized, if any, and the related income tax effect. Most of those respondents focused on individual receivables rather than on groups of receivables and proposed that debtors and creditors disclose similar information.

.169 The Board concluded that the information prescribed by paragraph .040 should be disclosed, by major category, for outstanding receivables whose terms have been modified in troubled debt restructurings. The information may be disclosed either separately for those receivables or as part of the disclosure about reduced-earning and nonearning receivables. The Board believes that the appropriate format for that disclosure depends primarily on the characteristics and number of receivables, including the proportion of those receivables that have reduced earning potential. It believes the argument has merit that the most meaningful disclosure about earnings potential for a financial institution typically should focus on entire portfolios of receivables, by major category, rather than only on receivables that have been restructured in troubled situations, but the Board acknowledges that determining appropriate disclosure for receivables in general is beyond the scope of this Statement. Accordingly, paragraphs .040 and .041 specify types of information that shall be disclosed and permit that information to be provided by major category for the aggregate of outstanding reduced-earning and nonearning receivables, by major category for outstanding receivables whose terms have been modified in troubled debt restructurings, or for each significant outstanding receivable that has been so restructured, depending on the circumstances.

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.170 This Statement contains three changes from the Exposure Draft concerning disclosure by creditors, all made in response to comments or suggestions from respondents to the Exposure Draft and all in paragraph .040, which was paragraph 34 of the Exposure Draft: (1) disclosure of information more in conformity with SEC Guides 61 and 3 [40] replaces disclosure of the weighted average effective interest rate and the range of maturities, (2) disclosure of the allowance for uncollectible amounts or other valuation allowance applicable to restructured receivables is deleted, and (3) disclosure of a commitment to lend additional funds to debtors owing restructured receivables is added.

.171 Disclosure of commitments to lend additional funds was chosen instead of a penalty suggested by some respondents to the Exposure Draft. They expressed concern that a creditor might avoid recognizing a loss under paragraphs .030-.032 by restructuring a troubled receivable in a way that the specified future cash receipts exceed the recorded investment in the receivable and then agree to lend funds to the debtor to meet those terms. They proposed that irrevocable commitments to lend to the debtor be included in the creditor's recorded investment to determine whether the creditor should recognize a loss at the time of restructuring. Since that test is equivalent to saying that a creditor must recognize a loss unless the restructured terms provide not only for recovery of the outstanding receivable but also for recovery of future loans to the same debtor (because future cash receipts from future loans are ignored), the test is excessively punitive. The Board decided that disclosure of those commitments is adequate. That disclosure may already be required by paragraphs 18 and 19 of *FASB Statement No. 5* [section 4311.18-.19], but paragraph .040(b) makes the disclosure explicit.

.172 Some respondents who advocated that the scope of this Statement exclude restructurings of receivables related to consumer financing activities or to all or certain residential properties (paragraph .063) also argued that, if those restructurings were embraced by this Statement, applicable requirements for disclosure would likely be burdensome and not very meaningful to financial statement users. They point out that the accounting, including information normally disclosed in financial statements or in other reports, for those types of receivables has been tailored to fit special characteristics of the receivables, such as large numbers of relatively small balances, interest rates fixed by state law rather than in a fluctuating

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[40] SEC, *Securities Exchange Act of 1934 Release No. 12748,* "Guides for Statistical Disclosure by Bank Holding Companies," August 31, 1976.

market, and numerous accounts on which collections are past due. The Board noted the special characteristics of those types of receivables and, since the scope of this Statement does not encompass appropriate disclosure for receivables generally, concluded that paragraphs .040 and .041 should not necessarily apply to those types of receivables that have been restructured.

ACCOUNTING SYMMETRY BETWEEN DEBTORS AND CREDITORS

.173 The Discussion Memorandum contained several questions on whether particular accounting by debtors and creditors should be symmetrical. Most respondents considered a criterion of symmetry between debtors and creditors an insignificant factor in accounting for troubled debt restructurings. Many noted that existing accounting principles for accounting by creditors for receivables after their initial recording and for recognizing losses already differ from those for accounting by debtors for payables and for recognizing gains. Some respondents also noted that differences usually exist between the debtor and creditor in a particular restructuring (for example, differences in the industry or industries in which they are involved, in their financial viability, and in the significance and frequency of that kind of event for them). The accounting for troubled debt restructurings prescribed in this Statement is symmetrical between debtors and creditors in most matters. However, the Board considered the types of differences described above, among other factors, in concluding that different accounting is appropriate for debtors and creditors in matters such as classifying gains or losses recognized at the time of troubled debt restructurings, accounting for contingent interest, and disclosing information about troubled debt restructurings.

EFFECTIVE DATE AND TRANSITION

.174 The Board concluded that prospective application of this Statement is appropriate and that the effective dates in paragraphs .043-.045 are advisable. In the Board's view, comparability of financial statements would not be greatly enhanced by restating past, nonrecurring troubled debt restructurings. Further, difficulties in retroactive application of the provisions of this Statement include identifying restructurings for which fair values would need to be determined and determining those fair values. A number of enterprises that in recent years have had several restructurings of those types would be unlikely to have information available to restate retroactively.

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AC Section 5500

CAPITAL

. . . stockholders' equity . . . treasury stock . . . dividends . . . quasi-reorganizations . . .

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AC Section 5511

Capital Surplus

[Source: ARB 43, Chap. 1A, Par. 2.]

Issue date, unless otherwise indicated: 1934 [1]

.01 Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.[2]

The next page is 9923.

[1] The above rule was adopted by the membership of the Institute in 1934. It had been recommended in 1932 to the New York Stock Exchange by the Institute's committee on cooperation with stock exchanges.

[2] See also section 5581, *Quasi-Reorganization or Corporate Readjustment.*

AC Section 5512

Donated Stock

[Source: ARB 43, Chap. 1A, Par. 6.]

Issue date, unless otherwise indicated: 1934[1]

.01 If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

The next page is 9961.

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[1] The above rule was adopted by the membership of the Institute in 1934.

AC Section 5515

Liquidation Preference of Preferred Stock

[Source: APB Opinion No. 10, Par. 10-11, as amended.]

Effective for fiscal periods beginning after December 31, 1966, unless otherwise indicated

.01 Companies at times issue preferred (or other senior) stock which has a preference in involuntary liquidation considerably in excess of the par or stated value of the shares. The relationship between this preference in liquidation and the par or stated value of the shares may be of major significance to the users of the financial statements of those companies and the Board believes it highly desirable that it be prominently disclosed. Accordingly, the Board recommends that, in these cases, the liquidation preference of the stock be disclosed in the equity section of the balance sheet in the aggregate, either parenthetically or "in short," rather than on a per share basis or by disclosure in notes.

.02 In addition, the financial statements should disclose, either on the face of the balance sheet or in notes pertaining thereto:

a. the aggregate or per share amounts at which preferred shares may be called or are subject to redemption through sinking fund operations or otherwise;

b. as called for by section 2011A.05, the aggregate and per share amounts of arrearages in cumulative preferred dividends. [As amended, effective for fiscal periods beginning after Dec. 31, 1968 by APB Opinion No. 15.] (See section 2011.)

The next page is 9971.

AC Section 5516

Convertible Debt and Debt Issued with Stock Purchase Warrants[1]

[Source: APB Opinion No. 14.]

Effective for fiscal periods beginning after December 31, 1966, unless otherwise indicated [2]

CONVERTIBLE DEBT

Discussion

.01 Convertible debt securities discussed herein are those debt securities which are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price or have a value at issuance not significantly in excess of the face amount. The terms of such securities generally include (1) an interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater than the market value of the common stock at time of issuance, and (3) a conversion price which does not decrease except pursuant to antidilution provisions. In most cases such securities also are callable at the option of the issuer and are subordinated to nonconvertible debt.

.02 Convertible debt may offer advantages to both the issuer and the purchaser. From the point of view of the issuer, convertible debt has a lower interest rate than does nonconvertible debt. Furthermore, the issuer of convertible debt securities, in planning its long-range financing, may view convertible debt as essentially a means of raising equity capital. Thus, if the market value of the underlying common stock increases sufficiently in the future, the issuer can force conversion of the convertible debt into common stock by calling the issue for redemption. Under these market conditions, the issuer can effectively terminate the conversion option and eliminate the debt. If the market

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[1] This section supersedes paragraphs 8 and 9 of APB Opinion No. 10 and paragraphs 11-15 of APB Opinion No. 12.

[2] See paragraphs .17 and .18.

value of the stock does not increase sufficiently to result in conversion of the debt, the issuer will have received the benefit of the cash proceeds to the scheduled maturity dates at a relatively low cash interest cost.

.03 On the other hand, the purchaser obtains an option to receive either the face or redemption amount of the security or the number of common shares into which the security is convertible. If the market value of the underlying common stock increases above the conversion price, the purchaser (either through conversion or through holding the convertible debt containing the conversion option) benefits through appreciation. He may at that time require the issuance of the common stock at a price lower than the current market price. However, should the value of the underlying common stock not increase in the future, the purchaser has the protection of a debt security. Thus, in the absence of default by the issuer, he would receive the principal and interest if the conversion option is not exercised.

.04 Differences of opinion exist as to whether convertible debt securities should be treated by the issuer solely as debt or whether the conversion option should receive separate accounting recognition at time of issuance. The views in favor of each of these two concepts are contained in the following paragraphs.

.05 The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he foregoes the right to redemption, and vice versa.

.06 Another reason advanced in favor of accounting for convertible debt solely as debt is that the valuation of the conversion option or the debt security without the conversion option presents various practical problems. In the absence of separate transferability, values are not estab-

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lished in the marketplace, and accordingly, the value assigned to each feature is necessarily subjective. A determination of the value of the conversion feature poses problems because of the uncertain duration of the right to obtain the stock and the uncertainty as to the future value of the stock obtainable upon conversion. Furthermore, issuers often claim that a subjective valuation of a debt security without the conversion option but with identical other terms (which are usually less restrictive on the issuer and less protective of the holder than those of nonconvertible debt) is difficult because such a security could not be sold at a price which the issuer would regard as producing an acceptable cost of financing. Thus, when the attractiveness to investors of a convertible debt security rests largely on the anticipated increased value of the issuer's stock, the conversion feature may be of primary importance, with the debt feature regarded more as a hedge than as the principal investment objective. Many proponents of the single-element view believe that the practical problems of determining separate values for the debt and the conversion option should not be controlling for purposes of determining appropriate accounting but such problems should be given consideration, particularly if valid arguments exist for each of the two accounting concepts identified in paragraph .04.

.07 The contrary view is that convertible debt possesses characteristics of both debt and equity and that separate accounting recognition should be given to the debt characteristics and to the conversion option at time of issuance. This view is based on the premise that there is an economic value inherent in the conversion feature or call on the stock and that the nature and value of this feature should be recognized for accounting purposes by the issuer. The conversion feature is not significantly different in nature from the call represented by an option or warrant, and sale of the call is a type of capital transaction. The fact that the conversion feature coexists with certain debt characteristics in a hybrid security and cannot be sold or transferred separately from these senior elements or from the debt instrument itself does not constitute a logical or compelling reason why the values of the two elements should not receive separate accounting recognition. Similar separate accounting recognition for disparate features of single

instruments is reflected in, for example, the capitalization of long-term leases—involving the separation of the principal and interest elements—and in the allocation of the purchase cost in a bulk acquisition between goodwill and other assets.

.08 Holders of this view also believe that the fact that the eventual outcome of the option available to the purchaser of the convertible debt security cannot be determined at time of issuance is not relevant to the question of reflecting in the accounting records the distinguishable elements of the security at time of issuance. The conversion option has a value at time of issuance, and a portion of the proceeds should therefore be allocated to this element of the transaction. The remainder of the proceeds is attributable to the debt characteristics, and should be so recognized for accounting purposes.

.09 Holders of this view also believe that the difficulties of implementation—which are claimed by some to justify or to support not recognizing the conversion option for accounting purposes—are not insurmountable and should not govern the conclusion. When convertible debt securities are issued, professional advisors are usually available to furnish estimates of values of the conversion option and of the debt characteristics, which values are sufficiently precise for the purpose of allocating the proceeds. If a nonconvertible debt security could not be sold at an acceptable price, the value of the conversion option is of such material significance that its accounting recognition, even on the basis of an estimate, is essential.

Opinion

.10 The Board is of the opinion that no portion of the proceeds from the issuance of the types of convertible debt securities described in paragraph .01 should be accounted for as attributable to the conversion feature. In reaching this conclusion, the Board places greater weight on the inseparability of the debt and the conversion option (as described in paragraph .05) and less weight on practical difficulties.

DEBT WITH STOCK PURCHASE WARRANTS

Discussion

.11 Unlike convertible debt, debt with detachable warrants to purchase stock is usually issued with the expecta-

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tion that the debt will be repaid when it matures. The provisions of the debt agreement are usually more restrictive on the issuer and more protective of the investor than those for convertible debt. The terms of the warrants are influenced by the desire for a successful debt financing. Detachable warrants often trade separately from the debt instrument. Thus, the two elements of the security exist independently and may be treated as separate securities.

.12 From the point of view of the issuer, the sale of a debt security with warrants results in a lower cash interest cost than would otherwise be possible or permits financing not otherwise practicable. The issuer usually cannot force the holders of the warrants to exercise them and purchase the stock. The issuer may, however, be required to issue shares of stock at some future date at a price lower than the market price existing at that time, as is true in the case of the conversion option of convertible debt. Under different conditions the warrants may expire without exercise. The outcome of the warrant feature thus cannot be determined at time of issuance. In either case the debt must generally be paid at maturity or earlier redemption date whether or not the warrants are exercised.

.13 There is general agreement among accountants that the proceeds from the sale of debt with stock purchase warrants should be allocated to the two elements for accounting purposes. This agreement results from the separability of the debt and the warrants. The availability of objective values in many instances is also a factor. There is agreement that the allocation should be based on the relative fair values of the debt security without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants should be accounted for as paid-in capital. The remainder of the proceeds should be allocated to the debt security portion of the transaction. This usually results in issuing the debt security at a discount (or, occasionally, a reduced premium).

Opinion

.14 The Board is of the opinion that the portion of the proceeds of debt securities issued with detachable stock purchase warrants which is allocable to the warrants should

be accounted for as paid-in capital. The allocation should be based on the relative fair values of the two securities at time of issuance.[3] Any resulting discount or premium on the debt securities should be accounted for as such.[4] The same accounting treatment applies to issues of debt securities (issued with detachable warrants) which may be surrendered in settlement of the exercise price of the warrant. However, when stock purchase warrants are not detachable from the debt and the debt security must be surrendered in order to exercise the warrant, the two securities taken together are substantially equivalent to convertible debt and the accounting specified in paragraph .10 should apply.

.15 When detachable warrants are issued in conjunction with debt as consideration in purchase transactions, the amounts attributable to each class of security issued should be determined separately, based on values at the time of issuance.[3] The debt discount or premium is obtained by comparing the value attributed to the debt securities with the face amount thereof.

OTHER TYPES OF DEBT SECURITIES

Opinion

.16 The Board recognizes that it is not practicable in this section to discuss all possible types of debt with conversion features, debt issued with stock purchase warrants, or debt securities with a combination of such features. Securities not explicitly discussed in this section should be dealt with in accordance with the substance of the transaction. For example, when convertible debt is issued at a substantial premium, there is a presumption that such premium represents paid-in capital.

EFFECTIVE DATE OF THIS SECTION

.17 This section is effective for fiscal periods beginning after December 31, 1966.[5] However, if a portion of the proceeds of a convertible debt issue covered by paragraph .10

[3] The time of issuance generally is the date when agreement as to terms has been reached and announced, even though the agreement is subject to certain further actions, such as directors' or stockholders' approval.

[4] See sections 5361 and 5362.

[5] This was the effective date of paragraphs 8 and 9 of APB Opinion No. 10 which were temporarily suspended by paragraphs 11-15 of APB Opinion No. 12. The latter Opinion stated that the Board might decide to have the Opinion resolving this question apply retroactively to fiscal periods beginning after December 31, 1966.

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was allocated to the conversion feature for periods beginning before January 1, 1969 that accounting may be continued with respect to such issues.

.18 Material adjustments resulting from adoption of this section which affect periods beginning prior to January 1, 1969 should be treated as prior period adjustments.

The next page is 10,051.

AC Section 5541

Accounting for Treasury Stock

[Source: ARB 43, Chap. 1A, Par. 4.]

Issue date, unless otherwise indicated: 1934 [1]

.01 While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

The next page is 10,061.

[1] The above rule was adopted by the membership of the Institute in 1934. It had been recommended in 1932 to the New York Stock Exchange by the Institute's committee on cooperation with stock exchanges.

AC Section 5542

Profits or Losses on Treasury Stock

[Source: ARB 43, Chap. 1B, as amended.]

Issue date, unless otherwise indicated: June, 1953

.01 Following an inquiry made by the New York Stock Exchange, a predecessor committee on accounting procedure in 1938 issued the following report:

"PROFITS OR LOSSES ON TREASURY STOCK"

.02 "The executive committee of the American Institute of Accountants has directed that the following report of the committee on accounting procedure, which it received at a meeting on April 8, 1938, be published, without approval or disapproval of the committee, for the information of members of the Institute:

TO THE EXECUTIVE COMMITTEE,
AMERICAN INSTITUTE OF ACCOUNTANTS:

.03 "This committee has had under consideration the question regarding treatment of purchase and sale by a corporation of its own stock, which was raised during 1937 by the New York Stock Exchange with the Institute's special committee on cooperation with stock exchanges.

.04 "As a result of discussions which then took place, the special committee on cooperation with stock exchanges made a report which was approved by the committee on accounting procedure and the executive committee, and a copy of which was furnished to the committee on stock list of the New York Stock Exchange. The question raised was stated in the following form:

.05 " 'Should the difference between the purchase and resale prices of a corporation's own common stock be reflected in earned surplus (either directly or through inclusion in the income account) or should such difference be reflected in capital surplus?'

.06 "The opinion of the special committee on cooperation with stock exchanges reads in part as follows:

.07 " 'Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock.'

.08 "This committee is in agreement with the views thus expressed; it is aware that such transactions have been held to give rise to taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure as above outlined.

.09 "The special committee on cooperation with stock exchanges continued and concluded its report with the following statement:

.10 " 'Accordingly, although your committee recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account).'

.11 "This committee agrees with the special committee on cooperation with stock exchanges, but thinks it desirable to point out that the qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions which in the aggregate are of substantial importance.

.12 "This committee recommends that the views expressed be circulated for the information of members of the Institute."

.13 The Board considers that the following accounting practices, in addition to the accounting practices indicated in paragraphs .03-.12 are acceptable, and that they appear to be more in accord with current developments in practice:

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a. When a corporation's stock is retired, or purchased for constructive retirement (with or without an intention to retire the stock formally in accordance with applicable laws):

  i. *an excess of purchase price over par or stated value* may be allocated between capital surplus and retained earnings. The portion of the excess allocated to capital surplus should be limited to the sum of (a) all capital surplus arising from previous retirements and net "gains" on sales of treasury stock of the same issue and (b) the prorata portion of capital surplus paid in, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining capital surplus applicable to issues fully retired (formal or constructive) is deemed to be applicable prorata to shares of common stock. Alternatively, the excess may be charged entirely to retained earnings in recognition of the fact that a corporation can always capitalize or allocate retained earnings for such purposes.

  ii. *an excess of par or stated value over purchase price* should be credited to capital surplus.

b. When a corporation's stock is acquired for purposes other than retirement (formal or constructive), or when ultimate disposition has not yet been decided, the cost of acquired stock may be shown separately as a deduction from the total of capital stock, capital surplus, and retained earnings, or may be accorded the accounting treatment appropriate for retired stock, or in some circumstances may be shown as an asset in accordance with section 5541. "Gains" on sales of treasury stock not previously accounted for as constructively retired should be credited to capital surplus; "losses" may be charged to capital surplus to the extent that previous net "gains" from sales or retirements of the same class of stock are included therein, otherwise to retained earnings.

[As amended, effective for fiscal periods beginning after December 31, 1965, by APB Opinion

No. 6 and as amended, effective for fiscal periods beginning after October 31, 1970, by APB Opinion No. 16.]

.14 Laws of some states govern the circumstances under which a corporation may acquire its own stock and prescribe the accounting treatment therefor. Where such requirements are at variance with paragraph .13 the accounting should conform to the applicable law. When state laws relating to acquisition of stock restrict the availability of retained earnings for payment of dividends or have other effects of a significant nature, these facts should be disclosed. [As amended, effective for fiscal periods beginning after December 31, 1965, by APB Opinion No. 6.]

The next page is 10,151.

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AC Section 5561

Stock Dividends and Stock Split-Ups

[Source: ARB 43, Chap. 7B, as amended.]

Issue date, unless otherwise indicated: June, 1953

.01 The term *stock dividend* as used in this section refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

.02 The term *stock split-up* as used in this section refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares.

.03 This section is not concerned with the accounting for a distribution or issuance to shareholders of (a) shares of another corporation theretofore held as an investment, or (b) shares of a different class, or (c) rights to subscribe for additional shares or (d) shares of the same class in cases where each shareholder is given an election to receive cash or shares.

.04 The discussion of accounting for stock dividends and split-ups that follows is divided into two parts. The first deals with the problems of the recipient. The second deals with the problems of the issuer.

AS TO THE RECIPIENT

.05 One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this section. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

.06 In applying the principles of income determination to the accounts of a shareholder of a corporation, it is generally agreed that the problem of determining his income is distinct from the problem of income determination by the corporation itself. The income of the corporation is determined as that of a separate entity without regard to the equity of the respective shareholders in such income. Under conventional accounting concepts, the shareholder has no income solely as a result of the fact that the corporation has income; the increase in his equity through undistributed earnings is no more than potential income to him. It is true that income earned by the corporation may result in an enhancement in the market value of the shares, but until there is a distribution, division, or severance of corporate assets, the shareholder has no income. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.

(Note: The Board is of the opinion that paragraph .06 should not be construed as prohibiting the equity method of accounting for substantial intercorporate investments. [As amended, effective for fiscal periods beginning after December 31, 1965, by APB Opinion No. 6.] This method, which is described in section 5131, *The Equity Method of Accounting for Investments in Common Stock,* is required in certain circumstances.)

.07 The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-

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up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the *separate entity* concept of corporation accounting.

.08 The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known.[1] The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in *Eisner v. Macomber,* 252 U. S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

> "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased . . . the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones."

.09 Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividends or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

AS TO THE ISSUER

Stock Dividends

.10 As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation's assets or its respective shareholders' proportionate interests therein. However, it can-

[1] See, for instance, Freeman, "Stock Dividends and the New York Stock Exchange," *American Economic Review,* December, 1931 (pro), and Whitaker, "Stock Dividends, Investment Trusts, and the Exchange," *American Economic Review,* June, 1931 (con).

not fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a *dividend* in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

.11 Where the number of additional shares issued as a stock dividend is so great that it has, or may reasonably be expected to have, the effect of materially reducing the share market value, the committee believes that the implications and possible constructions discussed in the preceding paragraph are not likely to exist and that the transaction clearly partakes of the nature of a stock split-up as defined in paragraph .02. Consequently, the committee considers that under such circumstances there is no need to capitalize earned surplus, other than to the extent occasioned by legal requirements. It recommends, however, that in such instances every effort be made to avoid the use of the word *dividend* in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannot be done, the transaction be described, for example, as a *split-up effected in the form of a dividend.*

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.12 In cases of closely-held companies, it is to be presumed that the intimate knowledge of the corporations' affairs possessed by their shareholders would preclude any such implications and possible constructions as are referred to in paragraph .10. In such cases, the committee believes that considerations of public policy do not arise and that there is no need to capitalize earned surplus other than to meet legal requirements.

.13 Obviously, the point at which the relative size of the additional shares issued becomes large enough to materially influence the unit market price of the stock will vary with individual companies and under differing market conditions and, hence, no single percentage can be laid down as a standard for determining when capitalization of earned surplus in excess of legal requirements is called for and when it is not. However, on the basis of a review of market action in the case of shares of a number of companies having relatively recent stock distributions, it would appear that there would be few instances involving the issuance of additional shares of less than, say, 20% or 25% of the number previously outstanding where the effect would not be such as to call for the procedure referred to in paragraph .10.

.14 The corporate accounting recommended in paragraph .10 will in many cases, probably the majority, result in the capitalization of earned surplus in an amount in excess of that called for by the laws of the state of incorporation; such laws generally require the capitalization only of the par value of the shares issued, or, in the case of shares without par value, an amount usually within the discretion of the board of directors. However, these legal requirements are, in effect, minimum requirements and do not prevent the capitalization of a larger amount per share.

Stock Split-Ups

.15 Earlier in this section a stock split-up was defined as being confined to transactions involving the issuance of shares, without consideration moving to the corporation, for the purpose of effecting a reduction in the unit market price of shares of the class issued and, thus, of obtaining wider distribution and improved marketability of the

shares. Where this is clearly the intent, no transfer from earned surplus to capital surplus or capital stock account is called for, other than to the extent occasioned by legal requirements. It is believed, however, that few cases will arise where the aforementioned purpose can be accomplished through an issuance of shares which is less than, say, 20% or 25% of the previously outstanding shares.

.16 The committee believes that the corporation's representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or a split-up. Nevertheless, it believes that the issuance of new shares in ratios of less than, say, 20% or 25% of the previously outstanding shares, or the frequent recurrence of issuances of shares, would destroy the presumption that transactions represented to be split-ups should be recorded as split-ups.

The next page is 10,271.

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AC Section 5581

Quasi-Reorganization or Corporate Readjustment

(Amplification of Institute Rule No. 2 of 1934)

[Source: ARB 43, Chap. 7A.]

Issue date, unless otherwise indicated: June, 1953

.01 A rule was adopted by the Institute in 1934 which read as follows:

> "Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization."[1]

.02 Readjustments of the kind mentioned in the exception to the rule fall in the category of what are called quasi-reorganizations. This section does not deal with the general question of quasi-reorganizations, but only with cases in which the exception permitted under the rule of 1934 is availed of by a corporation. Hereinafter such cases are referred to as readjustments. The problems which arise fall into two groups: (a) what may be permitted in a readjustment and (b) what may be permitted thereafter.

PROCEDURE IN READJUSTMENT

.03 If a corporation elects to restate its assets, capital stock, and surplus through a readjustment and thus avail itself of permission to relieve its future income account or earned surplus account of charges which would otherwise be made thereagainst, it should make a clear report to its shareholders of the restatements proposed to be made, and obtain their formal consent. It should present a fair bal-

[1] See section 5511.

ance sheet as at the date of the readjustment, in which the adjustment of carrying amounts is reasonably complete, in order that there may be no continuation of the circumstances which justify charges to capital surplus.

.04 A write-down of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the amount should be described as an estimate and any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date should not be carried to income or earned surplus.

.05 Similarly, if potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, provision may properly be made to cover the maximum *probable* losses or charges. If the amounts provided are subsequently found to have been excessive or insufficient, the difference should not be carried to earned surplus nor used to offset losses or gains originating after the readjustment, but should be carried to capital surplus.

.06 When the amounts to be written off in a readjustment have been determined, they should be charged first against earned surplus to the full extent of such surplus; any balance may then be charged against capital surplus. A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus survives a readjustment in which any part of losses has been charged to capital surplus.

.07 If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company's interest in such earned surplus should be regarded as capitalized by the readjustment

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just as surplus at the date of acquisition is capitalized, so far as the parent is concerned.

.08 The effective date of the readjustment, from which the income of the company is thereafter determined, should be as near as practicable to the date on which formal consent of the stockholders is given, and should ordinarily not be prior to the close of the last completed fiscal year.

PROCEDURE AFTER READJUSTMENT

.09 When the readjustment has been completed, the company's accounting should be substantially similar to that appropriate for a new company.

.10 After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.[2]

.11 Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; charges against it should be only those which may properly be made against the initial surplus of a new corporation.

.12 It is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustments for the purpose of correcting erroneous credits made to capital surplus in the past. In this statement the committee has dealt only with that type of readjustment in which either the current income or earned surplus account or the income account of future years is relieved of charges which would otherwise be made thereagainst.

The next page is 10,291.

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[2] See section 5582.

AC Section 5582

Discontinuance of Dating Earned Surplus

[Source: ARB 46.]

Issue date, unless otherwise indicated: February, 1956

.01 Section 5581.10, *Quasi-Reorganization or Corporate Readjustment,* reads as follows:

> After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

.02 The committee believes that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. It also believes that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than ten years.

AC Section 6000

SPECIAL INDUSTRY APPLICATIONS

. . . public utilities . . . oil and gas producing companies

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AC Section 6011

Accounting Principles for Regulated Industries

[Source: APB Opinion No. 2, Addendum.]

Issue date, unless otherwise indicated: December, 1962

The following statement, approved by the Board, originally appeared in *The Journal of Accountancy,* December 1962, p. 67:

.01 The basic postulates and the broad principles of accounting comprehended in the term *generally accepted accounting principles* pertain to business enterprises in general. These include public utilities, common carriers, insurance companies, financial institutions, and the like that are subject to regulation by government, usually through commissions or other similar agencies.

.02 However, differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses. Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues. For example, if a cost incurred by a regulated business during a given period is treated for rate-making purposes by the regulatory authority having jurisdiction as applicable to future revenues, it may be deferred in the balance sheet at the end of the current period and written off in the future period or periods in which the related revenue accrues, even though the cost is of a kind which in a nonregulated business would be written off currently. However, this is appropriate only when it is clear that the cost will be recoverable out of future revenues, and it is not appropriate when there is doubt, because of economic conditions or for other reasons, that the cost will be so recoverable.

.03 Accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses by orders of regulatory authorities, and occasionally by court decisions or statutes. The fact that such accounting requirements are imposed by the government does not necessarily mean that they conform with generally accepted accounting principles. For example, if a cost, of a kind which in a nonregulated business would be charged to income, is charged directly to surplus pursuant to the applicable accounting requirements of the regulatory authority, such cost nevertheless should be included in operating expenses or charged to income, as appropriate in financial statements intended for use by the public.

.04 The financial statements of regulated businesses other than those prepared for filing with the government for regulatory purposes preferably should be based on generally accepted accounting principles (with appropriate recognition of rate-making considerations as indicated in paragraph .02) rather than on systems of accounts or other accounting requirements of the government.

.05 *Generally Accepted Auditing Standards* lists four standards of reporting, the first of which says that "The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting." In reporting on the financial statements of regulated businesses, the independent auditor should observe this standard and should deal with material variances from generally accepted accounting principles (with appropriate recognition of rate-making considerations as indicated in paragraph .02), if the financial statements reflect any such variances, in the same manner as in his reports on nonregulated businesses.

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AC Section 6021

Financial Accounting and Reporting by Oil and Gas Producing Companies

[Source: FASB Statement No. 19.]

December 1977

INTRODUCTION

.001 This Statement establishes standards of financial accounting and reporting for the oil and gas producing activities of a business enterprise. Those activities involve the acquisition of mineral interests in properties, exploration (including prospecting), development, and production of crude oil, including condensate and natural gas liquids, and natural gas (hereinafter collectively referred to as oil and gas producing activities).

.002 Existing authoritative accounting pronouncements do not explicitly or comprehensively establish standards of financial accounting and reporting for those activities. Numerous alternative accounting practices are presently followed by oil and gas producing companies, and the nature and extent of the information they disclose in their financial statements about their oil and gas producing activities vary considerably from company to company. The Board is issuing this Statement to address the financial accounting and reporting issues that led to the alternative practices.

.003 Appendix A contains background information. Appendix B sets forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others. Appendix C is a glossary of terms.

.004 The accounting standards in this Statement adhere to the traditional historical cost basis. Although the Board considered both *discovery value* and *current value* as alternative bases of accounting for oil and gas reserves, it determined for the reasons discussed in paragraphs .133-.141 that any decision on applying value accounting to oil and gas companies should await resolution of the broader issue of the general applicability of value accounting in

the Board's project, "Conceptual Framework for Financial Accounting and Reporting."

.005 This Statement supersedes *FASB Statement No. 9* [section 4097], "Accounting for Income Taxes—Oil and Gas Producing Companies."

SCOPE

.006 This Statement applies only to *oil and gas producing* activities; it does not address financial accounting and reporting issues relating to the transporting, refining, and marketing of oil and gas. Also, this Statement does not apply to activities relating to the production of other wasting (nonregenerative) natural resources; nor does it apply to the production of geothermal steam or to the extraction of hydrocarbons as a by-product of the production of geothermal steam and associated geothermal resources as defined in the *Geothermal Steam Act of 1970;* nor does it apply to the extraction of hydrocarbons from shale, tar sands, or coal.

.007 Accounting for interest on funds borrowed to finance an enterprise's oil and gas producing activities is excluded from consideration in this Statement because the broader subject of accounting for interest costs in general is a project presently on the Board's technical agenda.

.008 This Statement prescribes disclosures related to an enterprise's oil and gas producing activities that are considered necessary for fair presentation of the enterprise's financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Those disclosures are only part of the information that may be needed for investment, regulatory, or national economic planning and energy policy decisions.

.009 The Addendum to *APB Opinion No. 2* [section 6011], "Accounting for the 'Investment Credit'," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process" and discusses the application of generally accepted accounting principles to regulated industries. Accordingly, the provisions of the Addendum shall govern the application of this Statement to those oil and gas producing operations of a company that are regulated for rate-making purposes on an individual-company-cost-of-service basis.

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STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Definitions

.010 The glossary in Appendix C defines the following terms as they are used in this Statement:

a. Proved reserves.
b. Proved developed reserves.
c. Proved undeveloped reserves.
d. Field.
e. Reservoir.
f. Exploratory well.
g. Development well.
h. Service well.
i. Stratigraphic test well.
   i. Exploratory-type.
   ii. Development-type.
j. Proved area.

Basic Concepts

.011 An enterprise's oil and gas producing activities involve certain special types of assets. Costs of those assets shall be capitalized when incurred. Those types of assets broadly defined are:

a. *Mineral interests in properties* (hereinafter referred to as *properties*), which include fee ownership or a lease, concession, or other interest representing the right to extract oil or gas subject to such terms as may be imposed by the conveyance of that interest. Properties also include royalty interests, production payments payable in oil or gas, and other nonoperating interests in properties operated by others. Properties include those agreements with foreign governments or authorities under which an enterprise participates in the operation of the related properties or otherwise serves as "producer" of the underlying reserves (see paragraph .053); but properties do not include other supply agreements or contracts that represent the right to *purchase* (as opposed to *extract*) oil and gas. Properties shall be classified as proved or unproved as follows:
   i. *Unproved properties*—properties with no proved reserves.
   ii. *Proved properties*—properties with proved reserves.

b. *Wells and related equipment and facilities*,[1] the costs of which include those incurred to:

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[1] Often referred to in the oil and gas industry as "lease and well equipment" even though, technically, the property may have been acquired other than by a lease.

i. Drill and equip those exploratory wells and exploratory-type stratigraphic test wells that have found proved reserves.
ii. Obtain access to proved reserves and provide facilities for extracting, treating, gathering, and storing the oil and gas, including the drilling and equipping of development wells and development-type stratigraphic test wells (whether those wells are successful or unsuccessful) and service wells.

c. *Support equipment and facilities used in oil and gas producing activities,* such as seismic equipment, drilling equipment, construction and grading equipment, vehicles, repair shops, warehouses, supply points, camps, and division, district, or field offices.

d. *Uncompleted wells, equipment, and facilities,* the costs of which include those incurred to:
i. Drill and equip wells that are not yet completed.
ii. Acquire or construct equipment and facilities that are not yet completed and installed.

.012 The costs of an enterprise's wells and related equipment and facilities and the costs of the related proved properties shall be amortized as the related oil and gas reserves are produced. That amortization plus production (lifting) costs become part of the cost of oil and gas produced. Unproved properties shall be assessed periodically, and a loss recognized if those properties are impaired.

.013 Some costs incurred in an enterprise's oil and gas producing activities do not result in acquisition of an asset and, therefore, shall be charged to expense. Examples include geological and geophysical costs, the costs of carrying and retaining undeveloped properties, and the costs of drilling those exploratory wells and exploratory-type stratigraphic test wells that do not find proved reserves.

.014 The basic concepts in paragraphs .011-.013 are elaborated on in paragraphs .015-.041.

Accounting at the Time Costs Are Incurred

Acquisition of Properties

.015 Costs incurred to purchase, lease, or otherwise acquire a property (whether unproved or proved) shall be capitalized when incurred. They include the costs of lease bonuses and options to purchase or lease properties, the portion of costs applicable to

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minerals when land including mineral rights is purchased in fee, brokers' fees, recording fees, legal costs, and other costs incurred in acquiring properties.

Exploration

.016 Exploration involves (a) identifying areas that may warrant examination and (b) examining specific areas that are considered to have prospects of containing oil and gas reserves, including drilling exploratory wells and exploratory-type stratigraphic test wells. Exploration costs may be incurred both before acquiring the related property (sometimes referred to in part as prospecting costs) and after acquiring the property.

.017 Principal types of exploration costs, which include depreciation and applicable operating costs of support equipment and facilities (paragraph .026) and other costs of exploration activities, are:

a. Costs of topographical, geological, and geophysical studies, rights of access to properties to conduct those studies, and salaries and other expenses of geologists, geophysical crews, and others conducting those studies. Collectively, those are sometimes referred to as geological and geophysical or "G&G" costs.

b. Costs of carrying and retaining undeveloped properties, such as delay rentals, *ad valorem* taxes on the properties, legal costs for title defense, and the maintenance of land and lease records.

c. Dry hole contributions and bottom hole contributions.

d. Costs of drilling and equipping exploratory wells.

e. Costs of drilling exploratory-type stratigraphic test wells.[2]

.018 Geological and geophysical costs, costs of carrying and retaining undeveloped properties, and dry hole and bottom hole contributions shall be charged to expense when incurred.

.019 The costs of drilling exploratory wells and the costs of drilling exploratory-type stratigraphic test wells shall be capitalized as part of the enterprise's uncompleted wells, equipment, and facilities pending determination of whether the well has found proved reserves. If the well has found proved reserves (paragraphs .031-.034), the capitalized costs of drilling the well shall become part of the enterprise's wells and related equipment and

[2] While the costs of drilling stratigraphic test wells are sometimes considered to be geological and geophysical costs, they are accounted for separately under this Statement for reasons explained in paragraphs .200-.202.

facilities (even though the well may not be completed as a producing well); if, however, the well has not found proved reserves, the capitalized costs of drilling the well, net of any salvage value, shall be charged to expense.

.020 An enterprise sometimes conducts G&G studies and other exploration activities on a property owned by another party, in exchange for which the enterprise is contractually entitled to receive an interest in the property if proved reserves are found or to be reimbursed by the owner for the G&G and other costs incurred if proved reserves are not found. In that case, the enterprise conducting the G&G studies and other exploration activities shall account for those costs as a receivable when incurred and, if proved reserves are found, they shall become the cost of the proved property acquired.

Development

.021 Development costs are incurred to obtain access to proved reserves and to provide facilities for extracting, treating, gathering, and storing the oil and gas. More specifically, development costs, including depreciation and applicable operating costs of support equipment and facilities (paragraph .026) and other costs of development activities, are costs incurred to:

a. Gain access to and prepare well locations for drilling, including surveying well locations for the purpose of determining specific development drilling sites, clearing ground, draining, road building, and relocating public roads, gas lines, and power lines, to the extent necessary in developing the proved reserves.
b. Drill and equip development wells, development-type stratigraphic test wells, and service wells, including the costs of platforms and of well equipment such as casing, tubing, pumping equipment, and the wellhead assembly.
c. Acquire, construct, and install production facilities such as lease flow lines, separators, treaters, heaters, manifolds, measuring devices, and production storage tanks, natural gas cycling and processing plants, and utility and waste disposal systems.
d. Provide improved recovery systems.

.022 Development costs shall be capitalized as part of the cost of an enterprise's wells and related equipment and facilities. Thus, all costs incurred to drill and equip development wells, development-type stratigraphic test wells, and service wells are development costs and shall be capitalized, whether the well is successful or unsuccessful. Costs of drilling those wells and costs of constructing equipment and facilities shall be included in the enterprise's

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uncompleted wells, equipment, and facilities until drilling or construction is completed.

Production

.023 Production involves lifting the oil and gas to the surface and gathering, treating, field processing (as in the case of processing gas to extract liquid hydrocarbons), and field storage. For purposes of this Statement, the production function shall normally be regarded as terminating at the outlet valve on the lease or field production storage tank; if unusual physical or operational circumstances exist, it may be more appropriate to regard the production function as terminating at the first point at which oil, gas, or gas liquids are delivered to a main pipeline, a common carrier, a refinery, or a marine terminal.

.024 Production costs are those costs incurred to operate and maintain an enterprise's wells and related equipment and facilities, including depreciation and applicable operating costs of support equipment and facilities (paragraph .026) and other costs of operating and maintaining those wells and related equipment and facilities. They become part of the cost of oil and gas produced. Examples of production costs (sometimes called lifting costs) are:

a. Costs of labor to operate the wells and related equipment and facilities.
b. Repairs and maintenance.
c. Materials, supplies, and fuel consumed and services utilized in operating the wells and related equipment and facilities.
d. Property taxes and insurance applicable to proved properties and wells and related equipment and facilities.
e. Severance taxes.

.025 Depreciation, depletion, and amortization of capitalized acquisition, exploration, and development costs also become part of the cost of oil and gas produced along with production (lifting) costs identified in paragraph .024.

Support Equipment and Facilities

.026 The cost of acquiring or constructing support equipment and facilities used in oil and gas producing activities shall be capitalized. Examples of support equipment and facilities include seismic equipment, drilling equipment, construction and grading equipment, vehicles, repair shops, warehouses, supply points, camps, and division, district, or field offices. Some support equipment or

facilities are acquired or constructed for use exclusively in a single activity—exploration, development, or production. Other support equipment or facilities may serve two or more of those activities and may also serve the enterprise's transportation, refining, and marketing activities. To the extent that the support equipment and facilities are used in oil and gas producing activities, their depreciation and applicable operating costs become an exploration, development, or production cost, as appropriate.

Disposition of Capitalized Costs

.027 The effect of paragraphs .015-.026, which deal with accounting at the time costs are incurred, is to recognize as assets: (a) unproved properties; (b) proved properties; (c) wells and related equipment and facilities (which consist of all development costs plus the costs of drilling those exploratory wells and exploratory-type stratigraphic test wells that find proved reserves); (d) support equipment and facilities used in oil and gas producing activities; and (e) uncompleted wells, equipment, and facilities. Paragraphs .028-.041 which follow deal with disposition of the costs of those assets after capitalization. Among other things, those paragraphs provide that the acquisition costs of proved properties and the costs of wells and related equipment and facilities be amortized to become part of the cost of oil and gas produced; that impairment of unproved properties be recognized; and that the costs of an exploratory well or exploratory-type stratigraphic test well be charged to expense if the well is determined not to have found proved reserves.

Assessment of Unproved Properties

.028 Unproved properties shall be assessed periodically to determine whether they have been impaired. A property would likely be impaired, for example, if a dry hole has been drilled on it and the enterprise has no firm plans to continue drilling. Also, the likelihood of partial or total impairment of a property increases as the expiration of the lease term approaches if drilling activity has not commenced on the property or on nearby properties. If the results of the assessment indicate impairment, a loss shall be recognized by providing a valuation allowance. Impairment of individual unproved properties whose acquisition costs are relatively significant shall be assessed on a property-by-property basis, and an indicated loss shall be recognized by providing a valuation allowance. When an enterprise has a relatively large number of unproved properties whose acquisition costs are not individually significant, it may not be practical to assess impairment on a property-by-property basis, in which case the amount of loss to be recognized and the amount

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of the valuation allowance needed to provide for impairment of those properties shall be determined by amortizing those properties, either in the aggregate or by groups, on the basis of the experience of the enterprise in similar situations and other information about such factors as the primary lease terms of those properties, the average holding period of unproved properties, and the relative proportion of such properties on which proved reserves have been found in the past.

Reclassification of an Unproved Property

.029 A property shall be reclassified from unproved properties to proved properties when proved reserves are discovered on or otherwise attributed to the property; occasionally, a single property, such as a foreign lease or concession covers so vast an area that only the portion of the property to which the proved reserves relate—determined on the basis of geological structural features or stratigraphic conditions—should be reclassified from unproved to proved. For a property whose impairment has been assessed individually in accordance with paragraph .028, the *net* carrying amount (acquisition cost minus valuation allowance) shall be reclassified to proved properties; for properties amortized by providing a valuation allowance on a group basis, the gross acquisition cost shall be reclassified.

Amortization (Depletion) of Acquisition Costs of Proved Properties

.030 Capitalized acquisition costs of proved properties shall be amortized (depleted) by the unit-of-production method so that each unit produced is assigned a pro rata portion of the unamortized acquisition costs. Under the unit-of-production method, amortization (depletion) may be computed either on a property-by-property basis or on the basis of some reasonable aggregation of properties with a common geological structural feature or stratigraphic condition, such as a reservoir or field. When an enterprise has a relatively large number of royalty interests whose acquisition costs are not individually significant, they may be aggregated, for the purpose of computing amortization, without regard to commonality of geological structural features or stratigraphic conditions; if information is not available to estimate reserve quantities applicable to royalty interests owned (paragraph .050), a method other than the unit-of-production method may be used to amortize their acquisition costs. The unit cost shall be computed on the basis of the total estimated units of proved oil and gas reserves. (Joint production of both oil and gas is discussed in paragraph .038.) Unit-of-production amortization rates shall be revised

whenever there is an indication of the need for revision but at least once a year; those revisions shall be accounted for prospectively as changes in accounting estimates—see paragraphs 31-33 of *APB Opinion No. 20* [section 1051.31-.33], "Accounting Changes."

Accounting When Drilling of an Exploratory Well Is Completed

.031 As specified in paragraph .019, the costs of drilling an exploratory well are capitalized as part of the enterprise's uncompleted wells, equipment, and facilities pending determination of whether the well has found proved reserves. That determination is usually made on or shortly after completion of drilling the well, and the capitalized costs shall either be charged to expense or be reclassified as part of the costs of the enterprise's wells and related equipment and facilities at that time. Occasionally, however, an exploratory well may be determined to have found oil and gas reserves, but classification of those reserves as proved cannot be made when drilling is completed. In those cases, one or the other of the following subparagraphs shall apply depending on whether the well is drilled in an area requiring a major capital expenditure, such as a trunk pipeline, before production from that well could begin:

a. *Exploratory wells that find oil and gas reserves in an area requiring a major capital expenditure, such as a trunk pipeline, before production could begin.* On completion of drilling, an exploratory well may be determined to have found oil and gas reserves, but classification of those reserves as proved depends on whether a major capital expenditure can be justified which, in turn, depends on whether additional exploratory wells find a sufficient quantity of additional reserves. That situation arises principally with exploratory wells drilled in a remote area for which production would require constructing a trunk pipeline. In that case, the cost of drilling the exploratory well shall continue to be carried as an asset pending determination of whether proved reserves have been found only as long as both of the following conditions are met:

    i. The well has found a sufficient quantity of reserves to justify its completion as a producing well if the required capital expenditure is made.

    ii. Drilling of the additional exploratory wells is under way or firmly planned for the near future.

    Thus if drilling in the area is not under way or firmly planned, or if the well has not found a commercially producible quantity

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of reserves, the exploratory well shall be assumed to be impaired, and its costs shall be charged to expense.

b. *All other exploratory wells that find oil and gas reserves.* In the absence of a determination as to whether the reserves that have been found can be classified as proved, the costs of drilling such an exploratory well shall not be carried as an asset for more than one year following completion of drilling. If, after that year has passed, a determination that proved reserves have been found cannot be made, the well shall be assumed to be impaired, and its costs shall be charged to expense.

.032 Paragraph .031 is intended to prohibit, in all cases, the deferral of the costs of exploratory wells that find some oil and gas reserves merely on the chance that some event totally beyond the control of the enterprise will occur, for example, on the chance that the selling prices of oil and gas will increase sufficiently to result in classification of reserves as proved that are not commercially recoverable at current prices.

Accounting When Drilling of an Exploratory-Type Stratigraphic Test Well Is Completed

.033 As specified in paragraph .019, the costs of drilling an exploratory-type stratigraphic test well are capitalized as part of the enterprise's uncompleted wells, equipment, and facilities pending determination of whether the well has found proved reserves. When that determination is made, the capitalized costs shall be charged to expense if proved reserves are not found or shall be reclassified as part of the costs of the enterprise's wells and related equipment and facilities if proved reserves are found.

.034 Exploratory-type stratigraphic test wells are normally drilled on unproved offshore properties. Frequently, on completion of drilling, such a well may be determined to have found oil and gas reserves, but classification of those reserves as proved depends on whether a major capital expenditure—usually a production platform—can be justified which, in turn, depends on whether additional exploratory-type stratigraphic test wells find a sufficient quantity of additional reserves. In that case, the cost of drilling the exploratory-type stratigraphic test well shall continue to be carried as an asset pending determination of whether proved reserves have been found only as long as both of the following conditions are met:

i. The well has found a quantity of reserves that would justify its completion for production had it not been simply a stratigraphic test well.

ii. Drilling of the additional exploratory-type stratigraphic test wells is under way or firmly planned for the near future.

Thus if associated stratigraphic test drilling is not under way or firmly planned, or if the well has not found a commercially producible quantity of reserves, the exploratory-type stratigraphic test well shall be assumed to be impaired, and its costs shall be charged to expense.

Amortization and Depreciation of Capitalized Exploratory Drilling and Development Costs

.035 Capitalized costs of exploratory wells and exploratory-type stratigraphic test wells that have found proved reserves and capitalized development costs shall be amortized (depreciated) by the unit-of-production method so that each unit produced is assigned a pro rata portion of the unamortized costs. It may be more appropriate, in some cases, to depreciate natural gas cycling and processing plants by a method other than the unit-of-production method. Under the unit-of-production method, amortization (depreciation) may be computed either on a property-by-property basis or on the basis of some reasonable aggregation of properties with a common geological structural feature or stratigraphic condition, such as a reservoir or field. The unit cost shall be computed on the basis of the total estimated units of proved *developed* reserves, rather than on the basis of all proved reserves, which is the basis for amortizing acquisition costs of proved properties. If significant development costs (such as the cost of an offshore production platform) are incurred in connection with a planned group of development wells before all of the planned wells have been drilled, it will be necessary to exclude a portion of those development costs in determining the unit-of-production amortization rate until the additional development wells are drilled. Similarly it will be necessary to exclude, in computing the amortization rate, those proved developed reserves that will be produced only after significant additional development costs are incurred, such as for improved recovery systems. However, in no case should future development costs be anticipated in computing the amortization rate. (Joint production of both oil and gas is discussed in paragraph .038.) Unit-of-production amortization rates shall be revised whenever there is an indication of the need for revision but at least once a year; those revisions shall be accounted for prospectively as changes in accounting estimates—see paragraphs 31-33 of *APB Opinion No. 20* [section 1051.31-.33].

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Depreciation of Support Equipment and Facilities

.036 Depreciation of support equipment and facilities used in oil and gas producing activities shall be accounted for as exploration cost, development cost, or production cost, as appropriate (paragraph .026).

Dismantlement Costs and Salvage Values

.037 Estimated dismantlement, restoration, and abandonment costs and estimated residual salvage values shall be taken into account in determining amortization and depreciation rates.

Amortization of Costs Relating to Oil and Gas Reserves Produced Jointly

.038 The unit-of-production method of amortization requires that the total number of units of oil or gas reserves in a property or group of properties be estimated and that the number of units produced in the current period be determined. Many properties contain both oil and gas reserves. In those cases, the oil and gas reserves and the oil and gas produced shall be converted to a common unit of measure on the basis of their approximate relative energy content (without considering their relative sales values). However, if the relative proportion of gas and oil extracted in the current period is expected to continue throughout the remaining productive life of the property, unit-of-production amortization may be computed on the basis of one of the two minerals only; similarly, if either oil or gas clearly dominates both the reserves and the current production (with dominance determined on the basis of relative energy content), unit-of-production amortization may be computed on the basis of the dominant mineral only.

Information Available after the Balance Sheet Date

.039 Information that becomes available after the end of the period covered by the financial statements but before those financial statements are issued shall be taken into account in evaluating conditions that existed at the balance sheet date, for example, in assessing unproved properties (paragraph .028) and in determining whether an exploratory well or exploratory-type stratigraphic test well had found proved reserves (paragraphs .031-.034).

Surrender or Abandonment of Properties

.040 When an unproved property is surrendered, abandoned, or otherwise deemed worthless, capitalized acquisition costs relating thereto shall be charged against the related allowance for impair-

ment to the extent an allowance has been provided; if the allowance previously provided is inadequate, a loss shall be recognized.

.041 Normally, no gain or loss shall be recognized if only an individual well or individual item of equipment is abandoned or retired or if only a single lease or other part of a group of proved properties constituting the amortization base is abandoned or retired as long as the remainder of the property or group of properties continues to produce oil or gas. Instead, the asset being abandoned or retired shall be deemed to be fully amortized, and its cost shall be charged to accumulated depreciation, depletion, or amortization. When the *last* well on an individual property (if that is the amortization base) or group of properties (if amortization is determined on the basis of an aggregation of properties with a common geological structure) ceases to produce and the entire property or property group is abandoned, gain or loss shall be recognized. Occasionally, the partial abandonment or retirement of a proved property or group of proved properties or the abandonment or retirement of wells or related equipment or facilities may result from a catastrophic event or other major abnormality. In those cases, a loss shall be recognized at the time of abandonment or retirement.

Mineral Property Conveyances and Related Transactions

.042 Mineral interests in properties are frequently conveyed to others for a variety of reasons, including the desire to spread risks, to obtain financing, to improve operating efficiency, and to achieve tax benefits. Conveyances of those interests may involve the transfer of all or a part of the rights and responsibilities of operating a property (operating interest). The transferor may or may not retain an interest in the oil and gas produced that is free of the responsibilities and costs of operating the property (a nonoperating interest). A transaction may, on the other hand, involve the transfer of a nonoperating interest to another party and retention of the operating interest.

.043 Certain transactions, sometimes referred to as conveyances, are in substance borrowings repayable in cash or its equivalent and shall be accounted for as borrowings. The following are examples of such transactions:

a. Enterprises seeking supplies of oil or gas sometimes make cash advances to operators to finance exploration in return for the right to purchase oil or gas discovered. Funds advanced for exploration that are repayable by offset against purchases of oil or gas discovered, or in cash if insufficient oil or gas is pro-

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duced by a specified date, shall be accounted for as a receivable by the lender and as a payable by the operator.

b. Funds advanced to an operator that are repayable in cash out of the proceeds from a specified share of future production of a producing property, until the amount advanced plus interest at a specified or determinable rate is paid in full, shall be accounted for as a borrowing. The advance is a payable for the recipient of the cash and a receivable for the party making the advance. Such transactions, as well as those described in paragraph .047(a) below, are commonly referred to as production payments. The two types differ in substance, however, as explained in paragraph .047(a).

.044 In the following types of conveyances, gain or loss shall not be recognized at the time of the conveyance:

a. A transfer of assets used in oil and gas producing activities (including both proved and unproved properties) in exchange for other assets also used in oil and gas producing activities.
b. A pooling of assets in a joint undertaking intended to find, develop, or produce oil or gas from a particular property or group of properties.

.045 In the following types of conveyances, gain shall not be recognized at the time of the conveyance:

a. A part of an interest owned is sold and substantial uncertainty exists about recovery of the costs applicable to the retained interest.
b. A part of an interest owned is sold and the seller has a substantial obligation for future performance, such as an obligation to drill a well or to operate the property without proportional reimbursement for that portion of the drilling or operating costs applicable to the interest sold.

.046 If a conveyance is not one of the types described in paragraphs .044 and .045, gain or loss shall be recognized unless there are other aspects of the transaction that would prohibit such recognition under accounting principles applicable to enterprises in general.

.047 In accordance with paragraphs .044-.046, the following types of transactions shall be accounted for as indicated in each example.[3] No attempt has been made to include the many variations of those arrangements that occur, but paragraphs .044-.046

[3] Costs of unproved properties are always subject to an assessment for impairment as required by paragraph .028.

shall, where applicable, determine the accounting for those other arrangements as well.

a. Some production payments differ from those described in paragraph .043(b) in that the seller's obligation is not expressed in monetary terms but as an obligation to deliver, free and clear of all expenses associated with operation of the property, a specified quantity of oil or gas to the purchaser out of a specified share of future production. Such a transaction is a sale of a mineral interest for which gain shall not be recognized because the seller has a substantial obligation for future performance. The seller shall account for the funds received as unearned revenue to be recognized as the oil or gas is delivered. The purchaser of such a production payment has acquired an interest in a mineral property that shall be recorded at cost and amortized by the unit-of-production method as delivery takes place. The related reserve estimates and production data shall be reported as those of the purchaser of the production payment and not of the seller (paragraphs .050-.056).

b. An assignment of the operating interest in an unproved property with retention of a nonoperating interest in return for drilling, development, and operation by the assignee is a pooling of assets in a joint undertaking for which the assignor shall not recognize gain or loss. The assignor's cost of the original interest shall become the cost of the interest retained. The assignee shall account for all costs incurred as specified by paragraphs .015-.041 and shall allocate none of those costs to the mineral interest acquired. If oil or gas is discovered, each party shall report its share of reserves and production (paragraphs .050-.056).

c. An assignment of a part of an operating interest in an unproved property in exchange for a "free well" with provision for joint ownership and operation is a pooling of assets in a joint undertaking by the parties. The assignor shall record no cost for the obligatory well; the assignee shall record no cost for the mineral interest acquired. All drilling, development, and operating costs incurred by either party shall be accounted for as provided in paragraphs .015-.041 of this Statement. If the conveyance agreement requires the assignee to incur geological or geophysical expenditures instead of, or in addition to, a drilling obligation, those costs shall likewise be accounted for by the assignee as provided in paragraphs .015-.041 of this Statement. If reserves are discovered, each party shall report its share of reserves and production (paragraphs .050-.056).

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d. A part of an operating interest in an unproved property may be assigned to effect an arrangement called a "carried interest" whereby the assignee (the carrying party) agrees to defray all costs of drilling, developing, and operating the property and is entitled to all of the revenue from production from the property, excluding any third party interest, until all of the assignee's costs have been recovered, after which the assignor will share in both costs and production. Such an arrangement represents a pooling of assets in a joint undertaking by the assignor and assignee. The carried party shall make no accounting for any costs and revenue until after recoupment (payout) of the carried costs by the carrying party. Subsequent to payout the carried party shall account for its share of revenue, operating expenses, and (if the agreement provides for subsequent sharing of costs rather than a carried interest) subsequent development costs. During the payout period the carrying party shall record all costs, including those carried, as provided in paragraphs .015-.041 and shall record all revenue from the property including that applicable to the recovery of costs carried. The carried party shall report as oil or gas reserves only its share of proved reserves estimated to remain after payout, and unit-of-production amortization of the carried party's property cost shall not commence prior to payout. Prior to payout the carrying party's reserve estimates and production data shall include the quantities applicable to recoupment of the carried costs (paragraphs .050-.056).

e. A part of an operating interest owned may be exchanged for a part of an operating interest owned by another party. The purpose of such an arrangement, commonly called a joint venture in the oil and gas industry, often is to avoid duplication of facilities, diversify risks, and achieve operating efficiencies. Such reciprocal conveyances represent exchanges of similar productive assets, and no gain or loss shall be recognized by either party at the time of the transaction. In some joint ventures which may or may not involve an exchange of interests, the parties may share different elements of costs in different proportions. In such an arrangement a party may acquire an interest in a property or in wells and related equipment that is disproportionate to the share of costs borne by it. As in the case of a carried interest or a free well, each party shall account for its own cost under the provisions of this Statement. No gain shall be recognized for the acquisition of an interest in joint assets, the cost of which may have been paid in whole or in part by another party.

f. In a unitization all the operating and nonoperating participants pool their assets in a producing area (normally a field) to form

a single unit and in return receive an undivided interest (of the same type as previously held) in that unit. Unitizations generally are undertaken to obtain operating efficiencies and to enhance recovery of reserves, often through improved recovery operations. Participation in the unit is generally proportionate to the oil and gas reserves contributed by each. Because the properties may be in different stages of development at the time of unitization, some participants may pay cash and others may receive cash to equalize contributions of wells and related equipment and facilities with the ownership interests in reserves. In those circumstances, cash paid by a participant shall be recorded as an additional investment in wells and related equipment and facilities, and cash received by a participant shall be recorded as a recovery of cost. The cost of the assets contributed plus or minus cash paid or received is the cost of the participant's undivided interest in the assets of the unit. Each participant shall include its interest in reporting reserve estimates and production data (paragraphs .050-.056).

g. If the entire interest in an unproved property is sold for cash or cash equivalent, recognition of gain or loss depends on whether, in applying paragraph .028 of this Statement, impairment had been assessed for that property individually or by amortizing that property as part of a group. If impairment was assessed individually, gain or loss shall be recognized. For a property amortized by providing a valuation allowance on a group basis, neither gain nor loss shall be recognized when an unproved property is sold unless the sales price exceeds the original cost of the property, in which case gain shall be recognized in the amount of such excess.

h. If a part of the interest in an unproved property is sold, even though for cash or cash equivalent, substantial uncertainty usually exists as to recovery of the cost applicable to the interest retained. Consequently, the amount received shall be treated as a recovery of cost.[4] However, if the sales price exceeds the carrying amount of a property whose impairment has been assessed individually in accordance with paragraph .028 of this Statement, or exceeds the original cost of a property amortized by providing a valuation allowance on a group basis, gain shall be recognized in the amount of such excess.

i. The sale of an entire interest in a proved property that constitutes a separate amortization base is not one of the types of

[4] The carrying amount of the interest retained shall continue to be subject to the assessment for impairment as required by paragraph .028.

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conveyances described in paragraph .044 or .045. The difference between the amount of sales proceeds and the unamortized cost shall be recognized as a gain or loss.

j. The sale of a part of a proved property, or of an entire proved property constituting a part of an amortization base, shall be accounted for as the sale of an asset, and a gain or loss shall be recognized, since it is not one of the conveyances described in paragraph .044 or .045. The unamortized cost of the property or group of properties a part of which was sold shall be apportioned to the interest sold and the interest retained on the basis of the fair values of those interests. However, the sale may be accounted for as a normal retirement under the provisions of paragraph .041 with no gain or loss recognized if doing so does not significantly affect the unit-of-production amortization rate.

k. The sale of the operating interest in a proved property for cash with retention of a nonoperating interest is not one of the types of conveyances described in paragraph .044 or .045. Accordingly, it shall be accounted for as the sale of an asset, and any gain or loss shall be recognized. The seller shall allocate the cost of the proved property to the operating interest sold and the nonoperating interest retained on the basis of the fair values of those interests.[5]

l. The sale of a proved property subject to a retained production payment that is expressed as a fixed sum of money payable only from a specified share of production from that property, with the purchaser of the property obligated to incur the future costs of operating the property, shall be accounted for as follows:

    i. *If satisfaction of the retained production payment is reasonably assured.* The seller of the property, who retained the production payment, shall record the transaction as a sale, with recognition of any resulting gain or loss. The retained production payment shall be recorded as a receivable, with interest accounted for in accordance with the provisions of *APB Opinion No. 21* [section 4111], "Interest on Receivables and Payables." The purchaser shall record as the cost of the assets acquired the cash consideration paid plus the present value (determined in accordance with *APB Opinion No. 21* [section 4111]) of the retained production payment, which shall be recorded as a payable. The oil and gas reserve estimates

[5] A retained production payment denominated in money is not a mineral interest (see paragraphs .011(a) and .043).

and production data, including those applicable to liquidation of the retained production payment, shall be reported by the purchaser of the property (paragraphs .050-.056).

ii. *If satisfaction of the retained production payment is not reasonably assured.* The transaction is in substance a sale with retention of an overriding royalty that shall be accounted for in accordance with paragraph .047(k).

m. The sale of a proved property subject to a retained production payment that is expressed as a right to a specified quantity of oil or gas out of a specified share of future production shall be accounted for in accordance with paragraph .047(k).

Disclosure

.048 An enterprise engaged in oil and gas producing activities shall include in a complete set of annual financial statements the disclosures specified in paragraphs .050-.059. Those disclosures may be made within the body of the financial statements, in the notes thereto, or in a separate schedule that is an integral part of the financial statements.

.049 Disclosure of capitalized costs (paragraph .057) shall also be included in a complete set of interim financial statements that present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Disclosures of reserve quantities and of costs incurred as set forth in paragraphs .050-.056 and .058 and .059 are not required in such interim financial statements, though the Board encourages disclosure in those financial statements of information about a major discovery or other favorable or adverse event that causes a significant change from the reserve data reported in the most recent annual financial statements.

Disclosure of Reserve Quantities

.050 Net quantities of an enterprise's interests in proved reserves and proved developed reserves of (a) crude oil (including condensate and natural gas liquids) and (b) natural gas shall be reported as of the beginning and the end of each year for which a complete set of financial statements is presented. "Net" quantities of reserves include those relating to the enterprise's operating and nonoperating interests in properties as defined in paragraph .011(a). Quantities of reserves relating to royalty interests owned shall be included in "net" quantities if the necessary in-

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formation is available to the enterprise; if reserves relating to royalty interests owned are not included because the information is unavailable, that fact and the enterprise's share of oil and gas produced for those royalty interests shall be reported for each year for which a complete set of financial statements is presented. "Net" quantities shall not include reserves relating to interests of others in properties owned by the enterprise.

.051 Changes in the net quantities of an enterprise's proved reserves of oil and of gas during each year for which a complete set of financial statements is presented shall be reported. Changes resulting from each of the following shall be separately shown with appropriate explanation of significant changes:

a. *Revisions of previous estimates.* Revisions represent changes in previous estimates of proved reserves, either upward or downward, resulting from new information (except for an increase in proved acreage) normally obtained from development drilling and production history or resulting from a change in economic factors.
b. *Improved recovery.* Changes in reserve estimates resulting from application of improved recovery techniques shall be separately shown if significant. If not significant, such changes shall be included in revisions of previous estimates.
c. *Purchases of minerals-in-place.*
d. *Extensions, discoveries, and other additions.* Additions to an enterprise's proved reserves that result from (i) extension of the proved acreage of previously discovered (old) reservoirs through additional drilling in periods subsequent to discovery and (ii) discovery of new fields with proved reserves or of new reservoirs of proved reserves in old fields.
e. *Production.*
f. *Sales of minerals-in-place.*

.052 If an enterprise's proved reserves of oil and gas are located entirely within its home country, that fact shall be disclosed. If some or all of its reserves are located in foreign countries, the disclosures of net quantities of reserves of oil and of gas and changes in them required by paragraphs .050 and .051 shall be separately reported for (a) the enterprise's home country (if significant reserves are located there) and (b) each foreign geographic area in which significant reserves are located. Foreign geographic areas are individual countries or groups of countries as appropriate for meaningful disclosure in the circumstances.

.053 Net quantities disclosed in conformity with paragraphs .050-.052 shall not include oil or gas subject to purchase under long-term supply, purchase, or similar agreements and contracts, including such agreements with foreign governments or authorities. However, quantities of oil or gas subject to such agreements with foreign governments or authorities as of the end of each year for which a complete set of financial statements is presented, and the net quantity of oil or gas received under the agreements during each such year, shall be separately disclosed if the enterprise participates in the operation of the properties in which the oil or gas is located or otherwise serves as the "producer" of those reserves, as opposed, for example, to being an independent purchaser, broker, dealer, or importer.

.054 In determining the reserve quantities to be reported in conformity with paragraphs .050-.053:

a. If the enterprise issues consolidated financial statements, 100 percent of the *net* reserve quantities attributable to the parent company and 100 percent of the *net* reserve quantities attributable to its consolidated subsidiaries (whether or not wholly owned) shall be included.
b. If the enterprise's financial statements include investments that are proportionately consolidated, the enterprise's reserve quantities shall include its proportionate share of the investee's net oil and gas reserves.
c. If the enterprise's financial statements include investments that are accounted for by the equity method, the investee's net oil

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	Total Worldwide		United States		Foreign Geographic Area A		Foreign Geographic Area B		Other Foreign Geographic Areas	
	Oil	*Gas*	*Oil*	*Gas*	*Oil*	*Gas*	*Oil*	*Gas*	*Oil*	*Gas*
Proved developed and undeveloped reserves:										
Beginning of year	X	X	X	X	X	X	X	X	X	X
Revisions of previous estimates	X	X	X	X	X	X	X	X	X	X
Improved recovery	X	X	X	X	X	X	X	X	X	X
Purchases of minerals-in-place	X	X	X	X	X	X	X	X	X	X
Extensions, discoveries, and other additions	X	X	X	X	X	X	X	X	X	X
Production	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)
Sales of minerals-in-place	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)
End of year	X	X	X	X	X	X	X	X	X	X
Proved developed reserves:										
Beginning of year	X	X	X	X	X	X	X	X	X	X
End of year	X	X	X	X	X	X	X	X	X	X
Oil and gas applicable to long-term supply agreements with foreign governments or authorities in which the company acts as producer:										
Proved reserves at end of year	X	X			X	X	X	X	X	X
Received during the year	X	X			X	X	X	X	X	X
Company's proportional interest in reserves of investees accounted for by the equity method, end of year	X	X	X	X	X	X	X	X	X	X

and gas reserves shall *not* be included in the disclosures of the enterprise's reserves. However, the enterprise's (investor's) share of the investee's net oil and gas reserves shall be separately reported as of the end of each year for which a complete set of financial statements is presented.

.055 In reporting reserve quantities and changes in them, oil reserves (which include condensate and natural gas liquids) shall be stated in barrels, and gas reserves in cubic feet. Disclosures of the type called for by paragraphs .050-.054 are diagrammed on the previous page.

.056 If important economic factors or significant uncertainties affect particular components of an enterprise's proved reserves, explanation shall be provided. Examples include unusually high expected development or lifting costs; the necessity to build a major pipeline or other major facilities before production of the reserves can begin; or contractual obligations to produce and sell a significant portion of reserves at prices that are substantially below those at which the oil or gas could otherwise be sold in the absence of the contractual obligation.

Disclosure of Capitalized Costs

.057 The aggregate amount of capitalized costs relating to an enterprise's oil and gas producing activities (paragraph .011) and the aggregate amount of the related accumulated depreciation, depletion, amortization, and valuation allowances shall be reported as of the end of each period for which financial statements are presented. Paragraph 5 of *APB Opinion No. 12* [section 2043.02], "Omnibus Opinion—1967," requires disclosure of "balances of major classes of depreciable assets, by nature or function." Thus, separate disclosure of the amount of capitalized costs for one or more of asset categories (a) to (d) in paragraph .011 or for a combination of two or more of those categories often may be appropriate.

Disclosure of Costs Incurred in Oil and Gas Producing Activities

.058 The financial statements of an oil and gas producing company shall disclose the amounts of each of the following types of costs for each year for which a complete set of financial statements is presented (whether those costs are capitalized or charged to expense at the time they are incurred under the provisions of paragraphs .015-.026). As defined in the paragraphs cited, exploration, development, and production costs *include* depreciation of support equipment and facilities used in those activities and *do not include* the expenditures to acquire support equipment and fa-

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cilities. Also, as stated in paragraph .025, production (lifting) costs do not include depreciation, depletion, and amortization of capitalized acquisition, exploration, and development costs.

a. Property acquisition costs (paragraph .015).
b. Exploration costs (paragraph .017).
c. Development costs (paragraph .021).
d. Production (lifting) costs (paragraph .024).

.059 If some or all of those costs are incurred in foreign countries, the amounts shall be disclosed separately for each of the geographic areas for which reserve quantities are disclosed (paragraph .052).

Accounting for Income Taxes

.060 Some costs incurred in an enterprise's oil and gas producing activities enter into the determination of taxable income and pretax accounting income in different periods. A principal example is intangible drilling and development costs, which are deductible in determining taxable income when incurred but which, for successful exploratory wells and for all development wells, are capitalized and amortized for financial accounting purposes under the provisions of this Statement. As another example, some geological and geophysical costs, which are charged to expense when incurred under the provisions of this Statement, are deferred and deducted in subsequent periods for income tax purposes.

.061 Comprehensive interperiod income tax allocation by the deferred method, as described in *APB Opinion No. 11* [section 4091], "Accounting for Income Taxes," shall be followed by oil and gas producing companies for intangible drilling and development costs and other costs incurred that enter into the determination of taxable income and pretax accounting income in different periods.

.062 In applying the comprehensive interperiod income tax allocation provision of the preceding paragraph, the possibility that statutory depletion in future periods will reduce or eliminate the amount of income taxes otherwise payable shall not be taken into account. That is, the so-called *interaction* of book/tax timing differences with any anticipated future excess of statutory depletion allowed as a tax deduction over the amount of cost depletion otherwise allowable as a tax deduction shall not be recognized in determining the appropriate periodic provision for income taxes. Accordingly, the excess of statutory depletion over cost depletion for tax purposes shall be accounted for as a permanent difference

in the period in which the excess is deducted for income tax purposes; it shall not be anticipated by recognizing interaction.

Effective Date and Transition

.063 This Statement shall be effective for financial statements for fiscal years beginning after December 15, 1978 and for interim periods within those fiscal years. Accounting changes adopted to conform to the provisions of this Statement, including changes to apply comprehensive interperiod income tax allocation (paragraph .061) and to eliminate the recognition of the interaction of book/tax timing differences with the excess of statutory depletion over cost depletion for tax purposes (paragraph .062), shall be made retroactively by restating the financial statements of prior periods. Financial statements for the fiscal year in which this Statement is first applied, and for interim periods of that year, shall disclose the nature of those accounting changes and their effect on income before extraordinary items, net income, and related per share amounts for each period restated. The disclosures specified by paragraphs .050-.059 shall be included in complete sets of financial statements that have been restated pursuant to the provisions of this paragraph.

.064 Retroactive application of the provisions of this Statement requires the use of estimates and approximations; a provision that would not have a significant effect on prior years' financial statements need not be retroactively applied. Further, retroactive application of some provisions of this Statement may require the use of estimates of a type that the enterprise had not previously made; information that may have become available some time after the year being restated may be taken into account in making those estimates, except that estimates of quantities of oil and gas reserves that had been made in prior years shall not currently be revised in retrospect.

The provisions of this Statement need not be applied to immaterial items.

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Appendix A

BACKGROUND INFORMATION

.065 Financial accounting and reporting for oil and gas producing companies has been debated for many years in the United States by the accounting profession, regulatory agencies, industry groups, and the companies themselves. The principal focus in recent years has been on the two widely different methods of accounting followed by those companies—the full cost method and the successful efforts method.

.066 In 1964, the American Institute of Certified Public Accountants commissioned Robert E. Field, a partner of Price Waterhouse & Co., to study the various accounting methods used by companies in the extractive industries and to make recommendations for consideration by the AICPA Accounting Principles Board in formulating a pronouncement. The study was published by the AICPA in 1969 as *Accounting Research Study No. 11,* "Financial Reporting in the Extractive Industries." The recommendations in *ARS No. 11* essentially supported the successful efforts method of accounting.

.067 In 1970, the APB asked its Committee on Extractive Industries to (a) study the recommendations in *ARS No. 11* and (b) "determine the appropriate accounting practices with the intent of narrowing the different accounting practices in the extractive industries." In mid-1971, the Committee drafted a proposed APB Opinion dealing only with determination of the appropriate *cost center,* on the belief that issues associated with the cost center question were at the heart of the full cost/successful efforts controversy. The full APB decided, however, that limiting an Opinion to the cost center question was inappropriate. The APB directed its Committee to prepare a paper containing recommendations on (a) determination of the cost center, (b) accounting for prediscovery and postdiscovery costs, (c) disposition of capitalized costs, and (d) disclosure of supplementary information in financial reports.

.068 The APB Committee paper was published in the fall of 1971 under the title "Accounting and Reporting Practices in the Petroleum Industry." The paper recommended using the *field* as the cost center and capitalizing all prediscovery and postdiscovery costs that could be directly associated with oil and gas reserves, including reinstatement of the costs of exploratory dry holes initially written off but later determined to be in a field. The APB sched-

uled a public hearing for November 1971, with the Committee paper to serve as the basis for the hearing.

.069 While the APB Committee was deliberating and preparing its paper, the Federal Power Commission was studying the accounting practices of natural gas producing companies subject to its jurisdiction. In October 1970, the FPC issued a proposal to require application of the full cost concept in FPC filings by natural gas companies. During the following thirteen months, the FPC weighed arguments for and against its proposal, including a request from the APB that the FPC delay final action until an APB Opinion could be issued. On November 5, 1971, the FPC issued Order No. 440 adopting the full cost method for mineral leases acquired after October 6, 1969 with each country as a cost center. Petitions for rehearing, which were filed on December 5, 1971, were denied by the FPC in Order No. 440-A issued January 5, 1972.

.070 The APB's public hearing was held on November 22 and 23, 1971. At the hearing, the recommendations in the APB Committee paper were opposed not only by advocates of the full cost method, who viewed the proposal to use the field as the cost center as effectively banning the full cost concept, but also by many advocates of successful efforts accounting, who disagreed with various aspects of the recommendations including, among other things, the capitalization of the costs of development dry holes and those exploratory dry holes determined to be in a field. After the hearing, the APB Committee on Extractive Industries continued to work on a proposed Opinion. The testimony given at that public hearing and the written submissions to the APB have been studied by the FASB.

.071 On July 1, 1973, the FASB succeeded the APB as the private sector accounting standards-setting body. The APB Committee prepared for the FASB a detailed report on its activities entitled "Accounting and Reporting Practices in the Oil and Gas Industry." That report is reprinted as an appendix to the FASB Discussion Memorandum on the project.

.072 In January 1973, a group of oil and gas producing companies that use the full cost method formed the Ad Hoc Committee (Petroleum Companies) on Full Cost Accounting. That Committee commissioned a research study by John H. Myers, Professor of Accounting at Indiana University. The study, entitled *Full Cost vs. Successful Efforts in Petroleum Accounting: An*

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Empirical Approach, was published in 1974. Dr. Myers simulated the results of accounting for various types of transactions under each of the two methods and concluded that full cost accounting together with disclosure of data on oil and gas reserves better serves the needs of users of financial statements.

.073 In 1975, Congress substantially reduced or eliminated the percentage depletion deduction for many oil and gas producing companies, which led to the issuance in October 1975 of *FASB Statement No. 9* [section 4097].

.074 The FASB did not place accounting and reporting in the extractive industries on its initial technical agenda in 1973, but the foreign oil embargo of that year and the resulting substantial increases in world oil prices aroused great interest in the oil and gas industry on the part of both the American public and the federal government. With other energy legislation enacted or under active consideration by Congress, the FASB decided that accounting by oil and gas producing companies should receive high priority. In October 1975, it added to its technical agenda a project entitled "Financial Accounting and Reporting in the Extractive Industries."

.075 In December 1975, President Gerald R. Ford signed Public Law 94-163, the *Energy Policy and Conservation Act* [42 U.S. Code, Sec. 6383]. Title V, Section 503 of the Act empowers the Securities and Exchange Commission either:

> to prescribe rules applicable to persons engaged in the production of crude oil or natural gas, or make effective by recognition, or by other appropriate means indicating a determination to rely on, accounting practices developed by the Financial Accounting Standards Board, if the Securities and Exchange Commission is assured that such practice will be observed by persons engaged in the production of crude oil or natural gas to the same extent as would result if the Securities and Exchange Commission had prescribed such practices by rule.

.076 The effect of Section 503 is to require that the contemplated accounting practices be developed by December 22, 1977 (24 months after the Act was signed into law) for all persons engaged either exclusively or partially in the production of crude oil or natural gas in the United States. The Act requires the SEC to provide an opportunity for interested persons to submit written comments on whether the Commission should recognize or otherwise rely on the standards developed by the FASB. That comment period can be after December 22, 1977.

.077 The Act further provides that the SEC shall assure that the accounting practices developed pursuant to Section 503 will, to the greatest extent practicable, permit the compilation of a national energy data base consisting of the following data with domestic and foreign operations treated separately:

(1) The separate calculation of capital, revenue, and operating cost information pertaining to—

(A) prospecting,

(B) acquisition,

(C) exploration,

(D) development, and

(E) production,

including geological and geophysical costs, carrying costs, unsuccessful exploratory drilling costs, intangible drilling and development costs on productive wells, the cost of unsuccessful development wells, and the cost of acquiring oil and gas reserves by means other than development. Any such calculation shall take into account disposition of capitalized costs, contractual arrangements involving special conveyance of rights and joint operations, differences between book and tax income, and prices used in the transfer of products or other assets from one person to any other person, including a person controlled by, controlling, or under common control with such person.

(2) The full presentation of the financial information of persons engaged in the production of crude oil or natural gas, including—

(A) disclosure of reserves and operating activities, both domestic and foreign, to facilitate evaluation of financial effort and result; and

(B) classification of financial information by function to facilitate correlation with reserve and operating statistics, both domestic and foreign.

(3) Such other information, projections, and relationships of collected data as shall be necessary to facilitate the compilation of such data base.

.078 The Board is issuing this Statement under its authority, which exists entirely apart from the Act, and also to assist the SEC in carrying out its obligations as contemplated by Congress under the Act as well as under the federal securities laws.

.079 The FASB appointed a task force of 18 persons in December 1975 to counsel the Board in preparing a Discussion Memorandum analyzing issues related to the project. Members of the task force came from the oil and gas industry, petroleum geology and engineering, other extractive industries, public accounting, banking, securities underwriting, and academe. Professor Horace R. Brock of North Texas State University was engaged by the Board to serve as chairman of the task force and consult-

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ant to the Board during the preparation of the Discussion Memorandum. Meetings of the task force were attended by observers from the following federal agencies and Congressional committee:

a. Cost Accounting Standards Board.

b. Federal Energy Administration.

c. Federal Power Commission.

d. Securities and Exchange Commission.

e. Oversight and Investigations Subcommittee of the Committee on Interstate and Foreign Commerce, United States House of Representatives.

f. United States General Accounting Office.

.080 The task force held its initial meeting in January 1976. Three additional meetings were held during that year. Much of the work of the task force was accomplished by correspondence, with task force members providing the Board with a significant amount of input concerning the accounting and reporting issues that they believed should be addressed in this project. Drafts of all sections of the Discussion Memorandum were sent to task force members and observers for written comment. Although the chairman of the task force and members of the staff of the FASB assumed primary responsibility for drafting the Discussion Memorandum, some sections were initially drafted by task force members expert on the particular matter being discussed.

.081 In February 1976, the FASB concluded, on the basis of a task force recommendation, that the Discussion Memorandum should not be restricted to only the oil and gas industry, but should cover accounting and reporting issues relevant to companies engaged in the search for and production of all wasting (nonregenerative) natural resources. That recommendation was not unanimously supported by the task force. Some members believed that it would be preferable to focus initially on the oil and gas industry, as the APB Committee on Extractive Industries had done. Those members were also concerned that broadening the study could blur important distinctions between oil and gas companies and other extractive industries. The FASB, in accepting the recommendation of a majority of the task force members, concluded that apparent similarities of operations among extractive industries warranted the inclusion of all such industries in the scope of the Discussion Memorandum. The Board noted in the Discussion

Memorandum, however, that inclusion of all extractive industries within the scope of the project at that stage did not mean that the Board intended to issue a single Statement covering all of those industries.

.082 On March 23, 1976, the SEC issued *Accounting Series Release No. 190* amending Regulation S-X to require companies that meet specified size tests to disclose certain replacement cost data relating to "inventories" and "productive capacity" in financial statements filed with the Commission for fiscal years ending on or after December 25, 1976. In that Release, the SEC delayed for one year the effective date of the required replacement cost disclosures for "mineral resource assets." SEC *Staff Accounting Bulletin No. 10* defines mineral resource assets as "those costs shown on the balance sheet representing assets which are directly associated with and which derive value from mineral reserves." In June 1977, the American Petroleum Institute published and submitted to the SEC a study by Professors Glenn A. Welsch and Edward B. Deakin, of the University of Texas at Austin, entitled *Measuring and Reporting the "Replacement" Cost of Oil and Gas Reserves*. In transmitting the study to the SEC, the API stated its view that "the concept of replacement cost as envisioned in ASR 190 is not applicable to oil and gas reserves" and urged the SEC to "permanently exempt oil and gas reserves from replacement cost disclosure."

.083 On May 12, 1976, the SEC issued *Securities Act Release No. 5706,* which requires that information relating to oil and gas properties, reserves, and production be disclosed in registration statements, proxy statements, and reports filed with the Commission.

.084 In preparing the Discussion Memorandum, the task force and the Board considered many research studies and other publications in addition to *ARS No. 11* and the study by Dr. Myers, including the proceedings of the APB's public hearing and studies of accounting and reporting practices in the extractive industries by public accounting firms and industry associations. Approximately 100 recent (generally post-1968) publications on accounting and reporting in the extractive industries were reviewed by the FASB staff; a bibliography is included as an appendix to the Discussion Memorandum. Copies of those publications are in the FASB library.

.085 The Board issued the Discussion Memorandum on December 23, 1976 with written comments due by March 7, 1977. In

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response to the Discussion Memorandum, the Board received 140 position papers, letters of comment, and outlines (totalling approximately 2,600 pages), copies of which have been available for inspection at the Board's offices since March 14, 1977 and are available for purchase. Copies were made available to each of the observer groups identified in paragraph .079.

.086 On January 31, 1977, in *Securities Act Release No. 5801,* the SEC called attention to publication of the FASB Discussion Memorandum and encouraged interested parties to obtain and comment on the Memorandum and to participate in the FASB public hearing. The Release states that "the Commission, consistent with its policy most recently expressed in Accounting Series Release No. 150, contemplates that the Financial Accounting Standards Board (FASB) will be providing the leadership in establishing financial accounting principles and standards for producers of oil and gas." A part of one of the chapters in the Discussion Memorandum was prepared by the staff of the SEC. It considers matters relating to the SEC's responsibilities regarding the national energy data base.

.087 The Board held a public hearing on the subject on March 30 and 31 and April 1 and 4, 1977. Thirty-nine presentations were made at the hearing. A transcript of the hearing (nearly 1,000 pages in length) is available for inspection or purchase. Copies were made available to each of the observer groups identified in paragraph .079.

.088 Seven days of concentrated preparatory sessions were held by the Board prior to deliberations on the issues. Those sessions were devoted to detailed examination of (a) the nature of acquisition, exploration, development, and production activities in the oil and gas industry; (b) the features and variations of the full cost method, the successful efforts method, discovery value accounting, and current value accounting; (c) reserve definitions and measurement; (d) reserve valuation; and (e) mineral property conveyances and contracts. Outside experts were invited to make presentations or otherwise assist the Board's staff in conducting the sessions. Those experts, eight of whom were task force members, included petroleum engineers and geologists, public accountants, corporate executives from the oil and gas industry, and academicians.

.089 Subsequent to issuance of the Discussion Memorandum, the Board and its staff have maintained close contact with representatives of the SEC who, in turn, have been in contact with the other government agencies concerned with implementing the *Energy Policy and Conservation Act* and other federal energy legislation,

with the mutual objective of keeping all parties informed of the others' activities regarding accounting and reporting by oil and gas producing companies. That close contact has continued after issuance of the FASB's Exposure Draft.

.090 In addition to the Discussion Memorandum and the research studies and other publications mentioned earlier in paragraph .084, two other research efforts were undertaken at the Board's request during its deliberations on the Exposure Draft:

a. Academic consultants conducted interviews to ascertain how investment and credit decisions regarding oil and gas producing companies are reached. The 24 interviewees included loan officers of large and small banks that make loans to large and small oil and gas companies, bank trust department officers, institutional securities underwriters for both large and small companies, securities analysts, and an officer of a bond rating agency. The selection of interviewees from both the Northeast and the Southwest was designed to include organizations that invest or recommend investments in small as well as large companies. While the limited number of interviews did not provide conclusive evidence, the majority of interviewees indicated that the method of accounting would not affect their investment and credit decisions regarding oil and gas producing companies. The key factor in the decisions of a number of interviewees was their own valuations of oil and gas reserves and other assets; others relied heavily on cash flow data rather than earnings; still others took into consideration the method of accounting when evaluating earnings. Several interviewees believed that reduced earnings from accounting changes probably affected some investors and thus could adversely affect some stock prices.

b. A study was made of how *FASB Statement No. 9* [section 4097] was applied in practice. The study found no relationship between the way that Statement was applied and the method of accounting employed or company size.

.091 On June 20, 1977, the SEC issued *Securities Act Release No. 5837* soliciting comments in connection with the Commission's responsibilities under the *Energy Policy and Conservation Act* to assure the development and observance of accounting practices to be followed by U.S. producers of crude oil and natural gas. That Release not only raised questions relating to the reporting of financial and operating data to the Federal Energy Administrator but also solicited comments about the extent to which that data should

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be "included in filings with the Commission in a manner which would require independent public accountants reporting on registrants' financial statements to be associated with the data." The Release indicated that "the Commission recognizes that the FASB is considering for inclusion in its proposed standard the disclosure of functional financial data and information on oil and gas reserves. The Commission will be cognizant of the FASB's conclusions in this area and will attempt to coordinate the reporting requirements pursuant to the Act and any revisions proposed to the disclosure requirements under the Securities Acts with the disclosures required in financial statements by the FASB. Reporting pursuant to the Act and any changes to the Commission's disclosure rules may encompass matters . . . in addition to or in greater detail than those required by the FASB."

.092 The Board issued an Exposure Draft of a proposed Statement on "Financial Accounting and Reporting by Oil and Gas Producing Companies" on July 15, 1977. It received letters of comment on the Exposure Draft from 195 respondents (totalling approximately 1,300 pages). Copies of the letters were made available to each of the observer groups identified in paragraph .079.

.093 After the Exposure Draft was issued, two additional research studies were conducted at the Board's request:

a. A research consultant, with assistance from the FASB staff, studied the effect of the Exposure Draft on the market prices of common stock issued by both full cost and successful efforts oil and gas producing companies. The research was conducted by Professor Thomas R. Dyckman of Cornell University, using data part of which was supplied by the FASB staff. Two research methodologies were employed. The first required two samples of equal size and was applied to companies that derive more than 50 percent of their revenue from exploration and production activities. The market prices of common shares issued by 22 full cost companies and 22 successful efforts companies were studied for the 11 weeks before and the 11 weeks after the Exposure Draft was issued. The study did not find statistically significant evidence that issuance of the Exposure Draft affected the market prices of securities issued by the full cost companies as compared to those of the successful efforts companies—except for some possible effect on the full cost companies during the week preceding and the week of issuance of the Exposure Draft, but the market soon adjusted, and evidence of a permanent or lingering effect was not found. The second methodology

employed different underlying statistical procedures and was applied to broader samples. Those samples were not limited to companies engaged primarily in exploration and production but were limited to oil and gas companies with annual revenues less than $1 billion each. The samples included 65 full cost companies and 40 successful efforts companies. Again, the evidence did not support the hypothesis that the prices of shares issued by full cost companies were adversely affected, other than for a very brief period, by issuance of the Exposure Draft. Both Professor Dyckman and the Board recognize that statistical testing may not necessarily be conclusive. Following issuance of this Statement, the Board will undertake a similar study with respect to whether this Statement adversely affects the market prices of securities of oil and gas producing companies that heretofore had been using the full cost method as compared to those that had been using the successful efforts method.

b. The Board commissioned a telephone interview survey of senior executive officers of 27 relatively small and medium sized, publicly traded, successful efforts oil and gas producing companies (with annual revenues ranging from $1 million to $441 million, average $68 million). No large integrated oil and gas companies were included. The study was conducted under the direction of Professor Horace R. Brock of North Texas State University. The purpose of the survey was to ascertain whether, in the judgment of those corporate officers, the use of the successful efforts method of accounting has had any negative effect on the ability of their companies to raise the capital necessary to finance their exploration and production activities. Most of the surveyed companies have raised capital externally during the past 10 years from one or more of the following sources: public issue of debt securities, public issue of equity securities, private placement of securities, special conveyances, borrowing from a local bank, international bank, or insurance company, and sale of participations in individual projects. None of the executive officers surveyed indicated that the company's use of successful efforts accounting had hindered its ability to raise capital. Four of the officers did indicate an uncertainty as to whether their continued use of the successful efforts method would affect their ability to raise capital in the future.

.094 On August 31, 1977, the SEC issued *Securities Act Release No. 5861* proposing to amend the Commission's regulations to incorporate therein the accounting standards set forth in the FASB

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Exposure Draft. The Commission stated that the reason for the proposal is to place the Commission in a position to adopt by December 22, 1977 financial accounting and reporting standards for oil and gas producing activities in the unlikely event that the FASB has not adopted final standards by that date. The Release states that the proposed standards would be applicable to both (1) persons filing reports with the Department of Energy and (2) filings with the Commission under federal securities laws. The Commission stated that it proposed the rules pursuant to its authority under the *Energy Policy and Conservation Act* and the federal securities laws. The Release deals only with accounting standards and does not address disclosure matters.

.095 On October 26, 1977, the SEC issued two Releases dealing with disclosures by oil and gas producing companies. The first Release, *Securities Act Release No. 5877,* proposes to amend the Commission's regulations to provide for disclosure in financial statements of certain operating and financial data relating to oil and gas producing activities. Like the proposal mentioned in the preceding paragraph, the disclosure standards proposed in this Release would apply both to (1) filings with the Commission pursuant to federal securities laws and (2) reports filed with the Department of Energy pursuant to the *Energy Policy and Conservation Act.* The SEC's proposed disclosures are generally the same as those proposed in the FASB Exposure Draft.

.096 The second SEC Release of October 26, 1977, *Securities Act Release No. 5878,* deals with replacement cost disclosures for mineral resource assets. The Release proposes (1) to rescind the requirement adopted in *ASR No. 190* for certain registrants to disclose replacement cost information about their mineral resource assets employed in oil and gas producing activities (see paragraph .082 of this Statement) and (2) to require, instead, that registrants with mineral resource assets employed in oil and gas producing activities disclose information based on the present value of future net revenues from estimated production of proved oil and gas reserves. The Release points out that "the proposed disclosures cannot be described as replacement cost information; however, they would provide information on the differences between the historical costs associated with proved oil and gas reserves shown in the financial statements and the future net revenues to be derived from these reserves." That proposal would be effective in filings covering fiscal years end-

ing on or after December 25, 1978. Comments on the proposal are to be submitted to the Commission by March 31, 1978.

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Appendix B

Basis for Conclusions

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Appendix B

BASIS FOR CONCLUSIONS

.097 This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including alternatives considered and reasons for accepting some and rejecting others.

Scope

.098 Although the Discussion Memorandum for this project analyzed issues and solicited comments on accounting and reporting by companies in all extractive industries, this Statement applies only to the oil and gas producing industry as had been proposed in the Exposure Draft. Some respondents to the Discussion Memorandum and the Exposure Draft said that the mining industries are sufficiently different from the oil and gas industry to warrant separate pronouncements. For instance, some said that in the mining industries the principal emphasis is on the development and operation of existing mines and known deposits whereas in the oil and gas industry the principal emphasis is on the search for new mineral deposits. Also, some respondents said that mining operations involve substantially lower exploration and acquisition costs and substantially higher development and production costs relative to the oil and gas industry, which, they claimed, is characterized by high finding costs and a high proportion of unsuccessful search activities. In the view of those respondents, *discovery* is the critical event leading to the production of oil and gas whereas *development* and *extraction* are the critical events for most other minerals. Many who favored separating the oil and gas industry from other extractive industries pointed out also that the full cost versus successful efforts controversy has little significance in the mining industry while it is the primary issue for the oil and gas industry. Still others noted that there is greater uniformity in current accounting practices within the mining industries than within the oil and gas industry. Thus, they took the position that current generally accepted accounting principles are adequate for the mining industries and do not require the attention of the FASB at this time. The Board has not yet examined in depth those and other claimed dissimilarities between the oil and gas industry and other extractive industries; nor has it decided whether there is a need to address the other extractive industries in a separate pronouncement.

.099 In response to questions raised in letters of comment on the Exposure Draft, paragraph .007 indicates that this Statement does not deal with accounting for interest costs because that matter is being addressed in another Board agenda project.

The Four Basic Accounting Alternatives

.100 Four basic methods of accounting for a company's oil and gas producing activities were considered by the Board:

a. Full costing.

b. Successful efforts costing.

c. Discovery value accounting.

d. Current value accounting.

The principal features of each of those four methods, and variations within each method, are described in paragraphs .104-.127.

.101 Both full costing and successful efforts costing have been considered as conforming to generally accepted accounting principles, and both, in various forms, are widely used today. Discovery value accounting and current value accounting are both proposals that are not presently followed by oil and gas producing companies or by other companies (except in a few specialized industries and then only for certain assets with readily determinable market prices) in preparing their financial statements. The full costing method came into use around 1960 and only since the late 1960s has become widely used. A 1973 survey of nearly 300 oil and gas companies found that roughly half used full cost accounting and half used successful efforts costing.[6] A 1972 survey showed that companies employing the successful efforts method account for approximately 87 percent of U.S. oil and gas production, indicating that full costing has been adopted by relatively more small and medium sized companies than large companies.[7] Testimony given at the Board's public hearing by a spokesperson for an association of independent petroleum producers indicated

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[6] Ginsburg, Feldman and Bress, Attorneys for Ad Hoc Committee (Petroleum Companies), *Comments of the Ad Hoc Committee (Petroleum Companies) on Full Cost Accounting,* File No. S7-464, presented to the Securities and Exchange Commission, 14 March 1973, p. 31.

[7] Porter, Stanley P., *"Full Cost" Accounting: The Problem It Poses for the Extractive Industries* (New York: Arthur Young & Company, 1972), p. 6.

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that many independent oil and gas companies follow federal income tax accounting practices in preparing their financial statements; income tax accounting is a variation of successful efforts accounting.

Basic Differences between Full Costing and Successful Efforts Costing

.102 The principal difference between full costing and successful efforts costing concerns costs that cannot be directly related to the discovery of specific oil and gas reserves. Under full costing those costs are carried forward to future periods as costs of oil and gas reserves generally; under successful efforts costing those costs are charged to expense. Full costing regards the costs of unsuccessful acquisition and exploration activities as necessary for the discovery of reserves. All of those costs are incurred with the knowledge that many of a company's prospects will not result directly in the discovery of reserves. However, the company expects that the benefits obtained from those prospects that do prove successful together with the benefits from past discoveries will be adequate to recover the costs of all activities, both successful and unsuccessful, and will result in an ultimate profit. Thus, all costs incurred in oil and gas producing activities are regarded as integral to the acquisition, discovery, and development of whatever reserves ultimately result from the efforts as a whole, and are thus associated with the company's reserves. Establishing a direct cause-and-effect relationship between costs incurred and specific reserves discovered is not relevant to full costing. Under successful efforts costing, however, except for acquisition costs of properties, a direct relationship between costs incurred and specific reserves discovered is required before costs are identified with assets; costs of acquisition and exploration activities that are known not to have resulted in the discovery of reserves are charged to expense.

.103 Although many variations exist within the successful efforts method, two principal approaches can be identified. One approach relies on an "area-of-interest" (or "project" or "prospect") as a cost center because the oil and gas reserves in that area-of-interest are deemed to represent the asset for which cost is determined. Under that approach, all costs incurred within that cost center are capitalized; if the area-of-interest is abandoned, the costs are charged to expense; if the area-of-interest proves successful, the capitalized costs are amortized as the reserves are produced. The second approach does not rely on a cost center for capitalization purposes; the accounting treatment is determined by the nature of the costs at the time they are incurred. This approach does not assign costs to oil and gas reserves until they are extracted; prior to then, this approach regards properties, wells, equipment,

and facilities as the assets to which costs relate. Under one variation of this approach, all exploratory costs are charged to expense when incurred, but the cost of an exploratory well is later capitalized by reinstatement if the well is successful. Under the other variation, all exploration costs except the costs of exploratory wells are charged to expense when incurred; the costs of exploratory wells are capitalized as "construction-in-progress" when incurred, to be expensed later if the well is determined to be unsuccessful.

Principal Features of Full Costing

.104 Under the full cost concept, all costs incurred in acquiring, exploring, and developing properties within a relatively large geopolitical (as opposed to geological) cost center (such as a country) are capitalized when incurred and are amortized as mineral reserves in the cost center are produced, subject to a limitation that the capitalized costs not exceed the value of those reserves.

.105 Many variations of the full cost method exist, one of which is in the selection of the cost center. Under the broadest concept of full costing, all acquisition, exploration, and development costs wherever and whenever incurred are capitalized and amortized on a pro rata basis over the production of all of the company's oil and gas reserves wherever and whenever discovered, subject to the aforementioned limitation. This approach is referred to as using a company-wide cost center. Most companies that use full costing, however, adopt a country or a continent as the cost center.

.106 If full costing is applied on a less-than-company-wide basis, the limitation (sometimes called a ceiling) on capitalized costs generally is applied separately to each cost center, though sometimes the comparison of unamortized capitalized costs and reserve values is made on the basis of groups of cost centers or on a company-wide basis. Variations also exist in the categories of reserves used in computing the limitation and in the methods of valuing those reserves.

.107 Under the full cost concept, acquisition, exploration, and development costs are sometimes included in the pool of capitalized costs associated with a cost center when incurred, so that if the cost center is producing, those costs are subject to amortization at once. In some cases, however, certain significant costs, such as those associated with offshore U.S. operations, are de-

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ferred separately without amortization until the specific property to which they relate is found to be either productive or nonproductive, at which time those deferred costs and any reserves attributable to the property are included in the computation of amortization in the cost center.

.108 Although most proponents of full costing indicate that the reserve value limitation is an essential condition for use of that method, preproduction costs incurred in a nonproducing cost center (for example, a country or continent in which the company has only recently begun its first exploration activity) are sometimes capitalized without regard to a limitation or ceiling test, based on the expectation that reserves will be discovered in the future sufficient to assure recovery of the capitalized costs.

.109 Under full costing and in many cases under successful efforts costing (if the amortization base comprises a number of properties), the unamortized costs relating to a property that is surrendered, abandoned, or otherwise disposed of are accounted for as an adjustment of accumulated amortization, rather than as a gain or loss that enters into the determination of net income, until *all* of the properties constituting the amortization base are disposed of, at which point gain or loss is recognized. Under full costing, the amortization base is normally a very large cost center —country or continent—whereas under successful efforts costing it is usually either individual properties or groups of properties with a common geological structural feature or stratigraphic condition. Therefore, recognition of gain or loss on abandonment of properties is more likely to be delayed under full costing than under successful efforts costing, although some proponents of full costing would recognize certain unusual or significant losses even before activities in an entire country or continent are discontinued.

.110 Variations within both the full cost method and the successful efforts method exist in (a) the categories of reserves used in computing amortization, (b) whether future development costs are anticipated if capitalized acquisition, exploration, or development costs are amortized on the basis of all proved reserves, (c) the extent to which properties are aggregated for amortization purposes, (d) the bases for determining amortization rates if oil and gas are jointly produced, (e) the categories of reserves and methods of valuation used in computing a limitation on capitalized costs, and (f) allocation of overhead.

Principal Features of Successful Efforts Costing

.111 Under successful efforts costing, except for acquisition costs of properties, a direct relationship between costs incurred and specific reserves discovered is required before costs are identified with assets. An acquired property is regarded as an asset until either a determination is made that it does not contain oil and gas reserves or the property is surrendered. Capitalized costs relating to producing properties are amortized as the reserves underlying those properties are produced.

.112 Many variations of successful efforts accounting exist. As noted in paragraph .103, a conceptual difference centers around the role of the cost center—whether a cost center is needed for cost capitalization purposes or only to compute amortization. For example, some proponents of successful efforts accounting would capitalize all geological and geophysical costs and, possibly, all carrying costs relating to a cost center, such as an area-of-interest, on grounds that any mineral reserves in the cost center represent the asset with which the costs are associated. If mineral reserves are found in that area-of-interest, those capitalized costs are carried forward as the costs of those reserves; otherwise, they are charged to expense. Those proponents of successful efforts thus rely in part on the concept of a cost center for the capitalize/expense decision. Others who favor successful efforts accounting would use a cost center, such as a field or a lease, only for purposes of amortizing costs. They would let the nature of the cost govern the capitalize/expense decision. For example, they might charge all G&G costs and all carrying costs to expense, based on the belief that such costs result in no identifiable future benefits, but they would capitalize all lease bonus expenditures on the basis that an asset (the right to explore for and extract oil and gas) has been acquired.

.113 With respect to property acquisition costs, relatively minor variations exist within the successful efforts method concerning the extent to which such items as brokers' fees, recording fees, legal costs, other direct costs, and allocations of indirect costs are considered acquisition costs. Those minor variations aside, virtually all advocates of successful efforts accounting capitalize all property acquisition costs when incurred, though different accounting methods are used to dispose of those costs subsequent to capitalization.

.114 Under successful efforts accounting, different methods are sometimes used to account for *pre*acquisition and *post*acquisition

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geological and geophysical costs. With respect to preacquisition G&G, some expense all such costs when incurred; others capitalize preacquisition G&G to the extent that those costs can be related to acquired properties and expense all other such costs. Some follow a practice of reinstating costs charged to expense in a prior period based on events and experience in subsequent periods. Others do not. With respect to postacquisition G&G, alternatives include (a) capitalize all postacquisition G&G as part of the cost of the acquired properties to which the G&G costs relate; (b) charge it all to expense when incurred; and (c) charge it all to expense when incurred but reinstate those costs that relate to reserves that are found. Some persons would capitalize only post*discovery* G&G while expensing when incurred all other postacquisition G&G as well as the preacquisition G&G.

.115 At least two variations can be identified in accounting for the costs of carrying undeveloped properties (delay rentals, *ad valorem* taxes, etc.) under successful efforts accounting: (a) charge all to expense as incurred and (b) charge to expense as incurred but reinstate if subsequently associable with an area-of-interest in which reserves are found.

.116 Some proponents of the successful efforts method defer all exploratory drilling costs as "construction-in-progress" for a period of time until a determination has been made whether reserves have been found, at which time the costs of dry holes are charged to expense. Others expense all exploratory drilling costs as incurred but reinstate costs relating to any reserves that are discovered. The costs of drilling a stratigraphic test well, which is drilled solely to obtain geological information and is not customarily intended to be completed as a producing well, are sometimes charged to expense when incurred; alternatively, those costs are sometimes capitalized to the extent that reserves are found (even though the well is not intended to be used to produce those reserves), with the costs of such wells that did not find reserves charged to expense when that determination is made.

.117 The principal alternative with respect to accounting for development costs within a successful efforts framework concerns the treatment of development dry holes. Some proponents of successful efforts accounting capitalize the costs of drilling unsuccessful development wells on grounds that those costs were incurred as part of the capital investment required to extract reserves that were previously discovered. On the other hand, many

successful efforts proponents take the position that those costs should be charged to expense on the basis that any dry hole, whether exploratory or development, has no future benefit. With respect to other development costs, some companies capitalize all while other companies—principally the smaller and closely held companies—follow the income tax accounting treatment under which intangible development costs are charged to expense as incurred.

.118 Whether capitalized preproduction costs are amortized or otherwise written off before production begins is another area of difference within the successful efforts method. Some companies do not amortize any capitalized costs until production of the related reserves begins. If reserves are not found, the entire cost is written off when the property is surrendered. A variety of methods is used by those companies that do amortize costs before production begins. A distinction normally is made between (a) acquisition costs of unproved properties and (b) preproduction costs relating to properties that become proved. Some companies amortize the acquisition costs of unproved properties or provide an allowance for impairment; other companies carry unproved properties at their cost without regard to diminution of value until either reserves are found or the property is surrendered. With respect to the capitalized preproduction costs relating to proved properties, amortization generally does not begin until production commences. Reinstatement of costs is another accounting alternative, and whether to establish a limitation on capitalized costs of proved properties is yet another area of difference.

.119 A number of other variations within the successful efforts method (which are also variations within full costing) were noted in paragraph .110.

Principal Features of Discovery Value Accounting

.120 Under discovery value accounting as it has generally been proposed, mineral reserves would be recorded at their estimated *value* when the reserves are discovered or, alternatively, when the reserves are developed. Property acquisition costs and other prediscovery costs generally would be deferred and written off when the areas to which the costs apply have been explored and the underlying reserves, if any, evaluated. Subsequent to discovery, the carrying amount of the reserves would not be adjusted for changes in prices; however, the carrying amount would be adjusted for revisions of estimated reserve quantities. The discov-

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ery value would be treated as revenue from the oil and gas exploration activities of the enterprise and would become the recorded value ("cost") of reserves for future accounting purposes. Those discovery value amounts would then be amortized against the revenues resulting from the production and sale of the minerals.

.121 Several variations of discovery value accounting have been proposed. If only proved developed reserves are included in the value computation, generally all development costs associated with the reserves will have been incurred; if additional development costs are incurred, the value of any incremental quantity of reserves discovered is recorded and, simultaneously, the related costs are written off. If undeveloped reserves are included in the value computation, an adjustment must be made for the expected future development costs (generally by reducing the value otherwise attributable to the reserves in the ground). When the development costs are eventually incurred, it is generally proposed that they be added to the carrying value of the reserves.

.122 Determination of the value of oil and gas reserves is critical to both discovery value accounting and current value accounting. Four principal valuation methods that might be used to measure the value of reserves (and other assets) were discussed at length in paragraphs 436-466 of the Discussion Memorandum. Briefly summarized, they are:

a. *Current cost.* Current cost is the amount of cash or its equivalent that would have to be paid if the same asset were acquired currently. The "same asset" may be an identical asset (current reproduction cost or current cost of replacement in kind) or an asset with equivalent productive capacity (current replacement cost).

b. *Current exit value in orderly liquidation.* Current exit value in orderly liquidation is the net amount of cash that could be obtained currently by selling the asset in orderly liquidation (current market value, if a market exists). The value of mineral reserves on a current exit value basis would equal the price at which the reserves could be sold in place by a willing seller to a willing buyer, neither being under any compulsion to sell or buy, both being competent and having reasonable knowledge of the facts.

c. *Expected exit value in due course of business.* Expected exit value in due course of business is the nondiscounted amount of

cash or its equivalent into which an asset is expected to be converted in the due course of business less the direct costs necessary to make that conversion (sometimes referred to as net realizable value). The value of mineral reserves on this basis would be an amount equal to the estimated net cash flows attributable to the reserves.

d. *Present value of expected cash flows.* The present value of expected cash flows is the present value of future cash inflows into which an asset is expected to be converted in the due course of business, less the present value of cash outflows necessary to obtain those inflows. Present value measurements require information about estimated amounts of future cash inflows and outflows, the timing of those expected cash flows, and the appropriate discount rate. Various discount rates that have been proposed include the (i) rate applicable to long-term government bonds issued by the government of the country in which the reserves are located, (ii) prime rate, (iii) company's weighted average or incremental long-term borrowing rate, (iv) company's weighted average cost of capital, and (v) discount rate used by company management internally to make individual investment decisions.

.123 Considerable disagreement exists as to which of those methods, if any, are suitable for valuation of oil and gas reserves, either at the time of discovery or subsequently. Also, under discovery value accounting, a decision must be made as to which categories of reserves enter into the value computation.

.124 Some discovery value accounting proponents would report the value of periodic discoveries of reserves as operating income. Others would segregate the discovery value from realized revenues and gains reported in the income statement. Still others would report the discovery values in a special unrealized income section of stockholders' equity in the balance sheet until realized through the actual production and sale of oil and gas.

Principal Features of Current Value Accounting

.125 Current value accounting involves the continuous use in the financial statements of one of the four methods of valuation identified in paragraph .122, or some other method. (Current value accounting could, of course, be applied to all of an enterprise's assets and liabilities, not just oil and gas reserves, but applying current value accounting beyond oil and gas reserves was not included in the scope of this project. Alternative methods of

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measurement are to be considered in the Board's project to develop a conceptual framework for financial accounting and reporting.)

.126 Most proponents of current value accounting for oil and gas reserves believe that the reserves should be valued at each financial statement date using the most current information available. Some proponents suggest that periodic changes in reserve values should be reflected directly in the income statement; others would report value changes directly in the stockholders' equity section of the balance sheet, perhaps by segregating or otherwise separately identifying the realized and unrealized amounts. Under current value accounting, separate data might be presented for (a) value increases resulting from new discoveries, (b) value changes resulting from adjustment of reserve quantities, and (c) holding gains and losses resulting from revaluing end-of-period reserve quantities to reflect the change in unit value during the period.

.127 As with discovery value accounting, decisions must be made as to which method of valuation should be used and which reserve categories should be included in the current value computations.

A Single Accounting Method

.128 The proposal that the two presently accepted accounting methods, full costing and successful efforts costing, be allowed to continue as optional alternatives received little support in the letters of comment submitted to the Board in response to the Discussion Memorandum or in the oral presentations made at the public hearing conducted by the Board before the Exposure Draft was issued. It was principally after the Exposure Draft was issued proposing to proscribe the full costing method that support for retaining both methods was expressed to the Board.

.129 The Board has considered the question of accounting alternatives at length, not only in connection with its oil and gas project but also for other projects on its agenda, and has concluded that differences in accounting may be appropriate when significant differences in facts and circumstances exist, but different accounting among companies for the same types of facts and circumstances impedes comparability of financial statements and significantly detracts from their usefulness to financial statement users.

.130 In the Board's judgment, the facts and circumstances surrounding the search for and development and production of oil and gas do not differ because of the size of a company or whether its securities are publicly traded. Similar types of risks of failure

and potential rewards of success prevail among all companies engaged in oil and gas producing activities; only the magnitude and number of projects vary. Although the scale or location of operations may differ among companies, that should not affect the principles underlying recognition of assets, measurement of the cost of those assets, and measurement of earnings. The costs of exploratory dry holes or abandoned properties, for example, should not be included in the costs of assets for some companies and reported as losses by other companies. Yet if full costing and successful efforts costing were both retained as optional accounting alternatives, different principles of asset recognition and measurement and earnings measurement would be regarded as appropriate for companies whose circumstances are substantially similar.

.131 Some respondents to the Exposure Draft cited the existence of other accounting alternatives—for instance, the use of both the last-in, first-out and the first-in, first-out methods in accounting for inventories—as justification for retaining full costing and successful efforts costing as optional alternatives. The Board does not believe that the availability of alternatives in unrelated areas of accounting should bear on a decision that the Board must make for a project on its agenda. In the Board's judgment, accounting for similar circumstances similarly and for different circumstances differently is a desirable objective in establishing standards of financial accounting and reporting. For that reason, the Board rejected the proposal, made by some respondents to the Exposure Draft, that intercompany comparability be achieved by footnote disclosure with retention of both full costing and successful efforts costing. Also, for that reason, the Board rejected the proposal that it simply "clean up" the many variations in full costing and the many variations in successful efforts costing presently used in practice by mandating only one acceptable approach to full costing and one acceptable approach to successful efforts costing and allowing companies to choose one of those two approaches.

.132 One of the principal criticisms of the work of the FASB's predecessors that led to creation of the FASB was that they did not sufficiently narrow or eliminate free choice accounting alternatives. A report entitled *Federal Regulation and Regulatory Reform* (the "Moss Report") issued in 1976 by the Subcommittee on Oversight and Investigations of the U.S. House of Representatives and a report entitled *The Accounting Establishment* (the "Metcalf Report") prepared in 1976 by the staff of the Subcommittee on Reports, Accounting and Management of the U.S. Senate were both strongly critical of the availability of alternative accounting

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principles. In its November 1977 report, "Improving the Accountability of Publicly Owned Corporations and Their Auditors," Senator Metcalf's Subcommittee concluded that "uniformity in the development and application of accounting standards must be a major goal of the standard-setting system." Moreover, two major financial statement user groups—the Financial Accounting Policy Committee of the Financial Analysts Federation (the national professional association of security analysts) and the Robert Morris Associates (the national professional association of bank lending officers)—have endorsed elimination of optional accounting alternatives not only for oil and gas producing companies but for other industries as well. The Securities and Exchange Commission, in *Securities Act Release No. 5877* (October 26, 1977), took a similar position, stating that the Board's oil and gas project "is expected to result in significant improvement in financial reporting through the establishment of uniform accounting standards so that investors are provided with a valid basis for comparing the financial statements of different companies." In the Board's judgment, when the same or similar facts and circumstances exist, as they do in the search for and development of oil and gas reserves, intercompany comparability requires a single method of accounting. Comparable reporting by companies competing for capital is, in the Board's judgment, in the public interest (see paragraphs .157-.174).

Reasons for Rejecting Discovery Value Accounting

.133 The Board concluded that financial statements of an oil and gas producing company should not be prepared on a discovery value basis for a number of reasons. One group of reasons relates to problems in measuring the value of reserves with reasonable accuracy at the point of discovery. Measurements of discovery value require estimates of (a) the quantity of reserves, (b) the amount and timing of costs to develop the reserves, (c) the timing of production of the reserves, (d) the production costs and income taxes, (e) selling prices, and (f) (for some valuation methods) appropriate discount rates that reflect both an interest element and a risk factor. Those estimates, in turn, might be based on predictions of changes in government regulations and restrictions (both domestic and foreign), technological changes (including not only the technology involved in oil and gas producing activities but also the technology of transportation, refining, and marketing of oil and gas products), and domestic and international economic conditions; or current regulations, technology, and conditions might be assumed to continue indefinitely. The uncertainties inherent in those estimates and predictions tend to make estimates of reserve values highly subjective and relatively unreliable for

the purpose of providing the basis on which to prepare financial statements of an oil and gas producing company.

.134 Under generally accepted accounting principles followed by companies in nearly all industries, revenue is normally recognized only when the earning process is complete or virtually complete and, then, only after an exchange transaction has taken place. The earning process is the continuum of profit-directed activities by which revenue is earned—purchasing, manufacturing, selling a product or rendering a service, delivery, cash collection, etc. The exchange transaction is the specific point at which the earning process is normally regarded as sufficiently complete to justify accounting recognition of revenue.

.135 Discovery value accounting recognizes revenue from exploration activities at the point of discovery even though it may be many years until the property is developed and the oil and gas are produced and sold. That is, the earning process is far from complete, at least as completion of that process is generally determined for other industries. Discovery is certainly a critical event in the search for and extraction of oil and gas, but there are many uncertainties standing between discovery of reserves and the ultimate realization of related revenues. Often many years pass, very substantial amounts of money are spent, and significant revisions are made to estimated quantities of reserves discovered.

.136 Exceptions to the general rule for revenue recognition are found in practice today. *APB Statement No. 4,* "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," paragraph 152 [section 1026.16], states:

> Sometimes revenue is recognized at the completion of production and before a sale is made. Examples include certain precious metals and farm products with assured sales prices. The assured price, the difficulty in some situations of determining costs of products on hand, and the characteristic of unit interchangeability are reasons given to support this exception.

.137 As noted earlier, reserves often are discovered many years before they are produced, and many dollars often are spent for development and production costs before the oil and gas reserves are extracted. Moreover, while oil and gas may to some extent be regarded as fungible, sales prices, particularly in the present domestic and international economic and regulatory environments, are anything but assured. Thus, the reasons given in support of the special revenue recognition principles for precious metals and farm products that have been produced and have assured sales prices do not apply to oil and gas producing activities.

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.138 Proponents of discovery value accounting argue that it provides better information about the success or failure of exploration activities, which activities are the most important ones in oil and gas production. However, discovery value accounting represents a fundamental change from the traditional, historical cost basis of preparing financial statements. Various alternatives to the historical cost measurement basis are under examination as part of the Board's conceptual framework project. Although covered in the Discussion Memorandum for the extractive industries project, valuation methods were addressed by relatively few respondents, and discovery value accounting received only very limited support among respondents. On balance, the Board concluded that estimated discovery values do not provide a satisfactory basis of accounting for oil and gas producing activities for the reasons that (a) values that were current when initially recorded quickly become out-of-date and (b) the mixture of values of minerals measured at different dates of discovery lacks both the verifiability of historical costs and the relevance of current values. The Board believes that issues relating to the accounting measurement basis should await resolution in the conceptual framework project.

Reasons for Rejecting Current Value Accounting

.139 Like discovery value accounting, current value accounting for oil and gas reserves requires estimation of reserve values. The uncertainties inherent in those estimates (discussed in paragraph .133) tend to make them subjective and relatively unreliable for the purpose of providing the underlying basis on which the financial statements of an oil and gas producing company are prepared.

.140 As noted in paragraph .138, the historical cost basis of accounting and certain alternative measurement bases are currently under examination as part of the Board's project on a conceptual framework for financial accounting and reporting. The Board has concluded that it should not attempt to resolve those issues in the narrow context of the extractive industries project.

.141 Moreover, as with discovery value accounting, adoption of current value accounting for oil and gas reserves would require reconsideration of the accounting concept of earnings (discussed in paragraphs .134-.137). Decisions would have to be made as to whether the periodic value changes should be reflected in determining earnings or only in the stockholders' equity section of the balance sheet, and whether realized value changes should be treated differently from unrealized. Those issues, too, are part of the Board's conceptual framework project.

Reasons for Accepting Successful Efforts Accounting and for Rejecting Full Costing

.142 None of the assenting or dissenting members of the Board consider it appropriate to capitalize costs of exploration efforts in a geological area in which no reserves are found simply because the company previously discovered valuable reserves in an unrelated geological area.

Successful Efforts Accounting Is Consistent with the Present Accounting Framework

.143 In the presently accepted financial accounting framework, an asset is an economic resource that is expected to provide future benefits, and nonmonetary assets generally are accounted for at the cost to acquire or construct them. Costs that do not relate directly to specific assets having identifiable future benefits normally are not capitalized—no matter how vital those costs may be to the ongoing operations of the enterprise. If costs do not give rise to an asset with identifiable future benefits, they are charged to expense or recognized as a loss.

.144 In the Board's judgment, successful efforts costing is consistent with that accounting framework, and full costing is not. Under full costing, even costs that are known *not* to have resulted in identifiable future benefits are nonetheless capitalized as part of the cost of assets to which they have no direct relationship.

.145 In the oil and gas industry, ultimately the expected future benefits that an enterprise is attempting to obtain through its acquisition, exploration, and development activities are represented by oil and gas reserves. But, other than by purchasing minerals-in-place, an enterprise does not acquire reserves directly. Rather, it acquires properties (rights to extract any reserves that may be discovered in the future) and it acquires (develops) systems capable of producing the oil and gas reserves that are discovered. Costs that are known *not* to relate directly to the discovery of oil and gas reserves or in the development of a system for the extraction of previously discovered reserves should not be capitalized. To capitalize them is inconsistent with the presently accepted accounting framework based on measuring the historical cost of an asset.

.146 Present accounting concepts place boundaries on the assets to be accounted for—boundaries determined by the transaction in which the asset was acquired, by physical attributes of the asset,

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by legal attributes of the asset, or by the way in which the asset is used. Full costing aggregates all oil and gas reserves within very broad cost centers (countries or continents), wherever those reserves may be located in the cost center and whenever discovered, and accounts for that aggregation as a single asset. All acquisition, exploration, and development costs incurred in that cost center are deemed to be the cost of the aggregate asset, even if those costs relate to activities that are known *not* to have been successful in acquiring, discovering, or developing reserves.

.147 The successful efforts method, on the other hand, circumscribes the boundaries of, and accounts separately for, individual assets. Under the "area-of-interest" approach to successful efforts costing, oil and gas reserves located in an individual area-of-interest are the assets accounted for. Under the approach to successful efforts in which no cost center is used for the capitalize/expense decision, individual properties or groups of geologically related properties and wells, equipment, and facilities are the assets accounted for. Either way, boundaries are placed on the assets being accounted for. Only those exploration and development costs that relate directly to specific oil and gas reserves are capitalized; costs that do not relate directly to specific reserves are charged to expense. The successful efforts method of accounting conforms to the traditional concept of the historical cost of an asset.

.148 Under the successful efforts method, certain types of costs may be capitalized as "construction-in-progress" pending further information about the existence of future benefits, but as soon as the additional information becomes available, and it is known whether future benefits exist, those costs are either reclassified as an amortizable asset or charged to expense.

Financial Statements Should Reflect Risk and Unsuccessful Results

.149 The function of the nation's capital markets is to direct capital to companies and institutions through decisions to invest and lend. Financial accounting and reporting provides one important source of information on which investment, lending, and related decisions are made.

.150 Enterprises seeking capital operate in varying circumstances of possible success or failure. That is, they offer varying degrees of risk and opportunity to those supplying capital. Although in-

vestors and lenders differ among themselves with regard to the risks they are willing to accept, they have one thing in common: They seek a higher expected return for accepting higher risk. Business enterprises seeking capital offer different risks. Capital is equitably allocated if the prices paid are commensurate with the risk.

.151 In the production of oil and gas, significant risks and returns arise in the search for reserves. In other words, discovery of oil and gas reserves is a critical event in determining failure or success, for assessing risks and returns. Because it capitalizes the costs of unsuccessful property acquisitions and unsuccessful exploratory activities as part of the costs of successful acquisitions and activities, full costing tends to obscure failure and risk. Successful efforts accounting, on the other hand, highlights failures and the risks involved in the search for oil and gas reserves by charging to expense costs that are known not to have resulted in identifiable future benefits.

.152 Neither full costing nor successful efforts costing reflects success at the time of discovery. Under both methods, success is reported at the time of sale. It might be said, therefore, that both methods tend to obscure, or at least delay, the reporting of success, but that is the consequence of the historical cost basis of accounting, and its adherence to the realization concept. The obscuring of failure, however, results only from the full cost method. Under successful efforts accounting, unsuccessful costs are charged to expense and not carried forward as assets. In the Board's judgment, financial statements prepared on the successful efforts basis, including disclosures (as required by this Statement) of capitalized costs and costs incurred in oil and gas producing activities (to provide an indication of effort) and of reserve quantities and changes therein (to provide an indication of accomplishment) will provide investors with important information about success as well as failure.

.153 Investors and creditors look to financial statements as an important source of information about companies' risks and returns. Investors and creditors focus on earnings—and in particular on earnings variability—as an indicator of risks and returns. As the Board noted in summarizing its *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises:*[8]

[8] FASB Discussion Memorandum, "Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement," December 2, 1976, paragraph 4.

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Earnings (or profits or net income) of a business enterprise are the focal point of the information communicated in financial statements. Earnings are a major motivating force in the economic activities of business enterprises and a major motivating force in the economic activities of those who lend to business enterprises, those who invest in them, and those who manage them. In general, earnings reduce the risk of those who lend funds to an enterprise or acquire its debt securities. Earnings also enable an enterprise to pay cash dividends to those who invest in its equity securities and enhance the prospects for increases in the market price of its stock. Thus, investors and creditors are generally more willing to commit funds to profitable enterprises than to unprofitable ones. Expectations of earnings, often based on a history of earnings, enable an enterprise to obtain both equity and debt financing.

.154 Some persons criticize successful efforts accounting on grounds that a company's earnings tend to fluctuate more under that method than under full cost accounting, depending on the level and degree of success or failure of the company's acquisition and exploration activities in a given accounting period. While fluctuating earnings may, indeed, be a *characteristic* of successful efforts accounting, it is not a *fault*. The successful efforts method enables investors and lenders to observe the impact of the risks inherent in oil and gas producing activities on a company's results of operations from period to period.

.155 A similar issue arose in connection with the Board's project on accounting by enterprises in the development stage. The Board concluded in *FASB Statement No. 7* [section 2062], "Accounting and Reporting by Development Stage Enterprises," that a development stage enterprise should not be permitted to capitalize costs that would be charged to expense when incurred by an established operating enterprise because to do so would tend to obscure, in financial statements, the impact of risks inherent in starting up a new company.

.156 The same issue has arisen in a number of other Board projects, for example, the projects on self-insurance, catastrophe losses, expropriations, and other contingencies and on foreign currency translation. A basic issue in each of those projects, as it is in the oil and gas project, was whether financial accounting standards should be adopted to normalize or average the effects of events that are inevitable over extended periods but occur at infrequent and relatively unpredictable intervals. Consistent with its conclusion in this Statement, the Board concluded in those projects that financial statements should report the effects of risk and not attempt to normalize them.

Ability to Raise Capital

.157 Many proponents of full costing have said, in written submissions in response to the Discussion Memorandum, at the public hearing, and in comment letters on the Exposure Draft, that adoption of the successful efforts method of accounting will inhibit the ability of oil and gas producing companies to raise capital to finance their exploration activities. In particular, they contend, small exploration companies will have special difficulties in obtaining capital because, under a successful efforts approach, their income statements will be more likely to report earnings fluctuations and in some cases net losses, and their balance sheets could even show cumulative deficits. Potential suppliers of capital will not understand those fluctuations, losses, and deficits, it is argued, and sources of capital will diminish or be more costly. Those results, they say, are at variance with national economic goals. A particular national economic goal they cite is to encourage additional oil and gas exploration.

.158 In the Board's judgment, the arguments put forth by those who say that adoption of successful efforts accounting and proscription of full costing will prevent them from raising the capital needed to finance their exploration and production activities are not persuasive. In a free enterprise economy in which capital is allocated among enterprises largely on the basis of individual investors' decisions, if a company is an economically successful enterprise, it will continue to attract capital. Its financial statements should provide those who supply capital with information that assists them in determining whether the expected returns on that capital are commensurate with the risks involved. In the Board's judgment, financial statements that are prepared in conformity with the provisions of this Statement will provide investors and creditors with that type of information. Many small oil and gas producing companies use the successful efforts method, not full costing; have done so for many years; and have generally been able to obtain capital to finance their exploration activities. Indeed, full costing is a relatively recent development in accounting for oil and gas producing activities. The 1973 survey (cited in paragraph .101 of this Statement), which was sponsored by a group of full costing petroleum companies, identified only *one* instance of its use prior to 1960, and it was not until the late 1960s that the use of full costing became relatively widespread.

.159 In examining the ability-to-raise-capital issue, the Board focused in particular on three distinct types of small exploration companies:

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a. Privately owned exploration companies. (A representative of the Independent Petroleum Association of America at the Board's public hearing estimated that there are 10,000 such companies in the United States.)

b. Publicly owned exploration companies. (A 1977 list of companies whose securities are registered with the SEC identifies 214 companies in the "petroleum and natural gas extraction" Standard Industrial Classification.)

c. Oil and gas exploration subsidiaries and divisions of companies that are mainly in other lines of business.

.160 As noted in paragraphs .101 and .117, a great many *privately* owned exploration companies follow federal income tax accounting practices in preparing their financial statements. Income tax accounting is a variation of successful efforts accounting. Those companies have for many years been able to obtain capital from external sources, including loans from local and international banks and insurance companies, from knowledgeable individual investors, and from private placements of securities.

.161 Many publicly owned oil and gas exploration companies follow the successful efforts method. In connection with the research study described in paragraph .093(a) of this Statement, the staff of the FASB identified 79 oil and gas companies that (a) have securities currently traded on a securities exchange or in the over-the-counter market and (b) derive more than 50 percent of their revenue from exploration and production. (The latter criterion eliminates virtually all of the major integrated companies from the group.) Of the publicly owned companies so identified, 41 percent use successful efforts accounting.

.162 Some responses to the Exposure Draft were from companies that are mainly in lines of business other than oil and gas but that have oil and gas exploration subsidiaries and divisions that use the full cost method. A number of the responses came from electric and gas public utility companies with oil and gas exploration subsidiaries recently formed or under active consideration. Those respondents urged retention of full costing for their subsidiaries and divisions on grounds that investors and lenders who supply capital to the enterprise do not regard the enterprise as an oil and gas producing company and thus would not understand the fluctuations of reported earnings or losses that, in their view, would more likely result from using successful efforts accounting, especially by a newly formed exploration subsidiary. In the Board's judgment, however, that is not an appropriate reason for allowing those subsidiaries and divisions to adopt or continue to use full costing. By choosing to seek the rewards of engaging in oil and

gas exploration activities, those enterprises have assumed the risks associated with the search for oil and gas reserves, and their financial statements should provide information about those risks and not obscure them. Investors and creditors seek a return on their capital commensurate with the risks involved, and financial statements should assist them in assessing those risks. One would expect that those who supply capital for a high-risk activity such as oil and gas exploration would demand a higher return than for capital invested in less risky activity.

.163 The telephone interview survey described in paragraph .093(b) provides additional evidence about the ability of small, publicly owned, successful efforts companies to raise capital. Professor Horace R. Brock of North Texas State University, or a person working under his direction, asked a senior executive officer of each of 27 small, publicly owned, successful efforts companies whether, in the officer's opinion, use of the successful efforts method has affected the company's ability to obtain the capital necessary to finance its exploration and production activities. None of the executive officers surveyed felt that the company's use of successful efforts accounting had hindered its ability to raise capital. Most of the surveyed companies raised capital externally during the past 10 years from public sales of equity and debt securities, loans from banks and insurance companies, private placements, investments by individual investors, or other outside sources. Those corporate officers were also asked whether they felt that their companies were denied access to any particular source of capital and, if so, whether the company's accounting method was a significant factor in any such situation. Again, they said that successful efforts accounting did not adversely affect their companies' ability to obtain capital from a desired source.

.164 Interviews with suppliers of capital to oil and gas producing companies resulted in a similar finding. As described in paragraph .090(a), 24 bank loan officers, bank trust department officers, and securities underwriters, all of whom work directly with oil and gas companies, were interviewed to ascertain how investment and credit decisions regarding such companies are reached. The majority of interviewees indicated that the method of accounting would not affect their investment and credit decisions regarding oil and gas producing companies.

.165 Some who favor retention of full costing argue that use of that method by newly formed exploration companies is essential to their viability, because investors will be disinclined to provide capital to those companies if their financial statements report net

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losses from operations and cumulative deficits. The Board found, however, in the course of its deliberations on *FASB Statement No. 7* [section 2062], that those who supply capital to companies in the development stage understand the special circumstances of those companies and the possibility that their financial statements will report losses and deficits. In connection with that project, the Board surveyed officers of 15 venture capital companies that provide capital to development stage enterprises (though not necessarily to oil and gas ventures). Those officers said that whether a development stage enterprise defers preoperating costs or charges them to expense has little effect on (a) the amount of venture capital to be provided to that enterprise and (b) the terms under which any venture capital is provided. That survey and related economic impact considerations were supported by a study conducted by the U.S. Department of Commerce, which is described in paragraph 50 of Statement No. 7 [section 2062.50].

.166 Most proponents of full costing indicate that the reserve value ceiling on capitalized costs is an essential condition for use of that method. Except for those new companies that find relatively large quantities of proved reserves in their initial exploration efforts or that purchase interests in proved properties, it seems likely that many new exploration companies would be reporting operating losses and cumulative deficits under full costing as well as under successful efforts costing.

.167 A few respondents to the Exposure Draft have said that their own companies' property acquisition and exploratory drilling programs would be sharply curtailed if they were forced to change from the full cost method of accounting to the successful efforts method. However, since the prospects of finding commercially recoverable reserves, the prices at which those reserves would be sold, the costs that would be incurred, and the income taxes that would be paid are totally unaffected by the method of accounting for the costs incurred, a decision not to go ahead with an otherwise commercially attractive project simply because successful efforts reporting is required would seem to be unlikely for the vast majority of companies. Conversely, a venture that is not otherwise commercially attractive does not become so simply because a particular method will be used to account for that venture in the company's financial statements. While a few respondents representing full cost companies did say that their companies would expect to reduce their exploration efforts because successful efforts accounting would reduce reported earnings, other companies that use full costing have said that an FASB Statement mandating successful efforts accounting will not affect their exploration plans.

For example, one such company has publicly stated that while a mandated change to successful efforts accounting would have a substantial effect on previously reported earnings, it would not change the value of the company's assets, its reserves, or its cash flow, and that the company had decided not to change its exploration program if successful efforts accounting is required.

.168 In support of their claim that adopting the successful efforts method will impair their companies' ability to raise capital and thereby reduce exploration activity, some persons have said that in November 1971 the Federal Power Commission adopted its Order No. 440 (which supports the full cost concept) to stimulate the search for and development of new natural gas supplies. (Order No. 440 is described in paragraph .069 of this Statement.) The petitions for rehearing of that Order that were filed with the FPC in December 1971 alleged, among other things, that the Commission had failed to reach any conclusion on what was stated to be the primary factor resulting in issuance of Order No. 440—namely, how full cost accounting would provide a stimulus for companies under the FPC's jurisdiction to conduct a search for and develop new gas supplies. In its Order No. 440-A denying the request for rehearing, the FPC stated: "Since we concluded that full-cost accounting on its merits should be adopted, it is not necessary for us to proceed further and reach a finding as to whether the accounting, as such, would provide a stimulus to discover and develop new gas supplies." (The Federal Power Commission is now the Federal Energy Regulatory Commission, a part of the Department of Energy.)

.169 Some advocates of full costing apparently feel that the securities markets, which bring together those who provide capital and those who seek it, will not understand financial results reported by the successful efforts method. They imply that investors' willingness to provide capital to a given company or industry is affected by that company's or industry's use of a particular method of accounting. However, a number of research studies indicate that the securities markets generally recognize and compensate for intercompany differences in accounting practices for the same or similar events and transactions. In a 1973 summary of the findings of the then-extant research, Stanford University Professor William H. Beaver noted:[9]

> The prevailing opinion in the accounting profession is that the market reacts naively to financial statement information.

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[9] Beaver, William H., "What Should Be the FASB's Objectives?", *The Journal of Accountancy*, August 1973, pp. 49-56.

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> This view is reinforced by the anecdotal data of the sort described earlier, and by the obvious fact that the market is populated with several million uninformed, naive investors, whose knowledge or concern for the subtleties of accounting matters is nil. However, in spite of this obvious fact, the formal research in this area is remarkably consistent in finding that the market, at least as manifested in the way in which security prices react, is quite sophisticated in dealing with financial statement data.

.170 The research undertaken at the Board's request to examine the effect of the oil and gas Exposure Draft on the market prices of common stock issued by both full cost and successful efforts companies (described in paragraph .093(a) of this Statement) corroborates that the securities markets are generally able to assimilate financial information and to understand the underlying economics of the oil and gas exploration and production industry. That study did not find statistically significant evidence that issuance of the Exposure Draft affected the market prices of common shares issued by full cost companies as compared to successful efforts companies—except for some possible effect on the full cost companies during the week preceding and the week of issuance of the Exposure Draft, but the market soon adjusted, and evidence of a permanent or lingering effect was not found. (As noted in paragraph .093(a), the Board will undertake a similar study of the impact of this Statement following its issuance.)

.171 The Board acknowledges that not all empirical evidence supports the view that the securities markets are entirely able to take into account the differences in accounting methods used by different companies. The studies referred to in paragraph .169 provide evidence only with respect to the securities markets as a whole; those researchers readily admit (and other research substantiates) the likelihood that decisions of individual investors in individual securities can be affected by accounting differences. As noted in paragraph .170, a Board-sponsored study found that the oil and gas Exposure Draft may have affected the prices of full cost companies' securities during the two weeks surrounding its issuance, though the effect was of brief duration. That finding supports the conclusions of other researchers that investors are sometimes unable to properly evaluate the impact of alternative accounting methods. Further, in situations in which accounting changes may have had a long-term effect on securities prices (as

opposed to a temporary disruption), that result might well be viewed as an equitable adjustment of the cost of capital.[10]

.172 Some respondents to the Exposure Draft said that adopting the successful efforts method and proscribing the full costing method would likely have anticompetitive effects and would be contrary to national economic or policy goals. Any national economic or policy goal that involves the use of data reported in or derived from financial statements can, in the Board's judgment, be best pursued if the relevant financial statements are prepared on a common basis, so that lenders, investors, government regulators, and others involved directly or indirectly in allocating capital can analyze and reach informed decisions on the basis of consistent and comparable financial data. To the extent that furtherance of competition in oil and gas exploration and production and the availability of increased capital resources to finance those efforts are perceived as national economic or policy goals and in the interest of the general public, those goals can best be fostered—and the likelihood of their attainment substantially increased—if all competitors disclose financial data in a marketplace free from the burdens of inconsistency, noncomparability, and misunderstanding, a marketplace in which risks and rewards are reported as objectively and as evenhandedly as possible.

.173 Financial accounting should attempt to report the results of business decisions as nearly as those results can be determined in accordance with the accepted framework of accounting for all enterprises. If an enterprise's operations are subject to economic influences that are manifested in fluctuating earnings, financial statements should report those fluctuations and not obscure them. If the economic influences that affect an enterprise's operations are manifested in only minor fluctuations, that too should be portrayed. Otherwise, accounting is not evenhanded, for it fails to distinguish different characteristics of enterprises that investors

[10] The contradictory conclusions of the various studies on accounting and securities prices and the implications of those conclusions are discussed in considerable depth in *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises,* which was issued by the Board in December 1976. A number of specific studies are cited in Chapter 2, "Investors and Creditors," of *Tentative Conclusions;* additional studies are identified in the bibliography of the extractive industries Discussion Memorandum. Chapter 2 of *Tentative Conclusions* discusses both the traditional view of investors' and creditors' information needs (which concentrates on analysis of individual securities and enterprises that issue them) and the more recent capital market theory (which concentrates on portfolios and the extent to which individual securities increase or decrease the level of risk of a portfolio). An appendix to *Tentative Conclusions* provides an even more technical discussion of recent capital market theory.

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may perceive as involving different risks. That evenhandedness becomes especially important for equitable allocation of capital. If financial reporting obscures differences that may be perceived as representing differences in risk or creates differences where none exist, it may contribute to channeling some capital into enterprises with expected returns and risks that are disparate—in effect, subsidizing the cost of capital to some companies at the expense of other companies.

.174 As explained in paragraphs .157-.173, the Board has not been presented with or able to obtain persuasive information indicating that adoption of successful efforts accounting and proscription of full costing will inhibit competition in exploration for and production of oil and gas reserves or in financing those activities. Indeed, the Board is of the view that, far from inhibiting competition, the removal of one of two significantly different optional alternative methods of accounting in similar situations will facilitate competition. The weight of the evidence before the Board is that independent oil and gas producing companies using successful efforts accounting do compete successfully and conduct effective exploration and production programs that they are able to finance through a variety of capital sources.

The "Cover" Concept Is Inconsistent with the Present Accounting Framework

.175 Under the full cost method, all costs incurred in acquiring, exploring, and developing properties within a relatively large geopolitical cost center (usually a country or a continent) are capitalized when incurred as costs of obtaining whatever reserves have been found in that cost center as long as the aggregate capitalized costs do not exceed the aggregate value of those reserves. If the value of previously discovered reserves exceeds the aggregate unamortized capitalized costs, unsuccessful acquisition and exploration costs are said to be adequately "covered" by the value of the previously discovered reserves, and a loss need not be recognized. In other words, current failures are "covered" and are not reported to the extent of past successes. Further, an increase in the market prices of previously discovered reserves in a cost center can enhance the amount of "cover" and further delay recognition of failures (losses) in that cost center.

.176 In the Board's judgment, the "cover" concept is inconsistent with the present accounting framework, and it also obscures risk (see paragraphs .149-.156). Reserves that may have been discovered ten, twenty, thirty, forty, or more years ago by a company

under completely different management, with very different technology, and in very different domestic and international economic and political circumstances, should not be used, as they are under the full cost method, to justify nonrecognition of current failures. Similarly, reserves located in, say, West Texas should not be used to "cover" unsuccessful acquisition and exploration efforts in Louisiana, Alaska, or Canada, or in the offshore U.S. waters.

Successful Efforts Is Comparable to Accounting In Other Extractive Industries

.177 Although not usually labeled as such, successful efforts accounting generally is followed in extractive industries other than the oil and gas industry. Because of its wide acceptance in those industries, requiring it for all oil and gas producing companies is likely to bring about greater comparability of financial statements among companies in the various extractive industries.

The Matching Concept Does Not Justify Full Costing

.178 Some persons contend that full costing is justified because a "better matching" of revenues and expenses is achieved if all costs incurred in acquisition, exploration, and development activities are amortized on a pro rata basis as total reserves are produced. Proponents of full costing argue that it is impossible to discover oil and gas reserves without incurring the costs of some unsuccessful acquisition, exploration, and development activities, and they sometimes compare those activities with manufacturing operations in which spoilage or breakage is unavoidable. They argue that "proper matching" requires that the costs incurred in unavoidable unsuccessful efforts be accounted for as reasonable and necessary costs of successful efforts in the same way that the costs of unavoidable spoilage or breakage are accounted for as costs of good products.

.179 Three pervasive principles by which revenues and expenses are matched are described in paragraphs 156-160 of *APB Statement No. 4* [section 1026.20-.24], as follows:

> *Associating Cause and Effect.* Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue . . . recognizing them as expenses accompanies recognition of the revenue.
>
> *Systematic and Rational Allocation* . . . . If an asset provides benefits for several periods its cost is allocated to the periods

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in a systematic and rational manner in the absence of a more direct basis for associating cause and effect.

Immediate Recognition. Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits, or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.

.180 A direct cause and effect justification for associating unsuccessful acquisition and exploration costs with revenues derived from successful activities has not been demonstrated. A direct cause and effect association can be said to exist between the costs of nonproductive fields and the revenues from reserves in productive fields, or between costs applicable to unsuccessful ventures and costs applicable to successful ventures, if there is a *reliable* association between total costs and reserves discovered as a direct result of incurring those costs. Only then could it be said that a cost gives rise to revenues, that is, causes revenues. Although some persons claim that *industry-wide* statistics indicate a general predictable relationship between total number of wells or total footage drilled and total reserves added, those relationships have not been constant, particularly over a relatively short period of time such as a year, and there can be no assurance that they will apply to the future. More importantly, to the best of the Board's knowledge no such relationship has been demonstrated to be predictable for an *individual company*. Accounting is done for individual companies, not for an industry as a whole, and for companies a direct association between finding costs and mineral reserves emerges only at the level of an individual property unit or within a given field or other localized geological structure. Even that association often is not evident at the time the costs are incurred, and that is when accounting decisions must be made.

.181 Systematic and rational allocation likewise does not justify attributing unsuccessful acquisition and exploration costs to the results of successful activities. As *APB Statement No. 4* [sections 1021-1029] states, allocation of an asset's cost is justified "if an asset provides benefits for several periods." In the full costing versus successful efforts costing controversy, the question is not whether or how to allocate capitalized costs but which costs to capitalize.

.182 The "immediate recognition" principle referred to in *APB Statement No. 4* [sections 1021-1029] is appropriate for unsuc-

cessful acquisition and exploration costs. According to that principle, costs are associated with the current period as expenses if they provide no discernible future benefits (for example, geological and geophysical costs) or, if previously capitalized, they no longer provide discernible benefits (for example, acquisition costs of abandoned properties). The application of the immediate recognition principle in this Statement is consistent with its application by the Board in other pronouncements. In paragraph 49 of *FASB Statement No. 2* [section 4211.49], "Accounting for Research and Development Costs," for example, the Board stated that "the general lack of discernible future benefits at the time the costs are incurred indicates that the 'immediate recognition' principle of expense recognition should apply."

.183 In *FASB Statement No. 2* [section 4211], moreover, the Board considered and rejected the argument that research and development costs be capitalized when incurred and amortized on a company-wide basis. Paragraphs 51 and 52 [sections 4211.51-.52] state:

> 51. Enterprises undertake research and development activities with the hope of future benefits. If there were no such hope, the activities would not be conducted. Some persons take the position that the accounting treatment for research and development costs should be determined by considering in the aggregate all of the research and development activities of an enterprise. In their view, if there is a high probability of future benefits from an enterprise's total research and development program, the entire cost of those activities should be capitalized without regard to the certainty of future benefits from individual projects.
>
> 52. The Board believes, however, that it is not appropriate to consider accounting for research and development activities on an aggregate or total-enterprise basis for several reasons. For accounting purposes the expectation of future benefits generally is not evaluated in relation to broad categories of expenditures on an enterprise-wide basis but rather in relation to individual or related transactions or projects. . . .

Value Ceiling Is Subjective

.184 Limiting capitalized costs to the estimated value of reserves, which is an integral part of the full cost method of accounting, requires estimation of reserve quantities, development costs, production costs, the timing of development and production, selling prices, and appropriate discount rates. The uncertainties inherent in those estimates and projections tend to make estimates of reserve values highly subjective, and estimates of value made by trained experts can differ markedly. Under the successful efforts method, the need to limit capitalized costs is much less crucial

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because the costs of unsuccessful efforts, which may represent a large part of the total capitalized costs under the full cost method, will have been charged to expense as incurred or recognized as a loss when the effort was determined to be unsuccessful.

Full Costing Does Not Represent Current Value on the Balance Sheet

.185 Some persons contend that by using full costing, asset carrying amounts reported in the balance sheet will be closer to the current values of most companies' oil and gas reserves than they would under successful efforts costing. In the Board's judgment, however, under neither method do the *costs* to acquire, explore, and develop mineral properties indicate the *values* of reserves discovered. Those values change continually, depending on revisions of estimates of reserve quantities, development costs, production costs, income taxes, the timing of future development and production, selling prices, and appropriate discount rates. The capitalized costs, however, do not change. Neither full costing nor successful efforts costing is intended to portray current values; both of those methods are based on historical costs.

The Ability to Manage Earnings Is Not Unique to Successful Efforts Accounting

.186 Some proponents of full costing contend that the ability of management to subjectively influence reported earnings is reduced under full costing. In their view, under successful efforts accounting, management may be inclined to smooth or average periodic reported earnings by (a) deciding to delay final determination of the outcome of a project or to delay the write-off of an unsuccessful venture, thus postponing loss recognition, (b) incurring larger or smaller amounts of costs that are charged to expense as incurred, such as in exploration, and (c) postponing or moving forward the times at which such costs are to be incurred.

.187 While a transaction-oriented accounting framework—which is the presently accepted framework—allows opportunities to postpone or accelerate earnings effects, those opportunities are not unique to the oil and gas industry. Nor are they unique to successful efforts accounting since full costing itself may be viewed as a method for averaging reported earnings over long periods of time. Most importantly, the Board does not believe that the potential actions described in the preceding paragraph should bear importantly on the accounting decisions confronting the

Board in this project. Even if accounting results were to influence some managers' decisions, it does not follow that accounting standards should be designed to accomplish or prevent an action by management. That type of accounting standard would require a judgment by the Board as to which potential actions are desirable and which are undesirable. Accounting should evenhandedly report economic actions taken, regardless of motivation. Accounting should not obscure the effect of actions and events in order to prevent what some believe to be "uneconomic" actions.

Simplicity Is Not the Overriding Criterion for Selection of Accounting Method

.188 Some persons advocate full costing on grounds that it reduces the amount of procedural and mechanical accounting work, thus saving time, effort, and cost in maintaining accounting records. They claim that since all costs incurred in acquisition, exploration, and development are capitalized, there is less need to make arbitrary cost allocations or to prepare separate computations of amortization on individual properties. The Board disagrees. Firstly, individual property records must be maintained for purposes of determining royalties, computing taxable income, and making management decisions to commit funds, abandon properties, and so forth, so the amount of additional effort that may be required under successful efforts accounting is not expected to be burdensome. More importantly, in the Board's judgment, accounting simplicity should not justify nonrecognition of losses at the time they are incurred.

Reasons for Specific Conclusions within the Successful Efforts Method

.189 Paragraphs .142-.188 set forth the Board's reasons for rejecting full cost accounting and accepting successful efforts accounting. As explained in paragraphs .111-.119, however, there are many variations within the successful efforts method. Paragraphs .190-.214 which follow explain the Board's conclusions regarding the principal variations considered.

Rejection of Area-of-Interest Approach

.190 Some proponents of successful efforts accounting believe that a cost center (such as an area-of-interest) has a central role in accumulating certain types of prediscovery costs prior to the time that a reasonable determination can be made as to whether future benefits will result from having incurred those costs. They would capitalize some or all prediscovery costs relating to an area-of-interest until it is determined whether that area contains proved

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reserves. If it is determined that the area-of-interest does not contain reserves, the costs are written off and a loss is recognized. Even among proponents of the area-of-interest approach there are differences as to which prediscovery costs relating to an area-of-interest should be capitalized. Some proponents would capitalize prediscovery drilling costs but not G&G; others would capitalize the G&G as well. Other successful efforts proponents use a cost center only for computing amortization rates. They believe that the nature of a cost, and not the nature of a cost center, should be the primary consideration in the capitalize/expense decision (discussed further in paragraph .103).

.191 The Board has adopted the latter view. Until discovery, delineation of the boundaries of a cost center such as an area-of-interest is arbitrary, and intercompany differences in defining cost centers are likely to be significant and unavoidable. Many years often elapse before reserves are discovered in an area-of-interest, if they are discovered at all. Thus, depending on the extent to which an area-of-interest proponent would capitalize prediscovery costs, exploration costs that have no identifiable future benefits may be carried forward as assets potentially for many years. The Board concluded that exploration expenditures that do not directly result in the acquisition of an asset having identifiable future benefits should not be capitalized simply because they fall within lines drawn on a map by individual companies, that is, lines drawn to circumscribe an area-of-interest or, as some would say, a project.

.192 Some persons who advocate capitalization of all costs associated with an area-of-interest say that doing so is essential for financial statements to reflect the total "historical cost" of a project that ultimately proves successful. Many projects, however, do not ultimately prove successful, and determination of success or failure of an area-of-interest often takes a number of years. In the Board's judgment, periodic reporting of financial position and results of operations to investors and creditors is an overriding consideration that precludes the indefinite accumulation of costs of unknown future benefit. The Board reached a similar conclusion in *FASB Statement No. 2* [section 4211], "Accounting for Research and Development Costs," in which the Board rejected the indefinite deferral of R&D costs on a project basis pending determination of success or failure of the project.

Charging G&G to Expense

.193 This Statement requires that geological and geophysical costs, whether incurred before or after acquisition of the related

property, be charged to expense when incurred. Those costs are information costs very much like research costs. To a considerable extent, G&G costs are incurred before any properties are acquired, and in the majority of cases the acreage surveyed is either never acquired or, if acquired, is ultimately abandoned or surrendered. It is difficult, and in many cases impossible, to correlate geological and geophysical expenditures with a specific discovery made many months or years later, even with the benefit of hindsight; such correlation clearly cannot be done at the time the G&G expenditures are incurred, which is when accounting decisions are made. For those reasons, the Board has concluded that G&G costs shall be charged to expense when incurred. While the costs of drilling stratigraphic test wells are sometimes considered to be geological and geophysical costs, they are accounted for separately under this Statement for reasons explained in paragraphs .200-.202.

.194 In response to recommendations made by commentators on the Exposure Draft, this Statement makes clear that dry hole contributions and bottom hole contributions are included in exploration costs (paragraph .017(c)). Also, in response to comments on the Exposure Draft, paragraph .020 has been added to provide for capitalization of contractually reimbursable G&G and other exploration costs.

Charging Carrying Costs to Expense

.195 Costs of carrying and retaining undeveloped properties do not increase the potential of those properties to contain oil and gas reserves. Carrying costs are incurred to *maintain* an enterprise's rights, not to *acquire* those rights. In a sense, they are penalties for having delayed drilling and development activities and, thereby, having delayed potential production of oil and gas. Because carrying costs do not enhance the future benefits from the enterprise's properties and other assets, they are charged to expense when incurred under the provisions of this Statement.

Charging the Costs of Drilling Unsuccessful Exploratory Wells to Expense

.196 Charging the costs of drilling unsuccessful exploratory wells to expense is generally regarded as an inherent part of the successful efforts method of accounting. Not all successful efforts proponents agree, however, on what constitutes unsuccessful exploratory wells, and there is also disagreement over the timing of expense recognition. Under this Statement, success is defined in terms of whether proved oil and gas reserves have been found. As to timing, under this Statement the costs of drilling exploratory

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wells are initially capitalized when incurred and are subsequently either charged to expense or reclassified as part of the enterprise's wells and related equipment and facilities when the determination is made as to whether proved reserves have been found. Further, this Statement establishes guidelines for determining whether the costs of drilling exploratory wells may continue to be carried as an asset pending determination of whether proved reserves have been found.

.197 Several alternatives regarding the timing of expense recognition are proposed by successful efforts advocates. Some persons, on grounds that the majority of all exploratory wells (73 percent for the U.S. as a whole in 1976) are unsuccessful, would charge all costs of drilling exploratory wells to expense when incurred, rather than regard them as "construction-in-progress" pending determination of success or failure. Some would subsequently "reinstate" the costs of drilling an exploratory well that is determined to have been successful. In the Board's judgment, however, reinstatement of costs previously charged to expense is inconsistent with generally accepted accounting principles for other industries. For example, the Board has previously rejected the notion of cost reinstatement with respect to research and development costs (paragraph 57 of *FASB Statement No. 2* [section 4211.57]). Consequently, the Board concluded that a method of accounting for oil and gas producing activities based on cost reinstatement is inappropriate.

.198 The best accounting, in the Board's judgment, is to capitalize as "construction-in-progress" the costs of drilling all exploratory wells pending determination of success or failure, that is, pending determination of whether proved reserves are found. The length of time it takes to drill an exploratory well is relatively short—generally a matter of weeks or months, although a few occasionally take a year or longer—so the period during which costs of undetermined future benefit are capitalized usually is relatively brief, and this Statement requires that the costs be charged to expense as soon as a determination is made that proved reserves have not been found. In the Board's judgment, it is appropriate that the costs of drilling exploratory wells be treated differently from G&G and similar exploration costs because, first, determination of success or failure is much more clear-cut for exploratory drilling than it is for G&G and similar exploration costs, and, second, because successful exploratory wells result directly in the discovery of proved reserves whereas G&G does not.

.199 The quantity of oil and gas reserves found by an exploratory well is normally estimated on or shortly after completion of drill-

ing; occasionally that assessment takes a matter of weeks or months, rarely longer. If, however, a major capital expenditure is required before production could begin—such as for construction of a trunk pipeline—the reserves found may not be classifiable as proved unless sufficient quantities of additional reserves are found as a result of additional exploratory drilling. The additional exploratory drilling might take several years to complete. Paragraph .031 of this Statement therefore divides exploratory wells that find oil and gas reserves into two types: Those that are not drilled in an area requiring a major capital expenditure such as a trunk pipeline before production could begin and those that are drilled in such an area. For the former type, when classification of the reserves that are found cannot be made at the time drilling is completed, a one-year capitalization period is provided if that is necessary to allow a reasonable period of time for determining whether to classify those reserves as proved. Recognizing, however, that the decision to make a major capital expenditure, such as for a trunk pipeline, must sometimes await the results of additional exploratory wells, the Board concluded not to impose the one-year presumption of impairment on exploratory wells drilled in areas requiring a major capital expenditure before production could begin. Instead, paragraph .031(a) establishes two conditions for continued capitalization that take into account the realities and economics of exploratory drilling in remote areas and, at the same time, prohibit the indefinite deferral of the costs of exploratory wells merely on the hope that the selling prices of oil and gas will increase or on the possibility that unplanned exploratory drilling activity in the indefinite future might find additional quantities of reserves.

Stratigraphic Test Wells Treated Similarly to Exploratory Wells and Development Wells

.200 Stratigraphic test wells are drilled to obtain information. They are not normally intended to be completed for hydrocarbon production and are customarily abandoned after drilling is completed and the information is obtained. Normally, stratigraphic test wells are drilled offshore to determine whether an offshore property contains sufficient reserves to justify the cost of constructing and installing a production platform and to determine where to locate such a platform.

.201 Under this Statement, stratigraphic test wells are divided into two types—exploratory-type and development-type—and the standards of accounting for the two types parallel the accounting for exploratory wells and development wells, respectively. Thus, an

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exploratory-type stratigraphic test well is accounted for in a manner similar to an exploratory well drilled in an area requiring a major capital expenditure before production could begin: The costs of drilling the exploratory-type stratigraphic test well are capitalized pending determination of whether proved reserves are found, subject to the condition that those costs not continue to be carried as assets indefinitely if stratigraphic test drilling activity in the area has ceased or if the quantity of reserves found would not justify completion of the well for production had it not been simply a stratigraphic test well. The capitalized costs either are reclassified as part of the cost of the enterprise's wells and related equipment and facilities if proved reserves are found or are charged to expense if proved reserves are not found. Thus if an exploratory-type stratigraphic test well discovers reserves that are classified as proved and facilities are to be installed to produce those reserves, the cost of the exploratory-type stratigraphic test well is accounted for as part of the cost of the facilities even though the particular well itself may be abandoned. Accounting for the other type of stratigraphic test well—development-type—is identical to accounting for development wells and other development costs generally: capitalize as part of the cost of an enterprise's wells and related equipment and facilities (reasons therefor discussed in paragraph .207).

.202 The method of accounting for exploratory-type stratigraphic test wells described in the preceding paragraph represents a change from the Exposure Draft, which had proposed that the costs of all stratigraphic test wells be charged to expense when incurred on grounds that they are similar to G&G costs. A number of respondents to the Exposure Draft pointed out that an important difference exists between the costs of stratigraphic test wells and G&G costs: G&G information, no matter how persuasive, does not provide sufficient evidence to classify reserves as proved; reserves are classified as proved only after an exploratory well or a stratigraphic test well has been drilled. Thus a stratigraphic test well can result directly in the discovery of proved reserves whereas information obtained from geological and geophysical studies cannot. Discovery of proved reserves establishes the existence of future benefits and justifies the continued capitalization of the costs of those stratigraphic test wells that find proved reserves. Because of the foregoing differences, the costs of exploratory-type stratigraphic test wells are more like the costs of drilling exploratory wells than they are like G&G costs. The Board agrees with that view, and this Statement reflects the appropriate modification from the Exposure Draft. Further, paragraph .034 provides for

deferral of the costs of exploratory-type stratigraphic test wells that find commercially producible quantities of reserves, even though those wells cannot be used to produce the reserves. That provision reflects the realities and economics of offshore drilling. Producible exploratory wells often are prohibitively expensive in offshore waters, and offshore exploratory drilling generally involves non-producible, expendable wells.

All Development Costs Capitalized

.203 Under this Statement, discovery of oil and gas reserves is viewed as the single most critical event in the search for and extraction of oil and gas. Discovery of proved reserves establishes the existence of future benefits and justifies the capitalization of the costs of successful exploratory wells and exploratory-type stratigraphic test wells as amortizable assets. After discovery, development costs are incurred to obtain additional access to those proved reserves and to provide facilities for extracting, treating, gathering, and storing the oil and gas. Those development costs result in the creation of a producing system of wells and related equipment and facilities—a system much like the production system of a manufacturing company.

.204 After discovery, all costs incurred to build that producing system, including the costs of drilling unsuccessful development wells and development-type stratigraphic test wells, are capitalized as part of the cost of that system under the provisions of this Statement. With respect to development dry holes, some persons take the position that no costs incurred in drilling a dry hole—exploratory or development—can provide future benefits, and therefore the costs of all dry holes, including development dry holes, should be charged to expense.

.205 In the Board's judgment, however, there is an important difference between exploratory dry holes and development dry holes. The purpose of an exploratory well is to search for oil and gas. The existence of future benefits is not known until the well is drilled. Future benefits depend on whether reserves are found. A development well, on the other hand, is drilled as part of the effort to build a producing system of wells and related equipment and facilities. Its purpose is to extract previously discovered proved oil and gas reserves. By definition (Appendix C, paragraph .274), a development well is a well drilled *within the proved area* of a reservoir to a *depth known to be productive*. The existence of future benefits is discernible from reserves already proved at the time the well is drilled. An exploratory well, because it is drilled

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outside a proved area, or within a proved area but to a previously untested horizon, is not directly associable with specific proved reserves until completion of drilling. An exploratory well must be assessed on its own, and the direct discovery of oil and gas reserves can be the sole determinant of whether future benefits exist and, therefore, whether an asset should be recognized. Unlike an exploratory well, a development well by definition is associable with known future benefits before drilling begins. The cost of a development well is a part of the cost of a bigger asset—a producing system of wells and related equipment and facilities intended to extract, treat, gather, and store known reserves.

.206 Moreover, because they are drilled only in proved areas to proved depths, the great majority of development wells are successful; a much smaller percentage (22 percent in the United States in 1976), as compared to exploratory wells (73 percent in the United States in 1976) are dry holes. Development dry holes occur principally because of a structural fault or other unexpected stratigraphic condition or because of a problem that arose during drilling, such as tools or equipment accidentally dropped down the hole, or simply the inability to know precisely the limits and nature of a proven reservoir. Development dry holes are similar to normal, relatively minor "spoilage" or "waste" in manufacturing or construction. The Board believes that there is a significant difference between the *exploration for* and the *development of* proved reserves. Therefore, in the Board's judgment, it is appropriate to account for the costs of development dry holes different from exploratory dry holes.

.207 For similar reasons, the Board believes that the costs of development-type stratigraphic test wells should be accounted for as other development costs. Development-type stratigraphic test wells are drilled *after* proved reserves have been discovered, and they are drilled *within* the proved area, generally either to assess more accurately the quantity of reserves that has been found or to provide information as to where best to locate the production platform. The existence of future benefits is discernible from reserves already proved at the time the development-type stratigraphic test well is drilled. The costs of drilling the well are part of the costs of developing a system that will produce those reserves. In the Board's judgment, it is inappropriate to account for the costs of development-type stratigraphic test wells different from other development costs. As explained in paragraph .202, the method of accounting for stratigraphic test wells in this Statement

represents a change from the proposal in the Exposure Draft as a result of comments made by respondents to the Exposure Draft.

Impairment Test for Unproved Properties

.208 When unproved properties are acquired, their acquisition costs are capitalized when incurred. Whether the unproved property will ultimately provide future benefits—that is, whether it contains proved oil and gas reserves—is unknown at the time of acquisition. However, a *property right* is acquired. That property right, and the underlying *right to search for and extract* oil and gas reserves, in themselves are in the Board's judgment a sufficient future benefit to justify capitalizing the acquisition cost of an unproved property at the time it is incurred. Because a purchase price has been paid, there is a presumption that the property right has an independent market value at the time equivalent to the purchase price. Thereafter, either as a result of unsuccessful exploration activities including those of other parties on nearby or adjacent properties or as the expiration of the property right approaches, the future benefits inherent in the right to search for and extract oil and gas in an unproved property may diminish or disappear entirely, with no offsetting benefits in terms of oil and gas discovered. Consequently, this Statement requires that unproved properties be assessed periodically and a loss recognized if those properties have been impaired. Many respondents to the Exposure Draft recommended that for practical reasons the Board should permit recognition of impairment of individually insignificant properties by amortizing their costs, either in the aggregate or by groups, on the basis of the experience of the enterprise and other information. This Statement reflects the appropriate modification of the Exposure Draft to permit amortization of individually insignificant properties.

Question of a Limitation Test for Proved Properties and Capitalized Exploration and Development Costs

.209 As explained in paragraphs .190 and .191, a cost center is not the primary consideration in the capitalize/expense decision under the approach to successful efforts accounting adopted by the Board in this Statement. Under that approach, the assets to which the capitalized acquisition, exploratory drilling, and development costs relate are *properties, wells, equipment, and facilities.* The question of whether to write down the carrying amount of productive assets to an amount expected to be recoverable through future use of those assets is unsettled under present generally accepted accounting principles. This is a pervasive issue that the Board has not addressed. Consequently, this Statement is not

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intended to change practice by either requiring or prohibiting an impairment test for proved properties or for wells, equipment, and facilities that constitute part of an enterprise's oil and gas producing systems.

Unit-of-Production Amortization

.210 Nearly all respondents to the Discussion Memorandum and the Exposure Draft favored unit-of-production amortization for capitalized acquisition, exploratory drilling, and development costs. There was some disagreement, however, as to the appropriate reserve categories on which to base amortization. Some persons favor using the same reserve categories for all amortizations. Within that group, some would use only *proved developed* reserves while others would use *all proved* reserves. Some who would use all proved reserves would include estimated future development costs in the amortization computation; others would use only actual costs incurred. Some persons would use different reserve categories for different types of capitalized costs.

.211 The Board believes that using estimated future development costs to compute amortization rates introduces an unnecessary and subjective element into the financial accounting and reporting process. Only development costs incurred to date should be amortized. Further, in the Board's judgment, costs should be amortized on the basis of estimates of quantities of proved reserves to which those costs relate. Proved developed reserves, by definition, relate to the costs of wells and related equipment and facilities. Acquisition costs relating to proved properties, on the other hand, were incurred to obtain not only the proved reserves that are already developed but also those proved reserves remaining to be developed. Accordingly, this Statement requires that acquisition costs of proved properties be amortized on the basis of all proved reserves, developed and undeveloped, and that capitalized exploratory drilling and development costs (wells and related equipment and facilities) be amortized on the basis of proved developed reserves.

.212 Respondents to the Exposure Draft cited three important aspects of its provisions regarding unit-of-production amortization that, in their view, required clarification or modification. The Board agrees that clarification or modification is needed for each of those matters, and the following changes have been made in this Statement:

a. Paragraph .029 has been modified to permit reclassification from unproved to proved of only a portion of an unusually

large property to which proved reserves have been attributed. The acquisition cost of the portion remaining as unproved will therefore not be subject to unit-of-production amortization, though it will continue to be subject to assessment for impairment.

b. Paragraph .035 has been modified to permit amortization of natural gas cycling and processing plants by other than the unit-of-production method if another method is deemed more appropriate in the circumstances.

c. Paragraph .035 has been modified to provide for exclusion of certain large front-end development costs that relate to an entire planned group of wells as a whole from immediate early amortization pending completion of drilling the additional wells; similarly, that paragraph now provides for exclusion from the amortization rate determination those proved developed reserves that will be produced only after significant expenditures are made.

.213 Two principal approaches were considered by the Board for equating, in computing amortization rates, oil and gas that are jointly produced from a property or group of properties. One is to equate the oil and gas on the basis of their relative energy content—their heat content based on the British Thermal Unit (BTU). The other approach is to equate oil and gas on the basis of their relative sales values.

.214 The relative energy content approach stresses the physical relationship of oil and gas. The relative sales value method is intended to emphasize their economic relationship. The Board rejected the relative sales value method principally because of problems in determining and using relative sales values. For example, because market prices of much of the oil and gas sold are regulated, sometimes with widely disparate prices prevailing for the same commodity and with relatively significant year-to-year fluctuations, the economic relationship as of a given date could be quite artificial and quite different from a similar determination made for the same reserves as of some prior or future date. Consequently, the Board rejected the relative sales value method.

Importance of the Definition of Proved Reserves

.215 Under the provisions of this Statement, capitalization and asset classification decisions hinge on whether *proved* reserves

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have been found. For that reason, the definition of proved reserves in Appendix C of this Statement assumes great importance. That definition is the one set forth in the rules and regulations of the Securities and Exchange Commission. The Board chose that definition, rather than definitions proposed by others and rather than creating a definition of its own, because the SEC definition is already required to be used in practice by oil and gas producing companies whose securities are publicly traded. The Board believes that conformity of the reserve definitions used in filings with the SEC, in information reported to the Department of Energy for the national energy data base, and in financial statements prepared in conformity with generally accepted accounting principles is desirable.

.216 Under paragraph .011 of this Statement, properties are classified as either unproved or proved depending on whether those properties have proved reserves. Although some oil and gas producing companies currently make a developed/undeveloped or producing/nonproducing distinction among properties, in the Board's judgment *discovery,* rather than development or production, is the single most critical event in an enterprise's oil and gas producing activities. The Board recognizes that some companies presently refer to properties with no proved reserves as *undeveloped* or *nonproducing,* for disclosure purposes; conversely, some companies heretofore have referred to properties with proved reserves as *developed* or *producing* properties even though some or all of a property's proved reserves may not be developed or producing.

Information Available after the Balance Sheet Date

.217 In response to questions raised in letters of comment on the Exposure Draft, paragraph .039 has been added to this Statement to clarify that information that becomes available after the balance sheet date but before the financial statements are issued shall be taken into account in evaluating conditions that existed at the balance sheet date, for example, in assessing unproved properties and in determining whether a well has found proved reserves. The Board believes that this position is consistent with the concepts in *FASB Statement No. 5* [section 4311], "Accounting for Contingencies."

Mineral Property Conveyances and Related Transactions

.218 Mineral property conveyances and related transactions may be classified according to their nature as a sale, a borrowing, an exchange of nonmonetary assets, a pooling of assets in a joint

undertaking, or some combination thereof. In the Board's judgment, the accounting principles set forth in the authoritative accounting literature and otherwise generally accepted in current practice for similar transactions in other industries should apply to the oil and gas industry. Paragraphs .043 and .047 apply accepted accounting practices to some of the more common types of conveyances.

.219 The transactions described in paragraph .043(a) are classified as borrowings because the funds advanced are repayable in cash or its equivalent. Although the purpose of advancing funds for exploration is to obtain future supplies, successful exploration is not assured, and to the extent production is inadequate to satisfy the obligation, the balance is payable in cash. Accordingly, the transaction is in substance a borrowing.

.220 A production payment repayable in cash out of the proceeds from a specified share of production until the amount advanced has been recovered with interest (paragraph .043(b)), is in substance a borrowing. Some hold the view that the recipient of the advance has no liability except to the extent that oil or gas is produced and that, accordingly, the recipient should account for the advance as deferred revenue. The Board did not find that reasoning persuasive. Normally, the advances are made by banks (often through an intermediary) or by other lenders under conditions that leave little doubt that the proved reserves are more than adequate to recover the funds advanced plus interest. The intent of the transaction is to obtain funds and not to sell oil or gas for future delivery. The recipient of the advance is at risk for any change in the price of oil or gas and for the cost of operating the property. The transaction is in substance a loan secured by reserves and is without recourse to other assets of the party receiving the advance. The reserves and production involved are reported by the recipient, not by the lender.

.221 The Exposure Draft had proposed that neither gain nor loss be recognized at the time of conveyance if a part of an interest owned is sold and either (a) substantial uncertainty exists about recovery of the costs applicable to the retained interest or (b) the seller has a substantial obligation for future performance. While agreeing that because of those uncertainties recognition of a *gain* is not appropriate in those situations, some respondents to the Exposure Draft said that recognition of a *loss* should not be prohibited. The Board agrees, and paragraph .045 of this Statement prohibits only the recognition of a gain in those situations. In addition, the phrase "substantial obligation for future per-

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formance" in paragraph .045(b) has been expanded to include examples, as suggested by some respondents to the Exposure Draft.

.222 A production payment to be satisfied by delivery of a specified quantity of oil or gas out of a specified share of production (paragraph .047(a)) is a sale for which income is not recognized because the earning process is not complete. The seller still has to perform the production and delivery function. Unlike the production payment payable in cash, the amount payable is not fixed, there is no specified or determinable rate of interest, and the risks of price changes rest with the purchaser rather than the seller. The purchaser, not the seller, reports the reserves and production because the substance of the transaction is the purchase of a mineral interest rather than the lending of cash.

.223 In some transactions, the owner of an operating interest in an unproved property arranges for another party to assume some or all of the exploration, drilling, development, and operating obligations in return for a share of the rewards if those efforts are successful. This Statement addresses three types of such arrangements: (a) assignment of the operating interest with retention of a nonoperating interest in return for which the assignee assumes the drilling, development, and operating obligations (paragraph .047(b)); (b) assignment of a part of an operating interest in return for assumption by the assignee of the obligation to drill one or more exploratory wells at assignee's cost, after which the property is to be jointly owned and operated if the drilling is successful (paragraph .047(c)); and (c) a carried interest arrangement by which the assignee assumes all the exploration drilling and development risk in return for a fractional operating interest but recovers the cost incurred, if the venture is successful, before the assignor shares in the production from the property (paragraph .047(d)).

.224 While the three types of conveyances described in the preceding paragraph have different features, in each instance one party has provided the property and the other party has agreed to incur certain high risk costs, and the benefits, if any, are to be shared in agreed proportions. The Board concluded that all those transactions represent a pooling of assets in a joint undertaking. The investment of each party in the joint operations consists of the carrying amount of the assets contributed by it. Each party will share in the resulting benefits, if any, according to the terms of the agreement. The cost of those benefits to the recipient is the amount of its investment. At the time of the transaction the earning process is incomplete and no gain or loss has been realized by either party. Each party records only its own costs and revenues and does not make a reassignment of costs to reflect the

interest that it obtains, or may obtain, in assets contributed by the other party. Each party looks upon its earning assets as those contributed by it.

.225 Some support the view that when part of an interest in an unproved property is relinquished to obtain another type of interest in the same property or an interest in wells and equipment, both parties to the transaction should reassign the cost each has incurred so that their accounts will reflect some cost for each type of asset. The Board rejected that view because there is no true exchange of assets in this type of transaction. As stated above each party's earning assets are those contributed by it, and the carrying amounts of those assets should be retained at their historical cost.

.226 In applying the above conclusions to carried interests, the Board recognizes that before payout a carried party will reflect no income and that at payout the carried party will own an interest in wells and related equipment and facilities, but its accounts will reflect only the original investment in the property. The Board believes, however, that the pooling concept best reflects the substance of the agreement between the parties. At the time expenditures are made it is not known whether payout will occur, and many carried interests, even in properties where production is obtained, do not pay out. The Board's conclusions in respect to accounting for this type of transaction are that a carried party has no revenue until payout and no cost of assets beyond the original leasehold cost; a carrying party's accounts reflect the investment, operating costs, and revenue that are at its risk or for its benefit; and the disclosures of reserves and production should be consonant with that basis of accounting.

.227 Because an exchange of fractional operating interests in undeveloped mineral properties upon formation of a joint venture (paragraph .047(e)) is a nonmonetary exchange of similar productive assets, accounting as prescribed in *APB Opinion No. 29*, "Accounting for Nonmonetary Transactions," paragraph 21(b) [section 1041.21(b)] is appropriate. In response to requests for clarification of gain or loss recognition in disproportional cost sharing arrangements paragraph .047(e) was expanded to provide that each party to a joint venture shall record its cost and that gain shall not be recognized if an interest in a property or other assets is acquired without cost or at a cost disproportionate to the interest acquired. This accounting is compatible with that prescribed for a free well or a carried interest.

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.228 The Board considered the transactions carried out to effect the unitization of oil and gas properties (paragraph .047(f)) to be a pooling of assets for which the earning process is incomplete. Unitizations result in a group of separate properties being combined and operated as a single property. Each participant normally has essentially the same quantity of oil and gas reserves immediately following the unitization as before. A payment of money to equalize the contributions of wells, equipment, and facilities does not in the Board's judgment change the substance of the transaction.

.229 Paragraph .047(g) has been added to this Statement to clarify the appropriate accounting for the sale of an entire interest in an unproved property. Recognition of gain or loss on the sale of a property whose impairment has been assessed individually is consistent with accounting for the sales of assets generally. Nonrecognition of gain or loss on the sale of a property whose impairment has been assessed by amortizing its cost as part of a group is compatible with the normal accounting for a partial retirement of assets subject to group depreciation; paragraph .047(g) also provides for recognizing gain when the sales price exceeds the original cost of the property sold, a circumstance that does not normally arise in the usual group depreciation situation for other types of assets.

.230 The sale of a part of an interest in an unproved property for cash (paragraph .047(h)) is viewed by some as the sale of an asset that results in a gain or loss. The Board does not agree with that view. The objective of the parties in this type of transaction is generally to diversify risks and jointly participate in any future costs and benefits. Since this Statement requires continuing evaluation of unproved properties for impairment, no loss need be recognized as stemming directly from the sale of a fractional interest. The Board concluded that because of the uncertainty of the recovery of costs applicable to the interest retained in an unproved property, the transaction should be accounted for as a recovery of cost and that a gain should be recognized only to the extent that proceeds from the fractional interest sold exceed the carrying amount of the property. The proposal in the Exposure Draft has been revised to clarify the question of gain recognition if the unproved property in which part or all of an interest is sold is part of a group for which an impairment allowance is provided in the aggregate.

.231 The risk of nonrecovery of the remaining cost is usually not significant if proved properties or parts of interests in proved properties are sold (paragraph .047(i)-(m)). Accordingly, the Board concluded that gain or loss should normally be recognized in those transactions consistent with other sales of capital assets.

.232 Paragraphs .047(l) and .047(m) have been added to clarify that accounting for the sale of a property with retention of a production payment shall be compatible with the accounting for the sale of production payments with retention of the operating interest. A retained production payment expressed in money may sometimes be so large that it is highly improbable that the production payment will be satisfied before the reserves are fully depleted. In those situations, therefore, paragraph .047(l) provides that the retained production payment shall be treated as an overriding royalty interest rather than as a receivable or payable.

Disclosure

.233 In establishing the disclosure standards in paragraphs .048-.059 of this Statement, the Board relied on the following general guidelines:

a. The disclosures in financial statements do not and cannot include all information that may be needed for investment, credit, regulatory, or national economic planning and energy policy decisions, although the accounting standards established by this Statement should contribute importantly to the reliability and uniformity of financial data used in those types of decisions. Financial statements are intended to present fairly an enterprise's financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Thus, financial statement disclosures are those disclosures that are considered necessary for such a fair presentation. Criteria such as relevance, reliability, verifiability, freedom from bias, and comparability provide guidance in considering which disclosures are necessary for fair financial statement presentation.

b. Oil and gas producing companies currently disclose a considerable amount of information about their oil and gas producing activities in annual reports to shareholders, in published statistical summaries, in filings with the SEC, Department of Energy, and other regulatory agencies, and in other publicly available documents. Most of that information is currently presented outside the scope of the companies' financial state-

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ments. This Statement will result in some of that information being included in financial statements and, for many companies, will result in changes in the bases of preparing the information.

c. The disclosures required by this Statement relate only to those activities (acquisition, exploration, development, and production) for which this Statement establishes accounting standards; therefore, this Statement does not prescribe disclosures related to transporting, refining, and marketing of oil and gas or other activities of an oil and gas producing company.

d. As a general proposition, disclosures required for companies engaged in oil and gas producing activities should be similar to those required for companies in other industries.

e. As elaborated on in paragraphs .149-.152, financial statements by themselves do not adequately portray the success of a company in finding and developing oil and gas reserves under either of the two historical cost methods of accounting for oil and gas producing activities—full costing or successful efforts costing. Under both methods, earnings are recognized at the time of sale, not at the time of discovery or production. Therefore, an important objective of the disclosures included in financial statements prepared by either of those historical cost methods should be to help the user of those statements relate a company's *efforts* (in terms of costs incurred in searching for and developing oil and gas reserves) and *accomplishments* (in terms of reserves discovered and developed).

f. The disclosure requirements must be consistent with and derived from the accounting standards established by this Statement. That is, a principal purpose of the disclosures should be to aid in understanding of the information *shown* in the financial statements of an oil and gas producing company. The disclosures should not be designed to present information that *might have been shown* in the financial statements had different accounting standards been established by this Statement.

Disclosures in Interim Financial Statements

.234 This Statement does not require that the disclosures of reserve quantities and of acquisition, exploration, development, and production costs be included in interim financial statements, though they are required in annual financial statements. The Board reached that conclusion principally because problems in gathering

data of that type on a timely basis become especially acute at interim reporting dates and, for some companies, the costs of that effort may be unduly burdensome. The Board presently has on its agenda a project on interim financial reporting in which the nature and extent of disclosures in interim financial statements are issues.

Disclosure of Information about Reserves

.235 Most of the respondents to the Discussion Memorandum and most of the interviewees in the research effort described in paragraph .090(a) of Appendix A said that information about quantities of oil and gas reserves is essential to understand and interpret the financial statements of an oil and gas producing company. Many felt that reserve information is the single most important type of disclosure that could be required of an oil and gas producing company. They said that discovery of reserves is the critical event in the oil and gas production cycle and that reserves and changes in reserves are key indicators of the success of a company. In general, the Board agrees with those views. None of the methods of accounting considered by the Board in this project, not even discovery value or current value accounting, would, in the Board's judgment, result in financial statements that would not need to be accompanied by disclosures of reserves and reserve changes. This Statement requires disclosure of information with respect to a company's oil and gas reserves.

.236 The Board does not agree with the view, expressed by some, that mineral reserve information is not accounting information and, if disclosed at all, should not be included in financial statements. Those who take that position argue that while reserve information may indeed be important, it is too subjective, too frequently revised, too unreliable, too "soft" to be reported in financial statements. In the Board's judgment, however, certain reserve information has the qualities of verifiability, reliability, freedom from bias, comparability, and the like to a sufficiently reasonable degree to warrant its inclusion in financial statements. Accordingly, the Board concluded that reserve information is so helpful and essential to an understanding of the financial position, results of operations, and changes in financial position of an oil and gas producing company that the added relevance of the financial statements from including the information more than compensates for the lack of precision of estimates of reserves.

.237 The Board considered the following broad areas of disclosure of information regarding oil and gas reserves:

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a. Disclosure of reserve quantities:

   i. Estimated reserve quantities, by categories and types of reserves.

   ii. Changes in estimated reserve quantities, by categories and types of reserves.

   iii. Other disclosures relating to estimated reserve quantities, such as geographic locations, ownership characteristics, quality of reserves, and unusual risks and uncertainties.

b. Disclosure of reserve values:

   i. Estimated value of reserves.

   ii. Changes in estimated reserve values.

c. Description of assumptions and difficulties in estimating quantities or values of oil and gas reserves.

Disclosure of Reserve Quantities

.238 This Statement relies on estimates of proved reserves and proved developed reserves for a number of capitalization and amortization determinations, and for the reasons discussed in paragraphs .235 and .236 disclosure of quantities of those categories of reserves, and of changes in those quantities, is required. In the Board's judgment, the constraints imposed on the estimator by the definitions of proved reserves and proved developed reserves in paragraph .271 of Appendix C will keep the subjectivity of the estimates to an acceptably low level for financial reporting purposes.

.239 Reserve increases that result from successful exploration and development efforts and from purchases of minerals-in-place, net of decreases from production and sales of minerals-in-place, represent the *physical* expansion or contraction of the quantity of the company's reserves from the beginning to the end of the period. Revisions of previous estimates, on the other hand, represent a change to the quantity that was *perceived* to have existed at the beginning of the period. The categories of changes in reserve quantities required to be separately reported by paragraph .051 are intended to reflect those differences. Some respondents to the Exposure Draft disagreed with the inclusion of changes in reserves resulting from application of improved recovery techniques among other additions; they pointed out that such changes are normally classified by industry practice as revisions of previous estimates. This Statement reflects a change from the Exposure Draft in response to the foregoing concerns. Paragraph .051 provides for separate disclosure of changes resulting from improved recov-

ery techniques if significant and for inclusion of those changes as revisions of previous estimates if not significant. Also, in response to comments on the Exposure Draft, paragraph .050 provides for exclusion of reserves relating to royalty interests owned if the reserve information is not available to the royalty owner. Also, paragraph .054(c) reflects a modification of the Exposure Draft to provide for separate disclosure of the investor's share of oil and gas reserves owned by an investee accounted for by the equity method.

.240 Because enterprises' interests in foreign oil and gas reserves are affected by political, economic, and environmental risks and considerations that are often significantly different from the risks associated with domestic reserves, this Statement requires that reserve quantities and changes in them be reported separately for each geographic area in which significant reserves are located. That requirement comports with the conclusions of the Board in *FASB Statement No. 14* [section 2081], "Financial Reporting for Segments of a Business Enterprise," which requires that the financial statements of a company that operates in different geographic areas report certain key information by geographic area.

.241 Some persons propose that disclosure be required of estimated future development costs relating to proved undeveloped reserves. In the Board's view, disclosure of cost projections of that nature and tentativeness should not be required in financial statements of oil and gas producing companies. The question is not unique to the oil and gas industry—indeed, the whole area of disclosure of forecasts is unsettled. To provide some indication of the extent to which development of proved reserves has been accomplished, paragraph .050 requires the separate reporting of year-end quantities of proved developed reserves. Further, the Board believes that estimates of reserves that are not classified as proved but that are regarded as probable reserves or possible reserves are too subjective to be required for inclusion in financial statements. Some persons have suggested that disclosure of those quantities be required.

.242 Some foreign governments have nationalized or otherwise taken over, in whole or in part, certain properties in which oil and gas producing companies previously had mineral interests. Some of those interests have been converted into long-term supply, purchase, or similar agreements with the foreign government or a government authority. In some countries, oil and gas producing companies can obtain access to oil and gas reserves only through such agreements, and not through direct acquisition of a traditional

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type of mineral interest in a property. If an oil and gas producing company participates in the operation of a property subject to such an agreement or otherwise serves as "producer" of the reserves from the property, it is the Board's judgment that the reserve quantities identified with, and quantities of oil or gas received under, agreements with foreign governments or authorities should be disclosed in the company's financial statements. In view of the different nature of those agreements, however, paragraph .053 requires that those reserve quantities be separately reported from the company's regular proved reserves. The fact that the reserves are available to the company under agreements that differ from domestic agreements does not justify excluding those reserves from the accounting and disclosure provisions of this Statement as long as the foreign agreements, in substance, represent the right to *extract* oil and gas.

.243 Although the Exposure Draft had proposed to include in an investor's reserve quantities, for purposes of the disclosures required by paragraphs .050-.056 of this Statement, the investor's share of reserves owned by an investee accounted for by the equity method, some respondents to the Exposure Draft pointed out that the investor's financial statements do not include the investee's individual assets, liabilities, revenues, or expenses. They questioned therefore the propriety of including the investee's reserves in the investor's. The Board is persuaded that the better approach is not to commingle the investee's and investor's reserves in the investor's disclosures but, rather, to require separate disclosure of the investee's reserves at year end. Paragraph .054(c) reflects the revised requirement.

.244 Some persons believe that information about ownership characteristics (for example, whether reserves are owned in fee, by domestic lease agreement, or by concession from a foreign government) and about quality of reserves (for example, sulphur or paraffin content or specific gravity) should accompany disclosure of reserve quantities. Because of differences from property to property in those types of characteristics, for many companies the disclosures either would be so broad and general that they would be of little or no value to financial statement users or they would be so detailed and voluminous that they could overwhelm or confuse financial statement users rather than inform them. Consequently, the Board believes that explanations of that type should not be required in general purpose financial statements. For similar reasons, this Statement does not require a description of the as-

sumptions used and difficulties involved in estimating quantities of oil and gas reserves.

Disclosure of Reserve Values

.245 The fact that the Board rejected both discovery value and current value as bases of accounting for oil and gas reserves did not, of itself, mean that the Board automatically had rejected estimated reserve values as additional financial statement disclosures. The Board viewed the use of estimated reserve values as the basis of accounting for oil and gas producing companies and the disclosure of estimated reserve values as part of the financial statements of those companies as separable decisions, although, of course, many common considerations are involved.

.246. The measurement problems discussed in paragraph .133 were important reasons for not requiring disclosure of estimated reserve values, as they were for not accepting discovery value or current value accounting. They were not, however, the only reasons.

.247 As noted in paragraphs .138 and .140, various bases of accounting measurement, including both historical cost and current value measurements, are under consideration as part of the Board's conceptual framework project. The Discussion Memorandum on "Financial Accounting and Reporting in the Extractive Industries" did raise issues relating to methods of valuing mineral reserves. Relatively few respondents supported the use of discovery value or current value accounting or the disclosure of estimated reserve values, and the Board received only limited response to the valuation issues. The Board has decided not to resolve those issues for the limited purpose of this Statement.

.248 The SEC's consideration of whether replacement cost disclosures or other reserve value disclosures can be applied to mineral resource assets (discussed in paragraphs .082 and .096 of Appendix A to this Statement) is another reason that led the Board to reject disclosure of estimated reserve values at this time. The Welsch and Deakin study (paragraph .082) has two fundamental conclusions: that the replacement cost concept of SEC *Accounting Series Release No. 190* is not relevant to oil and gas reserves and that the preferred surrogate for replacement cost is a present value method that the study calls "Equivalent Purchase Cost." In its June 15, 1977 letter transmitting that study to the SEC, though, the American Petroleum Institute, sponsor of the study, stated:

> We see in the Equivalent Purchase Cost method many of the deficiencies which caused the research team to conclude that

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> replacement cost is not relevant with respect to oil and gas reserves. The theoretical cost of a stream of future income fails to recognize that revenue sources cannot be replaced in kind and that they will originate in different environments with characteristics substantially different from the current revenue stream.
>
> The large majority of our Accounting Committee members cannot support this method on the grounds that the data provided would make little, if any, contribution to an investor's understanding of the economics of the business and, indeed, could be misleading.

.249 In *Securities Act Release No. 5837,* dated June 20, 1977, the Commission stated:

> The Commission's staff has recently received, and is currently reviewing, the results of the research study together with recommendations of the American Petroleum Institute. No comments are being solicited on the disclosure of current value and current cost data until the evaluation of the American Petroleum Institute project is completed.

.250 On October 26, 1977, in *Securities Act Release No. 5878,* the Commission proposed to rescind the requirement in *ASR No. 190* that certain registrants disclose replacement cost information about their mineral resource assets employed in oil and gas producing activities and, instead, to require registrants with mineral resource assets employed in oil and gas producing activities to disclose, in filings covering fiscal years ending on or after December 25, 1978, information based on the present value of future net revenues from estimated production of proved oil and gas reserves. The Commission has asked that comments on the proposal be submitted by March 31, 1978.

.251 The FASB will be holding a public hearing beginning January 16, 1978 on the broad subject of accounting measurement, including the question of whether one or more of the various types of "current value" measurements should be reported in financial statements of companies generally.

.252 The Board believes, therefore, that a decision as to whether reserve value information should be required to be included in financial statements should await consideration of the comments on the SEC proposal referred to in paragraph .250 and the written submissions and oral presentations in connection with the public hearing referred to in paragraph .251.

Disclosure of Capitalized Costs and of Costs Incurred

.253 The disclosures of capitalized costs (paragraph .057) and of costs incurred (paragraphs .058 and .059) are intended to com-

plement the disclosures of reserve quantities and changes therein. The reserve quantity disclosures are an indicator of *accomplishment.* Capitalized costs and costs incurred provide an indication of *effort.*

.254 Reserves are considered the focal point for assessing *accomplishment* because of the importance of discovery as the most critical event in the oil and gas production cycle and of development as the next most important event. Similarly, *effort* is much more a function of incurring costs than it is a function of disbursing cash. As a consequence, the disclosures required by paragraphs .058 and .059 include not only expenditures for acquisition, exploration, development, and production but also the *depreciation* of support equipment and facilities that are *used* in those activities. It is not the *purchase* of seismic equipment or a drilling rig, for example, but rather the *use* of that seismic equipment and the drilling rig in exploration and development activities that is an indication of effort. Thus, as paragraph .058 points out, exploration, development, and production costs include the *depreciation* of the seismic equipment and drilling rig but exclude the *expenditures* to acquire that equipment. Likewise, it is the incurrence of acquisition, exploration, and development costs that best indicates effort in terms of *finding and developing reserves.*

.255 The Exposure Draft had proposed to require certain special disclosures for a rate-regulated company that, under the Addendum to *APB Opinion No. 2* [section 6011], follows an accounting policy that involves capitalizing or amortizing costs on a basis different from that otherwise required by this FASB Statement. Since the Exposure Draft, the Board has begun work on a project that involves reconsideration of the Addendum to *APB Opinion No. 2* [section 6011]. Because the question of special disclosures such as those proposed in the Exposure Draft will be considered as part of that project, the Board has determined not to require the special disclosures that had been proposed.

Disclosure of Other Functional and Operating Data

.256 Some persons propose that aggregate revenues and expenses for oil and gas producing activities be disclosed in financial statements. In the Board's view, a serious doubt exists as to whether those aggregate revenue and expense disclosures will contribute to an understanding of an enterprise's profitability as reflected in its financial statements. Many oil and gas producing companies do not derive revenue from oil and gas producing activities but rather from the sale of refined oil and gas products. For those companies,

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even if practicable, information about the results of operations of oil and gas producing activities standing alone, without similar information for the company's transportation, refining, and marketing activities and for its other operations, would represent only a fragment of the overall picture of the company.

.257 Moreover, under the provisions of *FASB Statement No. 14* [section 2081], the combined activities of acquisition, exploration, development, and production are not considered to be an industry segment of an integrated oil and gas company. Paragraph 10(a) [section 2081.010(a)] of that Statement defines an industry segment as a "component of an enterprise engaged in providing a product or service or a group of related products and services *primarily to unaffiliated customers* (i. e., customers outside the enterprise) for a profit." (Emphasis added.) That paragraph goes on to say that "by defining an industry segment in terms of products and services that are sold primarily to unaffiliated customers, this Statement does not require the disaggregation of the vertically integrated operations of an enterprise." The Board reconsidered that decision as part of its project on the extractive industries and concluded that *FASB Statement No. 14* [section 2081] should not be amended to apply to oil and gas producing companies a disclosure requirement not required of companies in other industries.

.258 For the reasons in paragraphs .256 and .257 this Statement does not require disclosure of functional data for oil and gas producing activities beyond the disclosures of capitalized costs and of costs incurred.

.259 The Board considered various types of operating data as possible financial statement disclosures, in addition to the required disclosures relating to reserve quantities, including gross and net undeveloped acreage, gross and net productive acreage, and gross and net producing wells and well completions, and has concluded that those disclosures need not be included for a fair presentation of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.

Accounting for Income Taxes

.260 This Statement reaffirms the conclusion of *FASB Statement No. 9* [section 4097] that oil and gas producing com-

panies should apply interperiod income tax allocation, as described in *APB Opinion No. 11* [section 4091], for all timing differences, including those relating to intangible drilling and development costs. *FASB Statement No. 9* [section 4097], which this Statement supersedes, had permitted companies to recognize the interaction of book/tax timing differences with an anticipated future excess of statutory depletion over cost depletion in applying interperiod income tax allocation. As indicated in paragraph 16 of *FASB Statement No. 9* [section 4097.16], the question of whether interaction should be recognized was left unresolved by the Accounting Principles Board in *APB Opinion No. 11* [section 4091] and was not addressed by the Financial Accounting Standards Board in *FASB Statement No. 9* [section 4097]. Although recognition of interaction was permitted by *FASB Statement No. 9* [section 4097], it was not required. This Statement prohibits the recognition of interaction.

.261 The Board has rejected the concept of interaction for several reasons. First, an excess of statutory depletion over the amount of cost depletion otherwise allowable as a tax deduction becomes a benefit only when it is actually realized via income tax deduction. The interaction concept anticipates the possible future benefit by recognizing it as a reduction of book income tax expense in advance of realization. In the Board's judgment, the uncertainties described in the next paragraph make it inappropriate to anticipate the possible future tax benefit in advance of realization.

.262 Statutory depletion was eliminated or virtually eliminated for many companies by the *Tax Reduction Act of 1975* and was substantially reduced for many other companies by that Act. Further reductions are scheduled under that Act and subsequent legislation. Also, the law imposes certain limitations to statutory depletion that depend on future production, future sales prices, and future costs, all of which are difficult to estimate but which must be estimated if interaction is to be recognized. The uncertainties identified in this paragraph cause serious concern about anticipating tax benefits from future statutory depletion.

.263 Moreover, the interaction concept is inconsistent with the deferred method of income tax allocation described in paragraphs 19 and 34-37 of *APB Opinion No. 11* [section 4091.18 and section 4091.33-.36]. Although the recognition of interaction is consistent, in some respects, to the "partial allocation" theory discussed in paragraphs 26-28 [sections 4091.25-.27] of that Opinion, the APB rejected the partial allocation theory in favor of comprehensive income tax allocation by the

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deferred method (paragraphs 29-32 [section 4091.28-.31] of that Opinion).

.264 The concept of interaction is, essentially, a "cover" concept: Deferred income taxes that otherwise relate to *current* period pre-tax accounting income need not be recognized to the extent of offsetting possible *future* income tax benefits from excess statutory depletion. The Board has expressly rejected the "cover" concept in reaching certain decisions in this Statement (see paragraphs .175 and .176) and in *FASB Statement No. 8,* "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements" (see paragraphs 174-180 [section 1083.174-.180] of that Statement).

Effective Date and Transition

.265 This Statement was made effective for fiscal years beginning after December 15, 1978 to allow an oil and gas producing company sufficient time to gather the necessary data, modify its accounting systems, and otherwise prepare for transition to the accounting standards established by this Statement. The Exposure Draft had proposed a June 15, 1978 effective date; the change to December 15, 1978 is intended to give all companies at least one year to prepare for the change and to explain any impact it may have to investors and creditors. Voluntary adoption of the provisions of this Statement prior to its effective date is not prohibited by this Statement.

.266 For several reasons, the Board has concluded that the provisions of this Statement should be applied retroactively by restating the financial statements of prior periods. First, unlike FASB pronouncements that deal with a comparatively narrow accounting question, the standards established by this Statement prescribe the fundamental basis by which the financial statements of an oil and gas producing company shall be prepared. Moreover, because many variations of successful efforts accounting have heretofore been applied in practice, this Statement is likely to have an impact on the financial statements of a great many oil and gas producing companies, not just those companies presently using the full cost method. In the Board's judgment, because of the magnitude and pervasiveness of the impact of this Statement, restatement will result in the most meaningful and comparable financial statements of all oil and gas producing companies.

.267 Further, in paragraph 27 of *APB Opinion No.* 20 [section 1051.27], the Accounting Principles Board cited a change to or from the full cost method of accounting in the extractive industries as one of three special types of changes in accounting principle that should be reported by applying retroactively the new method in restatements of prior periods.

.268 The Board recognizes that some companies may encounter some difficulties in accumulating the necessary data or in making after-the-fact estimates or judgments to apply the provisions of this Statement retroactively. The Board believes, however, that the added interperiod and intercompany comparability thus obtained outweighs any cost-saving advantages of prospective application or the cumulative effect method. Further, because of (a) the diversity of cost capitalization and amortization practices heretofore followed by both full cost and successful efforts companies and (b) the fact that amortization of some previously capitalized costs could continue for ten, twenty, thirty, forty, or more years, the Board concluded that prospective application of the standards established by this Statement is inappropriate.

.269 With regard to some of the restatement problems cited by some respondents to the Exposure Draft, paragraph .064 points out that a provision of this Statement that would not have a significant effect on prior years' financial statements need not be retroactively applied. Also, in response to questions raised in letters of comment on the Exposure Draft, paragraph .064 allows the use of "hindsight" information in making the retroactive restatements except that reserve estimates should not now be revised in retrospect.

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Appendix C

GLOSSARY

.270 This glossary defines certain terms as they are used in this Statement.

.271 The definitions of categories of *reserves* used in this Statement are those set forth in the regulations of the Securities and Exchange Commission:[11]

> *Proved reserves.* Those quantities of crude oil, natural gas, and natural gas liquids which, upon analysis of geologic and engineering data, appear with reasonable certainty to be recoverable in the future from known oil and gas reservoirs under existing economic and operating conditions. Proved reserves are limited to those quantities of oil and gas which can be expected, with little doubt, to be recoverable commercially at current prices[12] and costs, under existing regulatory practices and with existing conventional equipment and operating methods. Depending upon their status of development, such proved reserves are subdivided into "proved developed reserves" and "proved undeveloped reserves."
>
> *Proved developed reserves.* Reserves which can be expected to be recovered through existing wells with existing equipment and operating methods. Proved developed reserves include both (a) proved developed *producing* reserves (those that are expected to be produced from existing completion intervals now open for production in existing wells) and (b) proved developed *nonproducing* reserves (those that exist behind the casing of existing wells, or at minor depths

[11] Adopted May 12, 1976 in *Securities Act Release No. 5706*, which deals with disclosure of estimates of oil and gas reserves in registration statements, proxy statements, and reports filed with the Commission.

[12] The term *current prices* is elaborated on by the SEC in *Securities Act Release No. 5837* as follows: "Current prices include consideration of changes in existing prices provided by contractual arrangements, by law, or by regulatory agencies, where applicable; and for changes in prices for gas to be produced subsequent to termination or expiration of existing contracts, which latter prices should be based on current prices plus escalation for similar production subject to the entity's or other entities' recent contracts." The term "escalation" is further elaborated on in *SEC Release No. 5877* as follows: "The 'escalation' referred to in these releases is limited to specific escalation provisions in recent contracts. Escalations to reflect future price expectations are not permitted."

below the present bottom of such wells, which are expected to be produced through these wells in the predictable future, where the cost of making such oil and gas available for production should be relatively small compared to the cost of a new well). Additional oil and gas expected to be obtained through the application of fluid injection or other improved recovery techniques for supplementing the natural forces and mechanisms of primary recovery should be included as "proved developed reserves" only after testing by a pilot project or after the operation of an installed program has confirmed through production response that increased recovery will be achieved.

Proved undeveloped reserves. Reserves which are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion. Reserves on undrilled acreage shall be limited to those drilling units offsetting productive units, which are reasonably certain of production when drilled. Proved reserves for other undrilled units can be claimed only where it can be demonstrated with certainty that there is continuity of production from the existing productive formation. Under no circumstances should estimates for proved undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual tests in the area and in the same reservoir.

.272 The following is the definition of a *field* used in this Statement:

Field. An area consisting of a single reservoir or multiple reservoirs all grouped on or related to the same individual geological structural feature and/or stratigraphic condition. There may be two or more reservoirs in a field which are separated vertically by intervening impervious strata, or laterally by local geologic barriers, or by both. Reservoirs that are associated by being in overlapping or adjacent fields may be treated as a single or common operational field. The geological terms "structural feature" and "stratigraphic condition" are intended to identify localized geological features as opposed to the broader terms of basins, trends, provinces, plays, areas-of-interest, etc.

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.273 The foregoing definition of a field relies, in turn, on the definition of a reservoir. The following definition shall be used for purposes of this Statement:

> *Reservoir.* A porous and permeable underground formation containing a natural accumulation of producible oil or gas that is confined by impermeable rock or water barriers and is individual and separate from other reservoirs.

.274 For purposes of this Statement, the following definitions of wells shall be used:

> *Exploratory well.* An exploratory well is a well that is not a development well, a service well, or a stratigraphic test well as those terms are defined below.
>
> *Development well.* A development well is a well drilled within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive.
>
> *Service well.* A service well is a well drilled or completed for the purpose of supporting production in an existing field. Wells in this class are drilled for the following specific purposes: gas injection (natural gas, propane, butane, or flue gas), water injection, steam injection, air injection, salt-water disposal, water supply for injection, observation, or injection for in-situ combustion.
>
> *Stratigraphic test well.* A stratigraphic test is a drilling effort, geologically directed, to obtain information pertaining to a specific geologic condition. Such wells customarily are drilled without the intention of being completed for hydrocarbon production. This classification also includes tests identified as core tests and all types of expendable holes related to hydrocarbon exploration. For purposes of this Statement, stratigraphic test wells (sometimes called "expendable wells") are classified as follows:
>
> 1. *Exploratory-type stratigraphic test well.* A stratigraphic test well not drilled in a proved area.
>
> 2. *Development-type stratigraphic test well.* A stratigraphic test well drilled in a proved area.

.275 The term *proved area* is used in the foregoing definitions of development well, exploratory-type stratigraphic test well and development-type stratigraphic test well. As used therein, a *proved area* is the part of a property to which proved reserves have been specifically attributed.

INTERNATIONAL ACCOUNTING STANDARDS

Introduction

In June, 1973, the American Institute of Certified Public Accountants became one of the founding members of the International Accounting Standards Committee. The objectives of IASC as set out in paragraph 1 of the revised Agreement are "to formulate and publish in the public interest, standards to be observed in the presentation of audited financial statements and to promote their worldwide acceptance and observance. . . ."

One of the provisions of the Agreement and Constitution of the IASC calls for the members of IASC

"to use their best endeavours:

(i) to ensure that published financial statements comply with these standards or that there is disclosure of the extent to which they do not and to persuade governments, the authorities controlling securities markets and the industrial and business community that published financial statements should comply with these standards;

(ii) to ensure (1) that the auditors satisfy themselves that the financial statements comply with these standards or, if the financial statements do not comply with these standards, that the fact of non-compliance is disclosed in the financial statements, (2) that in the event of non-disclosure reference to non-compliance is made in the audit report;

(iii) to ensure that, as soon as practicable, appropriate action is taken in respect of auditors whose audit reports do not meet the requirements of (ii) above . . ."

Statements of International Accounting Standards do not establish standards enforceable under the Code of Professional Ethics of the American Institute of Certified Public Accountants.

The following sets forth the views of the AICPA Board of Directors regarding the work of the International Accounting Standards Committee and compliance with the AICPA's commitment under the "best endeavours" clause set forth in the Agreement and Constitution of the IASC.

Work of the International Accounting Standards Committee

A. The Board of Directors subscribes to the philosophy of, and practical need for, harmonisation of basic accounting and reporting standards. The Board recognises that such harmonisation will not happen of its own accord and, therefore, supports the work of the International Accounting Standards Committee to formulate and publish basic international standards. They believe that the IASC should be supported to the maximum extent practicable and given every opportunity of fulfilling its purpose.

B. The Board believes that although the IASC is a relatively new body it is expected to have a significant impact on accounting and reporting standards worldwide. If such goal is to be achieved, it is essential that the confidence and respect for the work of the IASC must be gained as a result of a demonstrated capacity to produce timely and high quality standards responsive to the international needs of the professional and business communities throughout the world.

Implementation of "Best Efforts"

A. The Preface to Statements of International Accounting Standards [section 9000] states that national regulations or pronouncements govern financial reporting in each country. To achieve such acceptance in the United States, international accounting standards will have to be specifically adopted by the Financial Accounting Standards Board. In this regard, when an international accounting standard is issued it will be compared with U. S. practice to find out whether there are significant differences between the two.

B. If there are no significant differences, financial statements which comply with U. S. generally accepted accounting principles will automatically comply with the international accounting standards with respect to those subjects.

C. If there are significant differences, the AICPA will urge the FASB to give early consideration to such differences with a view to achieving harmonisation of those areas in which a significant difference exists.

D. Published pronouncements of the IASC will be included in this volume of AICPA PROFESSIONAL STANDARDS together with an indication of whether there are any significant differences between international standards and United States GAAP.

E. Continued effort will be made to ensure that the status of international accounting standards vis-à-vis accounting and reporting practices generally accepted in the U. S. and devel-

> opments therein are clearly understood by government authorities, securities commissions, stock exchanges and the business community. It is important that such groups be encouraged to put forth their views on drafts of the IASC since collectively they represent a broad base of experience and diversity of background which will add significantly to the process of harmonisation of U. S. and international accounting standards.

Accordingly, each Standard is followed by a summary of those situations in which the Standards established by the IASC are more demanding than or conflict with accounting principles generally accepted in the United States. This volume does not identify those matters with respect to which International Accounting Standards permit, but do not require, the use of a practice that is contrary to accounting principles generally accepted in the United States.

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AC Section 9000

INTERNATIONAL ACCOUNTING STANDARDS

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AC Section 9000

Preface to Statements of International Accounting Standards

This Preface is issued to set out the objectives and operating procedures of the International Accounting Standards Committee (IASC) and to explain the scope and authority of the Statements of International Accounting Standards. The Preface was approved in October 1977 for publication in March 1978 and supersedes the Preface published in January 1975. The approved text of this Preface is that published by the International Accounting Standards Committee in the English language.

.01 The International Accounting Standards Committee (IASC) came into existence on 29 June, 1973 as a result of an agreement by the leading professional bodies of Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States of America. A revised Agreement and Constitution was signed on 10 October, 1977. Under the terms of the revised Constitution,* accountancy bodies which were Associate Members become members of IASC and other accountancy bodies may become members. The business of the committee is conducted by a Board comprising representatives of the Founder Member bodies and from not more than two Member bodies.

THE OBJECTIVES

.02 The relationship which existed between IASC and the International Co-ordination Committee for the Accountancy Profession is carried forward to the International Federation of Accountants on the same general basis. IASC continues to be the body having responsibility and authority to issue, in its own name, pronouncements on International Accounting Standards.

.03 The objectives of IASC as set out in paragraph 1 of the 1977 Agreement* are "to formulate and publish in the public interest, standards to be observed in the presentation of audited financial statements and to promote their worldwide acceptance and observance".

* Note. Copies of the 1977 Agreement and Constitution may be obtained on request by application to the secretary of the International Accounting Standards Committee.

.04 By the same Agreement, the Members agree to support these objectives by undertaking the following obligations:

"(a) to support the standards promulgated by the Committee;

(b) to use their best endeavours:

(i) to ensure that published financial statements comply with these standards or that there is disclosure of the extent to which they do not and to persuade governments, the authorities controlling securities markets and the industrial and business community that published financial statements should comply with these standards;

(ii) to ensure (1) that the auditors satisfy themselves that the financial statements comply with these standards or, if the financial statements do not comply with these standards, that the fact of non-compliance is disclosed in the financial statements, (2) that in the event of non-disclosure reference to non-compliance is made in the audit report;

(iii) to ensure that, as soon as practicable, appropriate action is taken in respect of auditors whose audit reports do not meet the requirements of (ii) above;

(c) to seek to secure similar general acceptance and observance of these standards internationally."

AUDITED FINANCIAL STATEMENTS

.05 The term "financial statements" used in paragraphs .03 and .04 covers balance sheets, income statements or profit and loss accounts, statements of changes in financial position, notes and other statements and explanatory material which are identified as being part of the financial statements. Usually, financial statements are made available or published once each year and are the subject of a report by an auditor. International Accounting Standards apply to such financial statements of any commercial, industrial, or business enterprise.

.06 The management of such an enterprise may prepare financial statements for its own use in a number of different ways best suited for internal management purposes. When financial statements are issued to other persons, such as shareholders, creditors, employees, and the public at large, they should conform to International Accounting Standards.

.07 The responsibility for the preparation of financial statements and for adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and to report on the financial statements.

ACCOUNTING STANDARDS

.08 Within each country, local regulations govern, to a greater or lesser degree, the issue of financial statements. Such local regulations include accounting standards which are promulgated by the regulatory bodies and/or the professional accountancy bodies in the countries concerned.

.09 The accounting standards already published in many countries, as referred to in paragraph .08, sometimes differ in form and content. IASC takes cognisance of exposure drafts, or of accounting standards already issued on each subject and in the light of such knowledge produces an International Accounting Standard for worldwide acceptance. One of the objects of the formation of IASC was to harmonise as far as possible the diverse accounting standards and accounting policies at present in use in different countries.

.10 In carrying out this task of adaptation of existing standards, and in formulating International Accounting Standards on new subjects, it is the intention of IASC to concentrate on essentials. It therefore endeavours not to make the International Accounting Standards so complex that they cannot be applied effectively on a world wide basis. In the years to come it is to be expected that the International Accounting Standards issued by IASC will undergo revision and a greater degree of sophistication may then be appropriate.

.11 International Accounting Standards promulgated by IASC do not override the local regulations, referred to in paragraph .08 above, governing the issue of financial statements in a particular country. If the International Accounting Standards issued by IASC conform with local regulations on a particular subject, the financial statements issued in that country which comply with the local regulations will automatically comply with the International Accounting Standards in respect of that subject. The obligations undertaken by the Members of IASC, as explained in this Preface, are designed to ensure that when the International Accounting Standards differ from, or are in conflict with, the local regulations, either the financial statements or the auditor's report will indicate, in accordance with paragraph .04(b)(i) and (ii) of this Preface, in what respects the International Accounting Standards have not been observed.

THE SCOPE OF THE STANDARDS

.12 Any limitation of the applicability of specific International Accounting Standards is made clear in the statements of those Standards. International Accounting Standards are not intended

to apply to immaterial items. An International Accounting Standard applies from a date specified in the Standard and unless indicated to the contrary is not retroactive.

WORKING PROCEDURE—EXPOSURE DRAFTS AND STANDARDS

.13 The agreed working procedure is to select certain subjects for detailed study by Steering Committees. As a result of this work an exposure draft is prepared on a particular subject for consideration by the Board. If approved by a two-thirds majority, the exposure draft is addressed to professional accountancy bodies and to such governments, securities markets, regulatory and other agencies as the Board may determine. Adequate time is allowed for each exposure draft to be considered by the persons or organisations to whom it is sent for comment.

.14 The comments and suggestions received as a result of this exposure are then examined by the Board and the exposure draft is revised as necessary. Provided that the revised draft is approved by at least three-quarters of the total voting rights of the Board, it is issued as a definitive International Accounting Standard and becomes operative from a date stated in the Standard.

VOTING

.15 For the purpose of voting referred to in paragraphs .13 and .14 above, each country represented on the Board has one vote.

LANGUAGE

.16 The approved text of any exposure draft or Standard is that published by IASC in the English language. Members are responsible, under the authority of the Board, for preparing translations of exposure drafts and Standards so that, where appropriate, such translations may be issued in the languages of their own countries. These translations indicate the name of the accountancy body that prepared the translation and that it is a translation of the approved text.

THE AUTHORITY ATTACHING TO THE STANDARDS

.17 It is important to observe the degree of authority which attaches to the issue of the definitive International Accounting Standards when published in accordance with the procedure indicated above.

.18 The accounting profession cannot normally impose its views except upon its own members and the task therefore is to persuade by example, leadership, and exhortation, the classes of persons

referred to in paragraph .04(b)(i) above to support the Standards. In most countries of the world, the accounting profession has a prestige and standing which is of great significance in successfully achieving this task of persuasion. This explains, in this context, the use of the words "to use their best endeavours".

.19 Under the obligations referred to in paragraph .04(b)(ii) and (iii), Members of IASC must use their best endeavours to ensure that auditors comply with the provisions of paragraph .04(b)(ii) and that appropriate action, which may be of a disciplinary character, can be taken, in accordance with paragraph .04(b)(iii) if they do not comply. This is the most important and serious obligation which Members of IASC have undertaken.

CONCLUSION

.20 The Members of IASC believe that the adoption in their countries of International Accounting Standards, or disclosure of the extent to which they have not been observed will, over the years, have an important effect. It is to be expected that the quality of presentation of financial statements will be improved and that there will be an increasing degree of uniformity. Information will be provided as a routine which is necessary for a proper understanding of financial statements.

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AC Section 9001

Disclosure of Accounting Policies

Issue date, unless otherwise indicated: January, 1975

INTRODUCTION

.01 This Statement deals with the disclosure of all significant accounting policies which have been adopted in the preparation and presentation of financial statements.

.02 The purpose of International Accounting Standards and the authority attaching to them are set out in the Preface to Statements of International Accounting Standards [section 9000].

.03 The definition of *financial statements* as presently set out in the Preface to Statements of International Accounting Standards [section 9000] is repeated here for convenience. The term *financial statements* covers balance sheets, income statements or profit and loss accounts, statements of changes in financial position, notes and other statements and explanatory material which are identified as being part of the financial statements. International Accounting Standards apply to the financial statements of any commercial, industrial, or business enterprise.

.04 The management of such an enterprise may prepare financial statements for its own use in a number of different ways best suited for internal management purposes. When financial statements are issued to other persons, such as shareholders, creditors, employees, and the public at large, they should conform to International Accounting Standards.

.05 Usually, financial statements are made available once each year and are the subject of a report by an auditor.

Fundamental Accounting Assumptions

.06 Certain fundamental accounting assumptions underlie the preparation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed, together with the reasons.

.07 The following are recognised by the International Accounting Standards Committee as fundamental accounting assumptions:

(a) Going Concern

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

(b) Consistency

It is assumed that accounting policies are consistent from one period to another.

(c) Accrual

Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this Statement.)

Accounting Policies

.08 Accounting policies encompass the principles, bases, conventions, rules, and procedures adopted by managements in preparing and presenting financial statements. There are many different accounting policies in use even in relation to the same subject; judgment is required in selecting and applying those which, in the circumstances of the enterprise, are best suited to present properly its financial position and the results of its operations.

.09 Three considerations should govern the selection and application by management of the appropriate accounting policies and the preparation of financial statements:

(a) Prudence

Uncertainties inevitably surround many transactions. This should be recognised by exercising prudence in preparing financial statements. Prudence does not, however, justify the creation of secret or hidden reserves.

(b) Substance Over Form

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

(c) Materiality

Financial statements should disclose all items which are material enough to affect evaluations or decisions.

EXPLANATION

.10 Financial statements must be clear and understandable. They are based on accounting policies which vary from enterprise to enterprise, both within a single country and among countries. Disclosure of the significant accounting policies on which the financial statements are based is therefore necessary so that they may be properly understood. The disclosure of these policies should be an integral part of the financial statements; it is helpful to users if they are all disclosed in one place. Sometimes a wrong or inappropriate treatment is adopted for items in balance sheets, income statements or profit and loss accounts, or other statements. Disclosure of the treatment adopted is necessary in any case, but disclosure cannot rectify a wrong or inappropriate treatment.

Users of Financial Statements

.11 Financial statements give information which is used by a variety of users, especially shareholders and creditors (present and potential) and employees. Other important categories of users include suppliers, customers, trade unions, financial analysts, statisticians, economists, and taxing and regulatory authorities.

.12 The users of financial statements require them as part of the information needed, among other purposes, for making evaluations and financial decisions. They cannot make reliable judgments on these matters unless the financial statements clearly disclose the significant accounting policies which have been adopted in preparing them.

Variations in Accounting Policies and in their Disclosure

.13 The task of interpreting financial statements is complicated by the adoption of diverse policies in many areas of accounting. There is no single list of accepted policies to which users may refer and the diverse accounting policies that are presently available for adoption can produce significantly different sets of financial statements based on the same events and conditions. The following are examples of areas in which differing accounting policies exist and which therefore require disclosure of the treatment selected:

General

Consolidation policy

Conversion or translation of foreign currencies including the disposition of exchange gains and losses

Overall valuation policy (e. g., historical cost, general purchasing power, replacement value)
Events subsequent to the balance sheet date
Leases, hire purchase, or instalment transactions and related interest
Taxes
Long term contracts
Franchises

Assets

Receivables
Inventories (stock and work in progress) and related cost of goods sold
Depreciable assets and depreciation
Growing crops
Land held for development and related development costs
Investments: subsidiary companies, associated companies, and other investments
Research and development
Patents and trademarks
Goodwill

Liabilities and provisions

Warranties
Commitments and contingencies
Pension costs and retirement plans
Severance and redundancy payments

Profits and losses

Methods of revenue recognition
Maintenance, repairs, and improvements
Gains and losses on disposals of property
Reserve accounting, statutory or otherwise, including direct charges and credits to surplus accounts.

.14 Accounting policies are not at present regularly and fully disclosed in all financial statements. Considerable variation in format, clarity, and completeness of disclosure exists among and within those countries in which accounting policies are disclosed. In a single set of financial statements some significant accounting policies may be disclosed while other significant policies are not. Even in countries where disclosure of all significant accounting policies is required, guidelines to secure uniformity in the method of disclosure are not always available. The growth of international enterprises and finance has increased the neces-

sity for greater uniformity of financial statements across national boundaries.

.15 Financial statements should show corresponding figures for the preceding period. If a change in an accounting policy is made which has a material effect it is necessary to disclose that a change has been made and to qualify the effect. A change in an accounting policy which may not have a material effect in the current year should nevertheless be disclosed if it may have a material effect in subsequent years.

INTERNATIONAL ACCOUNTING STANDARD 1

DISCLOSURE OF ACCOUNTING POLICIES

International Accounting Standard 1 comprises paragraphs .16—.23 of this Statement. The Standard should be read in the context of paragraphs .01—.15 of this Statement and of the Preface to Statements of International Accounting Standards [*section 9000*].

.16 Going concern, consistency, and accrual are fundamental accounting assumptions. Where fundamental accounting assumptions are followed in financial statements, disclosure of such assumptions is not required. If a fundamental accounting assumption is not followed, that fact should be disclosed together with the reasons.

.17 Prudence, substance over form, and materiality should govern the selection and application of accounting policies.

.18 Financial statements should include clear and concise disclosure of all significant accounting policies which have been used.

.19 The disclosure of the significant accounting policies used should be an integral part of the financial statements. The policies should normally be disclosed in one place.

.20 Wrong or inappropriate treatment of items in balance sheets, income statements or profit and loss accounts, or other statements is not rectified either by disclosure of accounting policies used or by notes or explanatory material.

.21 Financial statements should show corresponding figures for the preceding period.

.22 A change in an accounting policy that has a material effect in the current period or may have a material effect in subsequent periods should be disclosed together with the reasons.

The effect of the change should, if material, be disclosed and quantified.

.23 This International Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January 1975.

COMPARISON OF INTERNATIONAL ACCOUNTING STANDARD 1 WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN THE UNITED STATES

Paragraph 21 of International Accounting Standard 1 states "Financial statements should show corresponding figures for the preceding period." Generally accepted accounting principles in the U. S. do not require the presentation of comparative financial statements. However, U. S. companies ordinarily issue comparative financial statements, and the benefits to users of presenting amounts for the preceding period for comparative purposes are widely recognized. In this regard, Chapter 2A of ARB 43 [section 2041] states:

> "The presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise. Such presentation emphasizes the fact that statements for a series of periods are far more significant than those for a single period and that the accounts for one period are but an installment of what is essentially a continuous history."

The next page is 11,075.

AC Section 9002

Valuation and Presentation of Inventories in the Context of the Historical Cost System

Issue date, unless otherwise indicated: October, 1975

INTRODUCTION

.01 This Statement deals with the valuation and presentation of inventories[1] in financial statements in the context of the historical cost system, which is the most widely adopted basis on which financial statements are presented.

.02 The Committee is aware of other systems that are proposed or used in financial statements, including systems that are based on replacement costs or other current values. Inventory valuation and presentation in the context of those other systems are beyond the scope of this Statement. International Accounting Standard 1, *Disclosure of Accounting Policies* [section 9001], requires that the system adopted must be clearly stated.

.03 This Statement does not deal with inventories accumulated under long-term construction contracts and with inventory treatment of by-products.

Definitions

.04 The following terms are used in this Statement with the meanings specified.

Inventories are tangible property (a) held for sale in the ordinary course of business, (b) in the process of production for such sale, or (c) to be consumed in the production of goods or services for sale.

Historical cost of inventories is the aggregate of costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition.

Costs of purchase comprise the purchase price including import duties and other purchase taxes, transport and handling costs,

[1] The term "inventories" is used throughout this Statement; in some countries inventories are described as "stock and work in progress."

and any other directly attributable costs of acquisition less trade discounts, rebates, and subsidies.

Costs of conversion are those costs, in addition to the costs of purchase, that relate to bringing the inventories to their present location and condition.

Net realisable value is the estimated selling price in the ordinary course of business less costs of completion and less costs necessarily to be incurred in order to make the sale.

EXPLANATION

.05 Inventories comprise a significant portion of the assets of many enterprises. The valuation and presentation of inventories therefore have a significant effect in determining and presenting the financial position and results of operations of those enterprises.

Determination of Historical Cost

.06 In determining historical cost as defined in paragraph .04, different interpretations arise in practice as regards production overhead, other overheads, and the cost formula to be used.

Production Overhead

.07 Production overhead is comprised of costs incurred for production other than direct materials and labour. Examples are indirect materials and labour, depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration.

.08 Production overhead requires analysis to determine the portion related to bringing the inventories to their present location and condition and thus to be included in the costs of conversion when determining the historical cost of inventories.

.09 Both fixed and variable production overhead incurred during production are usually allocated to costs of conversion. That practice is based on the view that they are both incurred in putting inventories in their present location and condition. Fixed production overhead is sometimes excluded in whole or in part from costs of conversion on the grounds that it is not considered to relate directly to putting inventories in their present location and condition.

.10 In a period of low production or if there is idle plant, it is customary to restrict the allocation of fixed production overhead to the costs of conversion by relating it to the capacity of the production facilities and not to the actual level of throughput. Capacity of the production facilities is variously interpreted, for example, as the normal production expected to be achieved over

a number of periods or seasons or as the maximum production that as a practical matter can be achieved. The interpretation is determined in advance and applied consistently, and is not modified for temporary conditions.

.11 Similarly, exceptional amounts of waste—material, labour, or other expenses—which do not relate to bringing the inventories to their present location and condition are excluded from conversion costs.

Other Overheads

.12 Overheads other than production overhead are sometimes incurred in bringing inventories to their present location and condition, for example, expenditures incurred in designing products for specific customers. On the other hand, selling expenses, general administrative overheads, research and development costs, and interest are usually considered not to relate to putting the inventories in their present location and condition.

Cost Formula Used

.13 Several different formulas with widely different effects are in current use for the purpose of assigning costs, including the following:

(a) First-in, first-out (FIFO)
(b) Weighted average cost
(c) Last-in, first-out (LIFO)
(d) Base stock
(e) Specific identification
(f) Next-in, first-out (NIFO)
(g) Latest purchase price.

.14 The FIFO, weighted average cost, LIFO, base stock, and specific identification formulas use costs that have been incurred by the enterprise at one time or another. The NIFO and latest purchase price methods use costs that have not all been incurred and are therefore not based on historical cost.

.15 Specific identification is a formula that attributes specific costs to identified items of inventory. This is an appropriate treatment for goods that have been bought or manufactured and are segregated for a specific project. If it is used, however, in respect of items of inventory which are ordinarily interchangeable, the selection of items could be made in such a way as to obtain predetermined effects on profit.

Valuation of Inventories Below Historical Cost

.16 The historical cost of inventories may not be realisable if their selling prices have declined, if they are damaged, or if they have become wholly or partially obsolete. The practice of writing inventories down below historical cost to net realisable value accords with the view that current assets should not be carried in excess of amounts expected to be realised. Declines in value are computed separately for individual items, groups of similar items, an entire class of inventory (for example, finished goods), or items relating to a class of business, or they are computed on an overall basis for all the inventories of the enterprise. The practice of writing inventories down based on a class of inventory, on a class of business, or on an overall basis results in offsetting losses incurred against unrealised gains.

.17 In some countries, writedowns are made which are not based on the practices described in paragraph .16. For example, writedowns below historical cost are arrived at by applying an arbitrary percentage to the amounts otherwise computed or by undisclosed reductions that result in secret reserves; these produce inappropriate effects on financial statements.

Presentation of Inventories

.18 The sub-classification of inventories in financial statements informs readers of the amounts held in different categories and the extent of the changes from period to period. Common sub-classifications are materials, work in progress, finished goods, merchandise, and production supplies.

.19 "Inventories" in balance sheets usually consist of items included in the definition of inventories in paragraph .04. Other items are sometimes shown under the heading "Inventories", for example, nonproduction supplies and research and development supplies.

INTERNATIONAL ACCOUNTING STANDARD 2

VALUATION AND PRESENTATION OF INVENTORIES IN THE CONTEXT OF THE HISTORICAL COST SYSTEM

International Accounting Standard 2 comprises paragraphs .20—.36 of this Statement. The Standard should be read in the context of paragraphs .01—.19 of this Statement and of the Preface to Statements of International Accounting Standards [*section 9000*].

.20 Inventories should be valued at the lower of historical cost and net realisable value.

Ascertainment of Historical Cost

.21 The historical cost of manufactured inventories should include a systematic allocation of those production overhead costs that relate to putting the inventories in their present location and condition. Allocation of fixed production overhead to the costs of conversion should be based on the capacity of the facilities. If fixed production overhead has been entirely or substantially excluded from the valuation of inventories on the grounds that it does not directly relate to putting the inventories in their present location and condition, that fact should be disclosed.

.22 Overheads other than production overhead should be included as part of inventory cost only to the extent that they clearly relate to putting the inventories in their present location and condition.

.23 Exceptional amounts of wasted material, labour, or other expenses should not be included as part of inventory cost.

.24 Except as set out in paragraphs .25 and .26, the historical cost of inventories should be accounted for using the FIFO formula or a weighted average cost formula.

.25 Inventories of items that are not ordinarily interchangeable or goods manufactured and segregated for specific projects should be accounted for by using specific identification of their individual costs.

.26 The LIFO or base stock formulas may be used provided that there is disclosure of the difference between the amount of the inventories as shown in the balance sheet and either (a) the lower of the amount arrived at in accordance with paragraph .24 and net realisable value or (b) the lower of current cost at the balance sheet date and net realisable value.

.27 Techniques such as the standard cost method of valuing products or the retail method of valuing merchandise may be used for convenience if they approximate consistently the results that would be obtained in accordance with paragraph .20.

Ascertainment of Net Realisable Value

.28 Estimates of net realisable value should be based not on temporary fluctuations of price or cost but on the most reliable evidence available at the time the estimates are made as to what the inventories are expected to realise.

.29 Inventories should be written down to net realisable value item by item or by groups of similar items; whichever method is used should be consistently applied.

.30 The net realisable value of the quantity of inventory held to satisfy firm sales contracts should be based on the contract price. If the sales contracts are for less than the inventory quantities held, net realisable value for the excess should be based on general market prices.[2]

.31 Normal quantities of materials and other supplies held for incorporation in the production of goods should not be written down below historical cost if the finished products in which they will be incorporated are expected to be realised at or above historical cost. Nevertheless, a decline in the price of materials may indicate that the historical cost of finished products to be produced will exceed net realisable value in which event a writedown of the materials inventories should be made; in this event, replacement cost may be the best available measure of the net realisable value of those materials.

Presentation in the Financial Statements

.32 The profit and loss of the period should be charged with the amount of inventories sold or used (unless allocated to other asset accounts) and with the amount of any writedown in the period to net realisable value.

.33 Inventories should be sub-classified in balance sheets or in notes to the financial statements in a manner which is appropriate to the business and so as to indicate the amounts held in each of the main categories.

.34 The accounting policies adopted for the purpose of valuation of inventories, including the cost formula used, should be disclosed. A change in an accounting policy related to inventories that has a material effect in the current period or may have a material effect in subsequent periods should be disclosed together with the reasons. The effect of the change should, if material, be disclosed and quantified. (See International Accounting Standard 1, Disclosure of Accounting Policies [section 9001].)

.35 If items are shown under the caption "Inventories" other than those comprehended by the definition in paragraph .04, their nature, amounts and basis of valuation should be disclosed.

Effective Date

.36 This International Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January 1976.

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[2] Firm sales contracts beyond inventory quantities held, and firm purchase contracts are beyond the scope of this Statement.

COMPARISON OF INTERNATIONAL ACCOUNTING STANDARD 2 WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN THE UNITED STATES

Valuation of Inventories at the Lower of Cost or Market

Paragraphs 20 and 31 of International Accounting Standard 2 state:

> "Inventories should be valued at the lower of historical costs and net realisable value.
>
> * * * * *
>
> "Normal quantities of materials and other supplies held for incorporation in the production of goods should not be written down below historical cost if the finished products in which they will be incorporated are expected to be realised at or above the historical cost. Nevertheless, a decline in the price of materials may indicate that the historical cost of finished products to be produced will exceed net realisable value in which event a writedown of the materials inventories should be made; in this event, replacement cost may be the best available measure of the net realisable value of those materials."

On the other hand, Statement 6 in Chapter 4 of ARB 43 [section 5121] provides that inventory is to be valued at the lower of cost or market as follows:

> "As used in the phrase *lower of cost or market* the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:
>
> (1) Market should not exceed the net realizable value (i. e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and
>
> (2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin."

Thus, literal application of the provision of ARB 43 that inventories be written down to replacement cost where replacement cost is less than net realizable value (but not less than net realizable value reduced by an allowance for an approximately normal profit margin) conflicts with the international standard (except where replacement cost is the best available measure of net realizable value).

As noted in FASB Interpretation No. 17 [section 1083-2], the discussion in Chapter 4 of ARB 43 [section 5121] states "because of the many variations of circumstances encountered in inventory pricing, Statement 6 is intended as a guide rather than a literal rule."

Valuation of Inventories at Quoted Market Prices

Chapter 4 of ARB 43 [section 5121] provides an exception to the general rule that inventories be valued at the lower of cost or market. The exception is as follows:

> "Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed."

International Accounting Standard 2 provides no exceptions to its basic requirement that inventories be valued at the lower of historical cost or net realizable value.

The next page is 11,089.

AC Section 9003

Consolidated Financial Statements

Issue date, unless otherwise indicated: June, 1976

INTRODUCTION

.01 The subject of this Statement is the presentation of consolidated financial statements for a group of companies under the control of one parent company. Consolidated financial statements have been developed to meet the need for information concerning the financial position and results of operations of a group of companies.

.02 This Statement also establishes as an International Accounting Standard the use of the equity method of accounting for the presentation of certain types of long-term investments in the consolidated financial statements. It does not deal with the equity method in the presentation of other forms of financial statements.

.03 This Statement does not deal with the following specialised subjects:

(a) Methods of accounting for business mergers or combinations and their effects on consolidation

(b) Accounting for goodwill

(c) Accounting for bonus share issues (stock dividends)

(d) Accounting for step-by-step acquisitions and disposals of subsidiaries and associated companies

(e) Accounting for shares issued by a subsidiary

(f) Accounting for reciprocal shareholdings when two companies in the group hold shares in each other

(g) Methods of translating financial statements expressed in foreign currencies

(h) Disclosure by product lines or activities in the financial statements of diversified companies

(i) Accounting for joint ventures.

Definitions

.04 The following terms are used for the purpose of this Statement.

An *investor* is a company that holds an interest in the voting power of another company (the investee).

An *investee* is a company in whose voting power an interest is held by another company (the investor).

A *subsidiary* is a company which is controlled by another company (known as the parent company).

A *parent company* is a company that has one or more subsidiaries.

Consolidated financial statements are statements which present the assets, liabilities, shareholders' accounts, revenue, and expenses of a parent company and its subsidiaries as those of a single enterprise.

Control is ownership, directly, or indirectly through subsidiaries, of more than one half of the voting power [1] of a company.

A *group* is a parent company and all its subsidiaries.

Minority interest is that part of the net results of operations, or of net assets, of a subsidiary attributable to shares owned other than by the parent company or another subsidiary.

Equity capital is the issued share capital of a company which is neither limited nor preferred in its participation in distributions of the profits of a company or in the ultimate distribution of its assets.

An *associated company* is an investee company that is not a subsidiary and in respect of which

(a) the investor's interest in the voting power of the investee is substantial, and

(b) the investor has the power to exercise significant influence over the financial and operating policies of the investee, and

(c) the investor intends to retain its interest as a long-term investment.

Significant influence is participation in the financial and operating policy decisions of the investee but not control of those policies. An investor may exercise significant influence in several ways, usually by representation on the board of directors but also by participation in policy making processes, material intercompany transactions, interchange of managerial person-

[1] Voting power refers to the rights attaching to voting shares issued and outstanding, that is, shares other than those held as "treasury stock". Treasury stock are a company's own shares which have been acquired by the issuing company and are legally available for reissue. This practice is not permitted in some countries.

nel, or dependency on technical information. If the investor holds less than 20% of the voting power of the investee, it should be presumed that the investor does not have the power to exercise significant influence, unless such power can be clearly demonstrated.

The *equity method* is a method of accounting by an investor for certain types of long-term investments in associated companies and for certain unconsolidated subsidiaries. Under the equity method, the investment account of the investor is adjusted in the consolidated financial statements for the change in the investor's share of net assets of the investee. The income statement reflects the investor's share of the results of operations of the investee.

DISCUSSION

Consolidated Financial Statements

Need for Consolidated Financial Statements

.05 Certain parties with interests in the parent company of a group, such as present and potential shareholders, employees, customers, and in some circumstances creditors, are concerned with the fortunes of the entire group. Consequently, they need to be informed about the results of operations and the financial position of the group as a whole.

.06 This need is served by consolidated financial statements, which present financial information concerning the group as that of a single enterprise without regard for the legal boundaries of the separate legal entities. The consolidated financial statements normally include the parent company and all its subsidiaries. In certain rare circumstances companies other than subsidiaries are treated as subsidiaries in the consolidated financial statements of a company that:

(a) owns a majority of the equity capital, but less than a majority of the voting power, or

(b) has the power to control by statute or contract the financial and operating policies of those companies. These policies are controlled, for example, by the power to nominate a majority of the board of directors, by management contract or by court decree.

.07 The needs of those interested in the financial position of a parent company or of individual subsidiaries, in particular, creditors and minority interests, are served by the separate financial statements of the parent company or of those subsidiaries.

Exclusion from Consolidation

.08 Subsidiaries are commonly excluded from consolidation in circumstances in which control is likely to be temporary or the ability of the parent company to control the assets is impaired.

.09 In some countries, it is considered appropriate to exclude from consolidation a subsidiary whose business activities are so dissimilar from those of the other companies within the group that the presentation of separate subsidiary financial statements with the consolidated financial statements would provide better information for the parent company shareholders and other users of the statements. An alternative to exclusion in such cases is the grouping, by type of business, of the assets and liabilities within the consolidated balance sheet and the revenue and expenses within the consolidated income statement.

.10 Further grounds considered by some as sufficient for excluding a subsidiary from consolidation include impracticability of consolidation, the likelihood of disproportionate expense or delay, or the opinion of the directors that the effect of consolidation would be misleading or harmful. Exclusions on these grounds are often subjective and may result in wide variations in practice among companies accounting for similar situations.

Consolidation Procedures

.11 In the consolidated financial statements, the accounts of the parent company and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, revenue, and expenses. The following are eliminated in consolidation:

(a) intercompany balances and intercompany transactions, including intercompany sales, intercompany charges, and intercompany dividends

(b) the cost to the parent of its investment in each subsidiary and the parent company's portion of share capital, preacquisition reserves, and preacquisition profits and losses of each subsidiary.[2]

.12 Unrealised profits resulting from intercompany transactions which are included in the carrying value of assets, such as inventories and fixed assets, are eliminated.[3] The portion of un-

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[2] The preacquisition reserves, and preacquisition profits and losses are not eliminated under the method of accounting for business combinations described as "mergers" or "pooling of interests", which is used in some countries.

[3] In some countries intercompany profits and losses of public utilities are not eliminated to the extent that they are recognised in the determination of the rates charged to consumers in accordance with regulations determined by government authorities.

realised profits arising in the current period is charged against consolidated income after giving appropriate consideration to minority interests. However, the profits are realised profits in the accounts of the selling company and therefore may be subject to tax. Since the tax relates to income which will not be reported in the consolidated financial statements until subsequent periods, the applicable tax expense is carried forward until the profit is so reported. If intercompany transactions have resulted in assets being stated in the consolidated financial statements at an amount lower than cost to the group, then the resulting unrealised losses and any related tax effects are eliminated on consolidation unless cost cannot be recovered.

.13 At the date of acquisition the cost of a parent company's investment in a subsidiary is allocated, if possible, to the subsidiary's individual identifiable assets and liabilities on the basis of their values, and the allocated amounts serve as the basis on which the subsidiary's assets and liabilities are reported in the parent company's consolidated financial statements subsequent to the acquisition. Any difference between the cost of the parent company's investment and the parent company's share in the amounts allocated to individual identifiable assets and liabilities is shown in the consolidated balance sheet appropriately described.[4]

.14 Taxes payable by either the parent company or by subsidiaries on distribution to the parent company of the undistributed profits of subsidiaries are accrued if it is reasonable to assume that any part of those profits will eventually be distributed, by way of dividend or otherwise, and will result in a tax liability at the time of remittance. If taxes are not accrued in respect of undistributed profits, there is sometimes disclosure of the cumulative amount of the undistributed profits on which taxes have not been recognised by the parent company because of the parent company's intention and power to undertake the long-term reinvestment of those profits.

.15 It is preferable that the parent company and its subsidiaries should have a common financial reporting period. If financial statements with different reporting dates are consolidated, significant transactions or events which have occurred in the intervening period are recognised through adjustments or disclosure. If a difference exists, the dates to which the financial statements of the subsidiaries have been prepared are disclosed. The consistency principle dictates that the length of the reporting periods

[4] Not applicable to mergers or pooling of interests referred to in footnote 2.

and any difference in the balance sheet dates should be consistent from period to period.

.16 The results of operations of a subsidiary for the financial reporting period in which the subsidiary is acquired are included in the consolidated income statement only from the date of its acquisition.[5] Similarly, the results of operations are included in consolidated income in the period of disposal only to the date of disposal.

.17 The losses applicable to the minority interest in a consolidated subsidiary may exceed the minority interest in the shareholders' equity of the subsidiary. The excess and any further losses applicable to the minority interest are charged against the majority interest except to the extent that the minority interest has a binding obligation to make good the losses. If future profits are reported by the subsidiary, the majority interest is credited with all such profits until the minority's share of losses previously absorbed by the majority has been recovered.

.18 If a subsidiary has outstanding cumulative preferred shares which are held outside the group, the investor computes its share of profits or losses after adjusting for the subsidiary's preferred dividends, whether or not dividends have been declared.

Investments in Associated Companies and Unconsolidated Subsidiaries

.19 There are two principal methods of accounting for investments in associated companies and in unconsolidated subsidiaries: the "cost" method and the "equity" method.

The Cost Method

.20 Under the cost method, an investor records an investment in the shares of an investee at cost; income is recognised only to the extent that dividends are distributed from net accumulated profits of the investee arising subsequent to the date of acquisition by the investor. Dividends received in excess of such subsequent profits are considered a recovery of investment and are recorded as reductions of the cost of the investment.

The Equity Method

.21 If an investor holds an investment in an associated company, the recognition of income on the basis of dividends received may not be an adequate measure of the income earned on the investment because the receipt of dividends may bear little relationship to the performance of the investee. The application of the equity method of accounting results in more informative reporting of the net assets and income of the investor.

[5] Not applicable to mergers or pooling of interests referred to in footnote 2.

.22 Under the equity method, the carrying amount of an investment in the shares of an investee is increased or decreased to recognise the investor's share of the profits or losses of the investee after the date of acquisition. Adjustments in the carrying amount of the investment may also be necessary to account for alterations in the investor's proportionate interest in the investee as a consequence of changes in the investee's share capital. Dividends received from an investee reduce the carrying amount of the investment.

Other Considerations

.23 If an investee ceases to fall within the definition of a subsidiary but the former parent company retains the power to exercise significant influence over the investee, the investment is accounted for as an associated company. However, an investee ceases to fall within the definition of a subsidiary and does not become an associated company if the investor loses both control and the power to exercise significant influence over the investee. Also, an investee ceases to fall within the definition of an associated company if the investor loses the power to exercise significant influence over the investee. For example, loss of control and the power to exercise significant influence might occur if the investee were placed under the control of a court or if bankruptcy or insolvency proceedings were instituted against it.

.24 Under the equity method as well as under the cost method of accounting, if the value of the investment is below the carrying amount for other than a temporary period, the investor's assets are overstated unless there is appropriate recognition of the decline in value.

Application of the Equity Method

.25 Many of the procedures appropriate for the application of the equity method of accounting are similar to those which are applicable in the consolidation of investments in subsidiaries.

.26 The investor's share of profits or losses is adjusted to eliminate unrealised profits and losses included in the carrying amounts of assets acquired by either the investor or the investee through intercompany transactions, after appropriate recognition of outside interests.

.27 The most recent available financial statements are used by the investor in applying the equity method. If the investor's and the investee's financial statements do not have a common date, significant transactions or events which have occurred in the intervening period are recognised through adjustments or disclosure. If a difference exists, the dates to which the financial

statements of the investees have been prepared are disclosed. The consistency principle dictates that the length of the reporting periods and any differences in the balance sheet dates should be consistent from period to period.

.28 In order to determine in subsequent financial periods the appropriate amount of the investor's share of the investee's income to be included in the consolidated income statement, the broad concepts underlying the consolidation procedures used on the acquisition of a subsidiary are adopted on the acquisition of an associated company. The consolidation procedures to be applied on the acquisition of a subsidiary are described in paragraph .13.

.29 Taxes that would be payable on distribution to the investor of the investor's share of the undistributed profits of the investee or on the disposal of the investment are accrued when the profits are recognised by the investor since taxes can be expected to become payable upon later dividend distribution or on disposal of the investment.

.30 If an investor's share of losses of an investee equals or exceeds the carrying amount of an investment accounted for by the equity method, the investor ordinarily discontinues applying the equity method. The investment is recorded at nil value. Additional losses are then provided for only if the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support of the investee. If the investee subsequently reports net income, the investor resumes applying the equity method only after its share of that net income equals the share of net losses not recognised during the period when the equity method was suspended.

.31 If the carrying amount of an investment is written down to recognise the decline in its value, the write-down is charged to consolidated income and deducted from the carrying amount of the related investment.

.32 If an investee has outstanding cumulative preferred shares, which are held outside the group, an investor computes its share of profits or losses after adjusting for the investee's preferred dividends, whether or not the dividends have been declared.

Disclosure

.33 Consolidated financial statements show the aggregate financial position and results of operations for a group of companies. In order that users of financial statements may obtain a clear understanding of the group's affairs, it may be necessary to pro-

vide additional information showing the composition of the group and an analysis of certain balances in the financial statements. In a large diversified group it may be helpful to disclose the name, nature of business, and proportion of voting power held of each significant subsidiary and associated company. It may also be important to present an analysis of retained income as related to the parent, subsidiaries, and associated companies and to disclose any statutory or contractual restrictions on the distribution of profits because this may affect the ability of the parent company to distribute dividends. In international companies an analysis of the geographical distribution of assets and liabilities may be useful in assessing the group's exposure to exceptional risks of operating in other countries, including the risk of foreign currency exchange rate fluctuations.

INTERNATIONAL ACCOUNTING STANDARD 3

CONSOLIDATED FINANCIAL STATEMENTS

International Accounting Standard 3 comprises paragraphs .34—.52 of this Statement. The Standard should be read in the context of paragraphs .01—.33 of this Statement and of the Preface to Statements of International Accounting Standards [*section 9000*].

Consolidated Financial Statements

.34 A parent company should issue consolidated financial statements, except that it need not do so when it is a wholly-owned subsidiary.

.35 A parent company which issues consolidated financial statements should consolidate all subsidiaries, foreign and domestic, as defined in paragraph .04, other than those referred to in paragraphs .36 and .37.

.36 A subsidiary should be excluded from consolidation if:

(a) control is to be temporary, or

(b) the subsidiary operates under conditions in which severe long-term restrictions on the transfer of funds impair control by the parent company over the subsidiary's assets and operations.

.37 A subsidiary may be excluded from consolidation if its activities are so dissimilar from those of the other companies in the group that better information for the parent company shareholders and other users of the statements would be provided by presenting separate financial statements in respect of such subsidiary with the consolidated financial statements.

.38 A company in which a group does not have control, but in which a group:

(a) owns more than half the equity capital, but less than half the voting power, or

(b) has the power to control, by statute or agreement, the financial and operating policies of the management of the company, with or without more than one half of the equity interest,

may be treated as a subsidiary and consolidated in the consolidated financial statements. In such circumstances, the reasons for consolidating the company should be disclosed.

.39 Uniform accounting policies should preferably be followed by companies in the consolidated financial statements. There should be disclosure of different accounting policies used, and of the proportion of assets and liabilities to which different accounting policies have been applied if they are included in a single balance sheet classification.

The Equity Method of Accounting for Investments

.40 Investments in associated companies as defined in paragraph .04 and in subsidiaries which are not consolidated for the reasons stated in paragraph .37 should be included in the consolidated financial statements under the equity method of accounting.

.41 As from the date that

(a) a subsidiary ceases to be consolidated for the reason stated in paragraph .36(b), or

(b) an investee ceases to fall within the definition of a subsidiary and does not become an associated company, or an investee ceases to fall within the definition of an associated company,

the investment should be stated in the consolidated balance sheet at the carrying amount under the equity method at that date. From that date, the investor should discontinue accruing its share of the subsequent profits or losses of the investee.

.42 If the carrying amount of an investment dealt with under the equity method, and of investments referred to in paragraph .41, exceeds the value of the investment and that difference is other than temporary, there should be appropriate recognition of the decline in value. Provision should be made for a decline in value of each such investment; individual investments should not be aggregated for evaluation in total.

Financial Statement Presentation

.43 The minority interest in the equity of consolidated companies should be classified in the consolidated balance sheet as a separate item and should not be shown as part of shareholders' equity. The minority interest in the profits or losses of such companies should be shown separately in the consolidated income statement.

.44 Investments accounted for under the equity method of accounting should be appropriately classified in the consolidated balance sheet and the investor's share of profits or losses should be disclosed as a separate item in the consolidated income statement. If the profits or losses for the period include unusual items, the investor's share of the unusual items should be shown separately in accordance with the accounting policies applicable to the investor.

.45 A gain or loss on a sale of shares in an investee by an investor should be recognised in the consolidated income statement. The amount recognised should be the difference at the time of sale between the proceeds of sale and the carrying amount in the consolidated financial statements of the shares sold.

Disclosure

.46 The disclosure of accounting policies—see International Accounting Standard 1, Disclosure of Accounting Policies [section 9001]—should include a description of the bases on which subsidiaries and associated companies have been dealt with.

.47 The following disclosures should be made in the consolidated financial statements:

(a) An appropriate listing and description of significant subsidiaries and associated companies and, in respect of such companies, differences in reporting dates from that of the parent company, unless disclosed in statements accompanying the consolidated financial statements.

(b) The reasons for not consolidating a subsidiary.

(c) The nature of the relationship between the parent company and a company that is not a subsidiary but is treated as a subsidiary in consolidation, as described in paragraph .38.

(d) The amounts relating to any significant unadjusted transactions occurring between the dates of investors' and investees' financial statements.

(e) An analysis of the amounts under each significant balance sheet and income statement caption if necessary to provide

a fair disclosure of the exposure to exceptional risks of operating in other countries, including the risk of foreign currency exchange rate fluctuations.

(f) The extent to which there are statutory or contractual restrictions on the distribution of the accumulated retained income of the group.

.48 When a subsidiary is excluded from consolidation in accordance with paragraph .37, separate financial statements in respect of that subsidiary should supplement the consolidated financial statements. The supplementary statements may be presented in condensed form provided they give adequate disclosure, including particulars of intra-group balances and the nature of transactions with the remainder of the group. There should be a reconciliation of the amount at which the results of operations of the excluded subsidiary are stated in the supplementary financial statements, and the amount included in the consolidated income statement in respect of that subsidiary. For the purposes of this supplementary disclosure the financial statements of two or more subsidiaries with similar operations may be combined.

.49 If a subsidiary is excluded from consolidation because of the restriction described in paragraph .36(b), the following disclosures should be made with respect to such investment:

(a) the name of the investee and the group's share in the net assets of the investee,

(b) the carrying value of the investment in the consolidated financial statements,

(c) the dividends received by the group during the period,

(d) the profits or losses for the period, with unusual items separately stated, and

(e) the amounts of any write-downs or adjustments to consolidated net income in the current period.

Transitional Provisions

.50 On the first occasion that consolidated financial statements are presented, comparative figures should be shown in respect of the consolidated balance sheet but need not be shown in respect of the consolidated income statement if it is not practicable to do so. In all subsequent years full comparative figures should be shown—see International Accounting Standard 1, Disclosure of Accounting Policies [section 9001].

.51 On the first occasion of the application of the equity method, there should be disclosure of the investee's income of earlier

periods which is attributable to the investor, and of any write-down of the investment at that time to recognise a decline in its value.

Effective Date

.52 The provisions of this International Accounting Standard become operative for financial statements covering periods beginning on or after 1 January 1977.

COMPARISON OF INTERNATIONAL ACCOUNTING STANDARD 3 WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN THE UNITED STATES

Paragraph 39 of International Accounting Standard 3 states:

> "Uniform accounting policies should preferably be followed by companies in the consolidated financial statements. There should be disclosure of different accounting policies used, and of the proportion of assets and liabilities to which different accounting policies have been applied if they are included in a single balance sheet classification."

Generally accepted accounting principles in the U. S. do not require disclosure "of the proportion of assets and liabilities to which different accounting policies have been applied if they are included in a single balance sheet classification."

The next page is 11,107.

AC Section 9004

Depreciation Accounting

Issue date, unless otherwise indicated: October, 1976

INTRODUCTION

.01 This Statement deals with depreciation accounting and applies to all depreciable assets except:

(a) forests and similar regenerative natural resources

(b) expenditures on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources

(c) expenditures on research and development

(d) goodwill.

Definitions

.02 In this Statement the following terms are used with the meanings specified.

Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to income either directly or indirectly.

Depreciable assets are assets which

(a) are expected to be used during more than one accounting period, and

(b) have a limited useful life, and

(c) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes.

Useful life is either (a) the period over which a depreciable asset is expected to be used by the enterprise; or (b) the number of production or similar units expected to be obtained from the asset by the enterprise.

Depreciable amount of a depreciable asset is its historical cost or other amount substituted for historical cost [1] in the financial statements, less the estimated residual value.

[1] This Statement does not deal with the differences which arise when revaluations are substituted for historical cost.

EXPLANATION

.03 Depreciable assets comprise a significant portion of the assets of many enterprises. Depreciation can therefore have a significant effect in determining and presenting the financial position and results of operations of those enterprises.

.04 The view is sometimes expressed that if the value of an asset has increased over the amount at which it is carried in the financial statements, it is unnecessary to provide for depreciation. It is considered, however, that depreciation should be charged in each accounting period on the basis of the depreciable amount irrespective of an increase in the value of the asset.

Useful Life

.05 Estimation of the useful life of a depreciable asset or a group of similar depreciable assets is a matter of judgment ordinarily based on experience with similar types of assets. For an asset using new technology or used in the production of a new product or in the provision of a new service with which there is little experience, estimation of the useful life is more difficult but is nevertheless required.

.06 The useful life of a depreciable asset for an enterprise may be shorter than its physical life. In addition to physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme of the enterprise, other factors need to be taken into consideration. These include obsolescence arising from technological changes or improvements in production, obsolescence arising from a change in the market demand for the product or service output of the asset, and legal limits such as the expiry dates of related leases.

Residual Value

.07 The residual value of an asset is often insignificant and can be ignored in the calculation of the depreciable amount. If the residual value is likely to be significant, it is estimated at the date of acquisition, or the date of any subsequent revaluation of the asset, on the basis of the realisable value prevailing at that date for similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used. The gross residual value in all cases is reduced by the expected costs of disposal at the end of the useful life of the asset.

Depreciation Methods

.08 Depreciable amounts are allocated to each accounting period during the useful life of the asset by a variety of systematic methods. Whichever method of depreciation is selected its consistent use is necessary, irrespective of the level of profitability of the enterprise and of taxation considerations, in order to provide comparability of the results of operations of the enterprise from period to period.

Land and Buildings

.09 Land normally has an indefinite useful life and is not usually regarded as a depreciable asset. However, land which does have a limited useful life for the enterprise is treated as a depreciable asset.

.10 Buildings are depreciable assets because they fall within the definition in paragraph .02.

.11 Some enterprises have not treated buildings as depreciable assets for the reason that the aggregate value of the building and the land on which it stands does not decline. As land and buildings are separate assets, recognition for accounting purposes of any increased value of the land is a different issue from the determination of the depreciable amount of the buildings.

Disclosure

.12 The selection of an allocation method and the estimation of the useful life of a depreciable asset are matters of judgment. The disclosure of the methods adopted and of the estimated useful lives or depreciation rates used provides users of financial statements with information which allows them to review the policies selected by management and enables comparisons to be made with other enterprises. For similar reasons, it is necessary to disclose the depreciable amount allocated in a period and the accumulated depreciation at the end of that period.

INTERNATIONAL ACCOUNTING STANDARD 4

DEPRECIATION ACCOUNTING

International Accounting Standard 4 comprises paragraphs .13—.19 of this Statement. The Standard should be read in the context of paragraphs .01—.12 of this Statement and of the Preface to Statements of International Accounting Standards [section 9000].

.13 The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

.14 The depreciation method selected should be applied consistently from period to period unless altered circumstances justify a change. In an accounting period in which the method is changed, the effect should be quantified and disclosed and the reason for the change should be stated.

.15 The useful life of a depreciable asset should be estimated after considering the following factors:

(a) expected physical wear and tear

(b) obsolescence

(c) legal or other limits on the use of the asset.

.16 The useful lives of major depreciable assets or classes of depreciable assets should be reviewed periodically and depreciation rates adjusted for the current and future periods if expectations are significantly different from the previous estimates. The effect of the change should be disclosed in the accounting period in which the change takes place.

.17 The valuation bases used for determining the amounts at which depreciable assets are stated should be included with the disclosure of other accounting policies—see International Accounting Standard 1, Disclosure of Accounting Policies [section 9001].

.18 The following should be disclosed for each major class of depreciable asset:

(a) the depreciation methods used

(b) the useful lives or the depreciation rates used

(c) total depreciation allocated for the period

(d) the gross amount of depreciable assets and the related accumulated depreciation.

Effective Date

.19 This International Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January 1977.

COMPARISON OF INTERNATIONAL ACCOUNTING STANDARD 4 WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN THE UNITED STATES

Paragraph 18 of International Standard 4 requires the disclosure, for each major class of depreciable asset, of certain information including "the useful lives or the depreciation rates used," "total depreciation allocated for the period," and "accumulated depreciation."

Generally accepted accounting principles in the U. S. do not require such information to be disclosed for each major class of depreciable assets. APB Opinion No. 12 [section 2043] requires disclosure of "depreciation expense for the period," but not by asset class. That Opinion also requires disclosure of "accumulated depreciation, either by major classes, of depreciable assets or in total." Disclosure of "the rates used in computing" depreciation is required by Regulation S-X but not by generally accepted accounting principles.

The next page is 11,117.

AC Section 9005

Information to Be Disclosed in Financial Statements

Issue date, unless otherwise indicated: October, 1976

INTRODUCTION

.01 This Statement deals with information to be disclosed in financial statements which include a balance sheet, an income statement, notes, and other statements and explanatory material which are identified as part of the financial statements.

.02 Financial statements are required, among other purposes, for making evaluations and financial decisions. Users cannot make reliable judgments unless the financial statements are clear and understandable. The information needed for this purpose will often extend beyond the minimum necessary to meet the requirements of local law or regulatory authorities.

.03 Certain minimum disclosures are set out in this Standard. These disclosures may be amplified by detailed disclosure requirements included in other International Accounting Standards which deal with specific accounting subjects.

.04 This Standard does not propose a particular format for the presentation of financial statements. The layout and groupings used in the Standard are based on the significant items affecting the financial statements of most industrial and commercial enterprises. A different layout and grouping may be appropriate for enterprises such as financial and insurance companies.

.05 In this Standard the definitions of parent company, subsidiary company and associated company are the same as those used in International Accounting Standard 3, Consolidated Financial Statements [section 9003].

INTERNATIONAL ACCOUNTING STANDARD 5

INFORMATION TO BE DISCLOSED IN FINANCIAL STATEMENTS

International Accounting Standard 5 comprises paragraphs .06—.19 of this Statement. The Standard should be read in the context of paragraphs .01—.05 of this Statement and of the Preface to Statements of International Accounting Standards [section 9000].

General Disclosures

.06 All material information should be disclosed that is necessary to make the financial statements clear and understandable.

.07 The name of the enterprise, the country of incorporation, the balance sheet date, and the period covered by the financial statements should be stated. A brief description of the nature of the activities of the enterprise, the legal form of the enterprise, and the currency in terms of which the financial statements are expressed should be given if they are not otherwise apparent.

.08 The amounts and classifications of items should be supplemented if necessary by additional information to make their meanings clear. Significant items should not be included with, or offset against, other items, without separate identification.

.09 Financial statements should show corresponding figures for the preceding period.

Specific Disclosures—Balance Sheet

General

.10 The following disclosures should be made:

(a) Restrictions on the title to assets
(b) Security given in respect of liabilities
(c) The methods of providing for pension and retirement plans
(d) Contingent assets and contingent liabilities, quantified if possible
(e) Amounts committed for future capital expenditure.

Long-Term Assets

.11 *Property, plant and equipment*—The following items should be disclosed:

(a) Land and buildings
(b) Plant and equipment
(c) Other categories of assets, suitably identified
(d) Accumulated depreciation.

Separate disclosure should be made of leaseholds and of assets being acquired on instalment purchase plans.

.12 *Other long-term assets*—The following items should be disclosed separately, including, if applicable, the method and period of depreciation and any unusual write-offs during the period:

(a) Long-term investments
Investments in subsidiaries

Investments in associated companies

Other investments, stating the market value of listed investments, if different from the carrying amount in the financial statements

(b) Long-term receivables

Accounts and notes receivable—trade

Receivables from directors

Intercompany [1] receivables

Associated company receivables

Other

(c) Goodwill

(d) Patents, trademarks, and similar assets

(e) Expenditures carried forward, for example, preliminary expenses, reorganisation expenses, and deferred taxes.

Current Assets

.13 The following items should be disclosed separately:

(a) Cash

Cash includes cash on hand and current and other accounts with banks. Cash which is not immediately available for use, for example, balances frozen in foreign banks by exchange restrictions, should be disclosed.

(b) Marketable securities, other than long-term investments

The market value should be disclosed if different from the carrying amount in the financial statements.

(c) Receivables

Accounts and notes receivable—trade

Receivables from directors

Intercompany receivables

Associated company receivables

Other receivables and prepaid expenses

(d) Inventories

Long-Term Liabilities

.14 The following items should be disclosed separately, excluding the portion repayable within one year:

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[1] The term "intercompany" used in this Statement refers to the presentation in the financial statements of balances or transactions between:

(a) A parent company and its subsidiaries

(b) A subsidiary and its parent company or other subsidiaries in the group.

(a) Secured loans
(b) Unsecured loans
(c) Intercompany loans
(d) Loans from associated companies.

A summary of the interest rates, repayment terms, covenants, subordinations, conversion features and amounts of unamortised premium or discount should be shown.

Current Liabilities

.15 The following items should be disclosed separately:

(a) Bank loans and overdrafts
(b) Current portions of long-term liabilities
(c) Payables
  Accounts and notes payable—trade
  Payables to directors
  Intercompany payables
  Associated company payables
  Taxes on income
  Dividends payable
  Other payables and accrued expenses

Other Liabilities and Provisions

.16 The significant items included in other liabilities and in provisions and accruals should be separately disclosed. Examples of such items are deferred taxes, deferred income and provisions for pensions.

Shareholders' Interests

.17 The following disclosures should be made separately:

(a) Share capital
  For each class of share capital:
    The number or amount of shares authorised, issued and outstanding [2]
    The par or legal value per share
    The capital not yet paid in
    The movement in share capital accounts during the period
    The rights, preferences, and restrictions with respect to the distribution of dividends and to the repayment of capital
    Cumulative preferred dividends in arrears

[2] Shares outstanding refers to shares other than those held as "treasury stock." Treasury stock are a company's shares which have been acquired by the issuing company or a consolidated subsidiary company and are legally available for reissue or resale. This practice is not permitted in some countries.

Reacquired shares

Shares reserved for future issuance under options and sales contracts, including the terms and amounts.

(b) Other equity, indicating the movement for the period and any restrictions on distribution

Capital paid in excess of par value (share premium)

Revaluation surplus

Reserves

Retained earnings.

Specific Disclosures—Income Statement

.18 The following information should be disclosed:

(a) Sales or other operating revenues
(b) Depreciation
(c) Interest income
(d) Income from investments
(e) Interest expense
(f) Taxes on income
(g) Unusual charges
(h) Unusual credits
(i) Significant intercompany transactions
(j) Net income.

Effective Date

.19 This International Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January 1977.

The next page is 11,127.

AC Section 9006

Accounting Responses to Changing Prices

Issue date, unless otherwise indicated: June, 1977

EXPLANATION

.01 This Statement deals with accounting responses to changing prices.

Changes in the Relationships Between Prices and in the General Level of Prices

.02 Prices do not remain constant. They change over time as the result of various economic and social forces. A change in the general level of prices, as measured by a general price index, reflects changes in the general purchasing power of money. Individual prices may change significantly, independently of each other, and even during times of relative stability in the general level of prices.

.03 Most financial statements are prepared without regard either for changes in the general level of prices, or for changes in specific prices except to the extent that they are reflected in the amounts realised by sale of goods or in the net realisable value of inventories which have fallen below historical cost. The need to remedy the shortcomings of the traditional accounting approach has focused attention on (a) specific price changes and (b) changes in the general level of prices.

Specific Price Changes

.04 The specific prices of goods or other assets held by an enterprise may change while such assets are held. The expression "specific prices" includes buying prices and selling prices. These prices may change whether or not there is a significant change in the general level of prices.

.05 The questions posed by changes in specific prices include:

(a) should assets held at the balance sheet date be presented at historical cost or at a current value, and how should the changes in prices be reflected in the financial statements?

(b) for assets sold or consumed during the accounting period, how should changes in prices of those assets while they were held be dealt with in the financial statements?

.06 There are enterprises which prepare financial statements that recognise both increases and decreases in the replacement prices of assets while they are held. That practice involves the presentation of assets in the balance sheet at their current replacement prices, the recognition in owners' equity of the effects of changes in those prices, and the recognition in the income statement of current replacement prices of assets sold or used. That practice and others, including some that involve recognition of increases and decreases in selling prices of assets during the period they are held, have been advocated for adoption in place of the historical cost system.

.07 Some proposals recommend the presentation of selected financial statement items based on current prices. This may be done through the adjustment of these items within the financial statements, by the presentation of supplementary information, or by disclosure in the notes to the financial statements.

Changes in the General Level of Prices

.08 Financial statements are traditionally stated in units of money. During inflation or deflation, the value of a unit of money changes—its general purchasing power decreases (inflation) or increases (deflation). The instability of conventional units of money in terms of general purchasing power has led to questions as to whether financial statements should continue to be prepared without regard for changes in the general purchasing power of money.

.09 Proposals have been made for enterprises which issue historical cost financial statements to prepare and present supplementary financial statements in which all items are stated in terms of the general purchasing power of the unit of money at a given date. Some enterprises have adopted these proposals.

.10 Other proposals recommend that the enterprise disclose the effect of changes in the general purchasing power of money on the shareholders' net equity interest only. This disclosure is usually made as supplementary information or by way of note.

Responding to the Problem of Changing Prices

.11 Financial information intended as a response to the problem of changing prices could be prepared in a number of different ways.

.12 Financial information could be prepared in units of money using current values in place of historical costs. This financial

information would recognise changes in specific prices of assets while they are held but would not recognise inflation or deflation as such.

.13 Financial information could be prepared on the basis of historical costs but with amounts stated in terms of general purchasing power. This financial information would recognise inflation or deflation but would not recognise changes in specific prices of assets while they are held.

.14 Financial information could be prepared by combining features of each of the responses described in paragraphs .12 to .13. This financial information would recognise both changes in specific prices and the influence of inflation or deflation.

.15 There is not yet an international consensus on a single method to reflect the impact of changing prices on financial statements. Many proposals have been issued throughout the world[1] and financial statements are being prepared on the bases suggested in some of these proposals. The development and application of the proposed methods will lead to a considerable improvement in the information provided by financial statements.

.16 At this time harmonisation of the accounting methods on this subject can best be aided by increased disclosure and description of the accounting treatments adopted. It should be expected that a further International Accounting Standard will be issued on the subject of reflecting the impact of changing prices in the financial statements.

INTERNATIONAL ACCOUNTING STANDARD 6

ACCOUNTING RESPONSES TO CHANGING PRICES

International Accounting Standard 6 comprises paragraphs .17—.18 of this Statement. The Standard should be read in the context of paragraphs .01—.16 of this Statement and of the Preface to Statements of International Accounting Standards [section 9000].

.17 In complying with International Accounting Standard 1, Disclosure of Accounting Policies [section 9001], enterprises should present in their financial statements information that describes the procedures adopted to reflect the impact on the financial statements of specific price changes, changes in the general level of prices, or of both. If no such procedures have been adopted that fact should be disclosed.

[1] The proposals that have been issued in IASC Member countries as at 30 November 1976 are briefly described in a Discussion Paper entitled "Treatment of Changing Prices in Financial Statements: A Summary of Proposals" issued 1 March 1977. The Discussion Paper is available from the IASC Member accountancy bodies.

.18 This International Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January 1978.

The next page is 11,137.

AC Section 9007

Statement of Changes in Financial Position

Issue date unless
otherwise indicated:
October, 1977

INTRODUCTION

.01 This Statement deals with the presentation of a statement which summarises for the period the resources made available to finance the activities of an enterprise and the uses to which such resources have been put. The title "Statement of Changes in Financial Position" is descriptive of a statement with that objective.[1]

EXPLANATION

.02 A statement of changes in financial position is often presented with the balance sheet and the income statement as an integral part of the financial statements. The inclusion of such a statement is useful to improve the understanding of the operations and activities of an enterprise for the reporting period.

.03 The statement of changes in financial position is prepared from financial data generally identifiable in the income statement, balance sheet and related notes. However, the statement of changes in financial position presents information which may not be readily available in a usable form in the other two statements. Sufficient information is generally given to enable the reconciliation of the amounts in the statement of changes in financial position to the related amounts in the other statements.

.04 For purposes of this Statement, the term "funds" generally refers to cash, to cash and cash equivalents, or to working capital. In a statement of changes in financial position the particular use of the term is made clear.

Funds Provided From or Used in Operations

.05 Funds provided from or used in the operations of an enterprise are normally shown separately in the statement of changes in financial position. This information indicates the extent to which an enterprise has generated funds from or used funds in its operations.

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[1] The title "Statement of Changes in Financial Position" is used throughout this Statement; in some countries "Statement of Source and Application of Funds", or a similar title, is used.

.06 Items which do not relate to the ordinary activities of an enterprise are often presented in the income statement separately from income from the ordinary activities. This practice improves the usefulness of the financial statements. For similar reasons such items are presented separately in the statement of changes in financial position either individually or as a single amount. For the purpose of this Statement these items are referred to as "unusual items".

.07 Different forms of presentation can be used to present the amount of funds provided from or used in the operations of an enterprise. A method commonly used is to show the net income (or loss) and to make adjustments for those revenues or expenses that do not involve a movement of funds in the current period (for example, depreciation). An alternative method is to begin with revenues that provided funds during the period and deduct the costs and expenses that involve a movement of funds. The resulting amount is described as funds from operations.

.08 When unusual items are presented separately in a statement of changes in financial position, they also are adjusted to the extent that they do not involve a movement of funds in the current period.

Other Sources and Uses of Funds

.09 Other sources and uses of funds are stated separately from the funds provided from or used in the operations. These include, for example:

(a) proceeds from the sale of long-term assets
(b) outlays for the purchase of long-term assets
(c) dividends in cash or other assets
(d) issue of long-term debt
(e) redemption and repayment of long-term debt
(f) issue of shares for cash or other assets
(g) redemption or repurchase of shares for cash or other assets.

.10 Some financing transactions of an enterprise involve the exchange of one form of security for another. When such exchanges are equivalent to the issue of one security and the redemption of the other, these transactions are part of the financing and investing activities of an enterprise and are disclosed in the statement of changes in financial position. An example of such a transaction is the conversion of long-term debt to common or ordinary shares.

.11 To achieve the objective of the statement of changes in financial position, it may be necessary to disclose separately the

investment and financing aspects of each type of transaction. For example, the proceeds on disposal of long-term assets are presented separately from the outlay for acquisition of long-term assets and, when an asset is acquired through the issue of long-term debt or equity, the issue of debt or equity and the acquisition of the asset are separately disclosed.

Consolidated Statement of Changes in Financial Position

.12 If a consolidated balance sheet and a consolidated income statement are presented, a statement of changes in financial position may be presented only on a consolidated basis. Under some circumstances it may also be appropriate to present a statement of changes in financial position with respect to the financial statements of the parent company.

Investments Accounted for Using the Equity Method

.13 In the statement of changes in financial position there are two methods of dealing with income from an investee company accounted for using the equity method of accounting.

.14 The amounts included in funds provided from or used in the operations as a result of such an investment may be restricted to the dividends received or currently receivable. This method is based on the view that the unremitted earnings of such an investee company do not represent current resources available to the investor. Under this method the adjustments described in paragraph .07 include the portion of the income from the investee company that does not involve a movement of funds.

.15 Alternatively, the investor's entire share of investee earnings can be included in funds provided from or used in operations and no adjustment is required in determining funds provided from or used in the operations. Under this method, the unremitted portion of the income from the investee company is shown separately as a use of funds.

Acquisition or Disposal of Subsidiaries[3]

.16 The acquisition or disposal of subsidiaries may be presented in the statement of changes in financial position as a single amount. Alternatively, the amounts of the individual assets and liabilities acquired or disposed of may be included with the separate sources and uses of funds of each asset and liability dealt with in the statement.

.17 Under both methods of presenting the acquisition or disposal of subsidiaries the following supplementary information is presented

[3] Not applicable to business combinations described as mergers or poolings of interest.

either in the statement of changes in financial position or by way of note:

(a) the total purchase or disposal price of the subsidiary,
(b) the portion of the purchase or disposal price discharged by cash and cash equivalents,
(c) the amount of cash and other working capital items in the subsidiary acquired or disposed of,
(d) the amounts of the other assets and liabilities in the subsidiary acquired or disposed of, summarised by each major category.

Presentation

.18 Several forms of presentation are used for the statement of changes in financial position. For example, the statement may show the sources of funds as equal to the uses of funds. Another form of presentation is to show a difference between the sources and the uses of funds which represents the net increase or decrease either in cash and cash equivalents or in working capital. No particular form of presentation is preferable for all enterprises, but the enterprise selects the form of presentation considered most informative in the circumstances.

.19 When a net change in working capital is presented as a single amount in the statement of changes in financial position, additional disclosure regarding changes in individual working capital items is often presented.

INTERNATIONAL ACCOUNTING STANDARD 7

STATEMENT OF CHANGES IN FINANCIAL POSITION

International Accounting Standard 7 comprises paragraphs .20—.23 of this Statement. The Standard should be read in the context of paragraphs .01—.19 of this Statement and of the Preface to Statements of International Accounting Standards [section 9000].

.20 A statement of changes in financial position should be included as an integral part of the financial statements. The statement of changes in financial position should be presented for each period for which the income statement is presented.

.21 Funds provided from or used in the operations of an enterprise should be presented in the statement of changes in financial position separately from other sources or uses of funds. Unusual items which are not part of the ordinary activities of the enterprise should be separately disclosed in the statement.

.22 Each enterprise or group of enterprises should adopt the form of presentation for the statement of changes in financial position which is most informative in the circumstances.

Effective Date

.23 This International Accounting Standard becomes operative for financial statements covering reporting periods beginning on or after 1 January 1979.

The next page is 11,151.

AC Section 9008

Unusual and Prior Period Items and Changes in Accounting Policies

Issue date, unless otherwise indicated: February, 1978

INTRODUCTION

.01 International Accounting Standard 5 [section 9005], *Information to be Disclosed in Financial Statements,* requires certain specific information to be disclosed in the income statement, including the identification of an amount described as net income [1] for the period. This Statement deals with the treatment in the income statement [2] of unusual items, prior period items, and changes in accounting policies and estimates.

.02 This Statement does not deal with the treatment of revaluations in excess of historical cost or depreciated historical cost, nor does it deal with the treatment of the tax effects of unusual items, prior period items, and changes in accounting policies and estimates.

Definitions

.03 For purposes of this Statement, the following terms are used:

Unusual items are gains or losses that derive from events or transactions that are distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly.

Prior period items are charges or credits that arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

EXPLANATION

.04 The income statement is the principal financial statement used to present the results of operations of an enterprise for a period. Two views are commonly expressed about which items should be included in the amount described as net income for the period. They are commonly referred to as "the current operating performance concept" and "the all inclusive concept".

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[1] Terms such as earnings or net profit may also be used; if a loss is incurred the term employed is net loss.

[2] This financial statement may also be known as a profit and loss account.

.05 Under *the current operating performance concept,* non-recurring items are excluded from reported net income. These items are shown after the determination of net income or as adjustments to retained earnings. Some consider that this approach facilitates comparisons between the current and prior periods because only items related to the recurring operations of the enterprise are included in the income statement. However, there is a danger that the importance of items excluded from reported net income may not be clearly recognised by users of the financial statements.

.06 Under *the all-inclusive concept,* transactions causing a net increase or decrease in shareholders' interests during the period, other than dividends and other transactions between the enterprise and its shareholders, are included in the net income for the period. Non-recurring items, including unusual items arising in the current period, prior period items, or adjustments related to changes in accounting policies, are included in net income but there may be separate disclosure of the individual amounts.

.07 Advocates of the all-inclusive concept claim that reporting in the income statement of items affecting the shareholders' interests during the period, other than dividends and other transactions between the enterprise and its shareholders, provides more useful information for the users of financial statements to enable them to evaluate the importance of the items and their effects on operating results. Although the all-inclusive concept is generally supported, there are circumstances in which it may be considered desirable to report certain items outside the income statement for the current period. However, unusual items are generally included in net income.

Income Attributable to Ordinary Activities

.08 Under both concepts referred to in paragraph .04, income from the ordinary activities of the enterprise generally is identified separately from unusual items. The fact that an item, otherwise typical of the ordinary activities of the enterprise, is abnormal in amount or infrequent in occurrence does not qualify the item as unusual. It remains a part of income from the ordinary activities although separate disclosure of its nature and amount may be appropriate. An example of such an item would be the write-off of a very large receivable from a regular trade customer.

Unusual Items

.09 Items described in some countries as extraordinary or special items are included within the term "unusual item" as used in this Statement. In those countries the terms extraordinary or special items have a defined meaning and a requirement

normally exists for the incorporation of a sub-total within the income statement described as "income before extraordinary (or special) items". This Statement does not set forth the specific format of the income statement. Instead it places emphasis on the separate disclosure of unusual items with an explanation of their nature.

.10 The gains or losses that may require separate disclosure as unusual items are not determined solely by the nature of the event or transaction but by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise. For example, in an enterprise which regularly trades in properties, the gains or losses arising on the sale of property would not be an unusual item.

Prior Period Items

.11 In rare circumstances, events come to light in the current financial period which show that the financial statements of one or more previous periods were prepared and presented on a wrong or inaccurate basis as a result of an error or an omission. The financial adjustments arising out of such events are referred to in this Statement as prior period items. Prior period items should not be confused with accounting estimates which are, by their nature, approximations that may need correction as additional information becomes known in subsequent periods. The charge or credit arising on the outcome of a contingency, which at the time of occurrence could not be estimated accurately, does not constitute the correction of an error but rather a change in estimate. Such an item is not treated as a prior period item.

.12 Prior period items are sometimes reported by adjusting opening retained earnings in the financial statements for the current period and amending the comparative information in respect of prior years which is included in the financial statements. Sometimes prior period items are reported as unusual items in the determination of net income for the current period. Supplementary information may be presented on a pro forma basis to show what the effect on income in prior periods would have been if the items had been reported in the period to which they relate.

.13 In order to facilitate comparisons between one period and another, amendment of the comparative information which is included in financial statements in respect of prior periods is useful to correct erroneous financial information presented in the previous financial statements. Whichever method is adopted, there is full disclosure of the amount and nature of the prior period items.

Changes in Accounting Policies

.14 A fundamental accounting assumption is that accounting policies are consistently applied—see International Accounting Standard 1 [section 9001], *Disclosure of Accounting Policies.* A change in an accounting policy used for reporting purposes is made only if the adoption of a new accounting policy is required by statute or by an accounting standard setting body, or if it is considered that the change would result in a more appropriate presentation of the financial statements of an enterprise. In all cases, it is necessary to present an explanation of the reason for a change.

.15 A change in an accounting policy can be introduced into the financial statements in different ways. The new policy may be applied:

(a) to the current and future financial statements. When practicable, supplementary information is presented on a pro forma basis to show what the effect on income in prior periods would have been if the new policy had then been in use;

(b) retroactively, as though it had always been in use. When a new policy is applied retroactively, the statements of income for all periods presented may be adjusted to reflect the new policy; or

(c) by presenting as a single item in the income statement for the current period the amount of the cumulative effect on retained earnings at the beginning of the period in which the change is made. Pro forma information is ordinarily presented to show what the effect on income of prior periods would have been if the new policy had then been in use.

Changes in Accounting Estimates

.16 The preparation of financial statements involves making estimates which are based on the circumstances existing at the time when the financial statements are prepared. For example, estimates are required of uncollectable receivables, inventory obsolescence, and the useful lives of depreciable assets. It may be necessary to revise an estimate in a subsequent period if there is a change in the circumstances on which the estimate was based. Revision of an estimate does not bring the resulting amount within the definition either of an unusual item or of a prior period item. Revision of an estimate that relates to an item that was treated as an unusual item is itself reported as unusual. A change in an accounting estimate sometimes has so material an effect on the income trend of the enterprise that there is a need to disclose the effects of the change.

.17 It is sometimes difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. For example, an enterprise may change from deferring and amortising a cost to reporting it as an expense when incurred because the estimated future benefits have become uncertain. In those cases where it is difficult to draw a clear distinction, it is usual for such changes to be treated as changes in accounting estimates, with appropriate disclosure.

INTERNATIONAL ACCOUNTING STANDARD 8

UNUSUAL AND PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

International Accounting Standard 8 comprises paragraphs .18—.24 of this Statement. The Standard should be read in the context of paragraphs .01—.17 of this Statement and of the Preface to Statements of International Accounting Standards [*section 9000*].

.18 Income from the ordinary activities of the enterprise during the period should be disclosed in the income statement as part of net income [3]. Unusual items should be included in net income; the nature and amount of each such item should be separately disclosed.

.19 Prior period items and the amount of the adjustments, if any, resulting from changes in accounting policies should be either:

(a) reported by adjusting opening retained earnings in the financial statements for the current period and amending the comparative information in respect of prior years which is included in the financial statements, or

(b) separately disclosed in the current income statement as part of net income.

In either case the disclosure relating to these items should be adequate to facilitate comparisons of the figures for the periods presented.

.20 A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or by an accounting standard setting body or if it is considered that the change would result in a more appropriate presentation of the financial statements of an enterprise.

.21 If there is a change in an accounting policy that has a material effect in the current period, or may have a material effect in subsequent periods, the effect of the change should be

[3] Terms such as earnings or net profit may also be used; if a loss is incurred, the term employed is net loss.

disclosed and quantified together with the reasons for the change (see International Accounting Standard 1 [section 9001], *Disclosure of Accounting Policies*).

.22 A change in an accounting estimate should be accounted for as part of income from the ordinary activities of the enterprise in:

(a) the period of change if the change affects the period only, or

(b) the period of change and future periods if the change affects both.

Revision of an estimate that relates to an item that was treated as an unusual item should itself be reported as unusual.

.23 If there is a change in an accounting estimate that has a material effect in the current period, or may have a material effect in subsequent periods, the effect of the change should be disclosed and quantified.

Effective Date

.24 This International Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January 1979.

→ ***The next page is 11,161.*** ←

AC Section 9009

Accounting for Research and Development Activities

Issue date, unless
otherwise indicated:
July, 1978

INTRODUCTION

.01 This Statement deals with accounting for research and development activities.

.02 The Statement does not deal with the following specialised activities:

(a) research and development activities conducted for others under a contract

(b) exploration for oil, gas and mineral deposits

(c) research and development activities of development stage enterprises.

Definitions

.03 The following terms are used in this Statement with the meanings specified:

Research is original and planned investigation undertaken with the hope of gaining new scientific or technical knowledge and understanding.

Development is the translation of research findings or other knowledge into a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production.

EXPLANATION

.04 An enterprise undertakes a programme of creative work to increase the stock of its scientific and technical knowledge and to devise new applications which will contribute to the maintenance of its business and its competitive position. The accounting treatment and disclosure of the costs of research and development activities are therefore important for users of financial statements.

The Costs of Research and Development Activities

.05 There can be practical difficulties in deciding the amounts of the costs specifically attributable to research and development activities. In order to achieve a reasonable degree of comparability between enterprises, and between accounting periods of the same enterprise, it is necessary to identify the elements comprising research and development costs.

.06 The costs incurred for research and development activities include the following:

(a) salaries, wages and other related costs of personnel

(b) the costs of materials and services consumed

(c) the depreciation of equipment and facilities

(d) a reasonable allocation of overhead costs. This allocation is made on bases similar to those used in allocating overhead costs to inventories (see International Accounting Standard 2 [section 9002], Valuation and Presentation of Inventories in the Context of the Historical Cost System)

(e) other costs, such as the amortisation of patents and licences.

.07 Costs incurred to maintain production or to promote sales of existing products are excluded from the costs of research and development activities. Thus, the costs of routine or periodic minor modifications to existing products, production lines, manufacturing processes and other ongoing operations as well as routine or promotional costs of market research activities are excluded.

.08 However, market research activities undertaken prior to the commencement of commercial production to establish the usefulness of a product or the existence of a potential market are similar to development activities. In these cases, the related costs are sometimes treated in the same way as development costs and are written off or deferred based on the same considerations.

The Accounting Treatment of Research and Development Costs

.09 The allocation of the costs of research and development activities to accounting periods is determined by their relationship to the expected future benefits to be derived from these activities. In most cases there is little, if any, direct relationship between the amount of current research and development costs and future benefits because the amount of such benefits, and the periods over which they will be received, are usually too uncertain. Research and development costs are therefore usually

charged to expense in the period in which they are incurred.

.10 If it can be demonstrated, however, that the product or process is technically and commercially feasible and that the enterprise has adequate resources to enable the product or process to be marketed, the uncertainties referred to in paragraph .09 may be significantly reduced. In such circumstances, it may be appropriate to defer the costs of development activities to future periods. Development costs previously written off are not reinstated because they were incurred at a time when the technical and commercial feasibility of the project was too uncertain to establish a relationship with future benefits and they were therefore proper charges to those past periods.

.11 Deferred development costs are amortised on a systematic basis, either by reference to the sale or use of the product or process or by reference to a reasonable time period. Technological and economic obsolescence creates uncertainties that restrict the number of units and the time period over which deferred costs are to be amortised.

Disclosure

.12 The accounting policy adopted for the costs of research and development activities is included in the statement of accounting policies (see International Accounting Standard 1 [section 9001], Disclosure of Accounting Policies). When applicable, information about amortisation practices is also required (see International Accounting Standard 5 [section 9005], Information to Be Disclosed in Financial Statements).

.13 The disclosure of (a) research and development costs, including the amortisation of deferred development costs, charged as an expense of each period, and (b) the unamortised balance, if any, of deferred development costs, enables the users of financial statements to consider the significance of such activities in relation to those of other enterprises as well as to the other activities of the enterprise itself.

.14 Further information which might usefully be provided could include a general description of the project, the stage which the project has reached, and the estimated future costs to complete it.

INTERNATIONAL ACCOUNTING STANDARD 9

ACCOUNTING FOR RESEARCH AND DEVELOPMENT ACTIVITIES

International Accounting Standard 9 comprises paragraphs .15-.25 of this Statement. The Standard should be read in the context of paragraphs .01-.14 of this Statement and of the Preface to Statements of International Accounting Standards [section 9000].

.15 Research and development costs should include:

(a) the salaries, wages and other related costs of personnel engaged in research and development activities

(b) the costs of materials and services consumed in research and development activities

(c) the depreciation of equipment and facilities to the extent that they are used for research and development activities

(d) overhead costs related to research and development activities,

(e) other costs related to research and development activities, such as the amortisation of patents and licences.

.16 The amount of the research and development costs described in paragraph .15 should be charged as an expense of the period in which they are incurred except to the extent that development costs are deferred in accordance with paragraph .17.

.17 Development costs of a project may be deferred to future periods if all the following criteria are satisfied:

(a) the product or process is clearly defined and the costs attributable to the product or process can be separately identified;

(b) the technical feasibility of the product or process has been demonstrated;

(c) the management of the enterprise has indicated its intention to produce and market, or use, the product or process;

(d) there is a clear indication of a future market for the product or process or, if it is to be used internally rather than sold, its usefulness to the enterprise can be demonstrated; and

(e) adequate resources exist, or are reasonably expected to be available, to complete the project and market the product or process.

.18 The deferral of development costs of a project under the criteria in paragraph .17 should be limited to the amount that, taken together with further development costs, related production costs, and selling and administrative costs directly incurred in marketing the product, can reasonably be expected to be recovered from related future revenues.

.19 If an accounting policy of deferral of development costs is adopted, it should be applied to all development projects that meet the criteria in paragraph .17.

.20 If development costs of a project are deferred, they should be allocated on a systematic basis to future accounting periods by reference either to the sale or use of the product or process or to the time period over which the product or process is expected to be sold or used.

.21 The deferred development costs of a project should be reviewed at the end of each accounting period. When the criteria of paragraph .17, which previously justified the deferral of the costs, no longer apply, the unamortised balance should be charged as an expense immediately. When the criteria for deferral continue to be met but the amount of deferred development costs (and other relevant costs as set out in paragraph .18) that can reasonably be expected to be recovered from related future revenues is exceeded by the unamortised balance of such costs, the excess should be charged as an expense immediately.

.22 Development costs once written off should not be reinstated even though the uncertainties which had led to their being written off no longer exist.

Disclosure

.23 The total of research and development costs, including amortisation of deferred development costs, charged as expense should be disclosed.

.24 The movement in and the balance of unamortised deferred development costs should be disclosed. The basis, proposed or adopted, for the amortisation of the unamortised balance should also be disclosed.

Effective Date

.25 This International Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January 1980.

COMPARISON OF INTERNATIONAL ACCOUNTING STANDARD 9 WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN THE UNITED STATES

Paragraph 11 of Statement of Financial Accounting Standards No. 2 [section 4211.11] provides that the costs of research and development activities shall include the costs of materials, equipment, facilities, and intangibles that are acquired for a particular research and development project and have no alternative future use. Those costs are to be charged to expense when the items are acquired even if that precedes the period in which they are consumed or used.

In describing the costs of research and development activities, International Accounting Standard 9 makes no distinction between the cost of items that are acquired for a particular research and development project and have no alternative future use and the cost of other items acquired for research and development activities.

Paragraph 6 of International Accounting Standard 9 states:

> "The costs incurred for research and development activities include the following . . .
> (b) the costs of materials and services consumed
> (c) the depreciation of equipment and facilities . . .
> (e) other costs, such as the amortisation of patents and licences."

Thus, the cost of items that are acquired for a particular research and development project and have no alternative future use (in other research and development projects or otherwise) are, according to Statement of Financial Accounting Standards No. 2 [section 4211], to be expensed when the items are acquired and, according to International Accounting Standard 9, are to be expensed when the items are consumed.

AICPA ACCOUNTING INTERPRETATIONS

During the time the Accounting Principles Board was in existence, the Institute staff was authorized to issue interpretations of accounting questions having general interest to the profession. The purpose of the interpretations was to provide guidance on a timely basis without the formal procedures required for an APB Opinion and to clarify points on which past practice may have varied and been considered generally accepted. These interpretations, which were reviewed with informed members of the profession, were not pronouncements of the Board and did not establish standards enforceable under the Institute's Code of Professional Ethics. Responsibility for their preparation rested with RICHARD C. LYTLE, *at that time administrative director of the Accounting Principles Board. Unless otherwise stated, the interpretations were not intended to be retroactive.*

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[1] See also AC section 1051-1, *Accounting Changes Related to the Cost of Inventory.*

* See also AC section 1091-1, *Applying Sections 1091 and 5141 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method.*

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[2] See also AC section 4063-1, *Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974.*

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[3] See also AC section 4111-1, Imputing Interest on Debt Arrangements made under the Federal Bankruptcy Act.

[4] See also AC section 1091-1, Applying Sections 1091 and 5141 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method.

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AC Section U1051

Accounting Changes: Accounting Interpretations of Section 1051

1. Changing EPS Denominator for Retroactive Adjustment to Prior Period

.001 *Question*—Section 1051.27 specifies that certain accounting changes should be reported by retroactively restating all prior periods presented. Section 1051.28 requires that the effect of these changes on the prior periods' earnings per share amounts be disclosed. The anti-dilution prohibitions of sections 2011.30 and 2011.40 require the exclusion from earnings per share computations of securities whose conversion, exercise, or other contingent issuance would have the effect of increasing the earnings per share amount or decreasing the loss per share amount. If these securities were originally included in the earnings per share computation in a prior period but would have been excluded if the retroactively restated amount had been reported in the prior period, should the securities be included or excluded when computing the restated earnings per share amount?

.002 *Interpretation*—A retroactively restated earnings per share amount should always be computed as if the restated income or loss had been originally reported in the prior period. Common stock assumed to be issued for exercise, conversion, etc., and included in the original earnings per share denominator should, therefore, in circumstances such as those described below be excluded from the denominator in computing the restated earnings per share amount.

.003 For example, assume that a corporation which reported $200,000 net income in the immediately preceding year changes its method of accounting for long-term construction-type contracts from the completed contract method to the percentage of completion method. In applying this change retroactively (see section 1051.27), the net income originally reported for the immediately preceding year is decreased $290,000 and restated as a net loss of

$90,000. Further assume that in the prior year the corporation had 900,000 shares of common stock and 150,000 warrants outstanding for the entire year. Each warrant could be exercised to purchase one share of common stock for $10 while the market price of common was $30 throughout the year. Earnings per share were originally reported as $.20 based on $200,000 net income divided by a denominator of 1,000,000 common shares (900,000 shares outstanding plus 100,000 shares for warrants computed under the treasury stock method). The assumption of exercise of warrants is anti-dilutive when there is a loss, so the restated amount would be reported as a net loss of $.10 per share based on $90,000 net loss divided by a denominator of 900,000 common shares outstanding.

.004 Note that retroactive restatement could also cause securities originally determined to be anti-dilutive to become dilutive. For example, assume the same facts as given in the preceding illustration except a $90,000 net loss was originally reported and is restated as $200,000 net income. Exercise of the warrants would not have been assumed in the original per share computation because the result would have been anti-dilutive but would be assumed in computing the restated earnings per share because the result is dilutive.

.005 Retroactive restatement may also cause the earnings per share numerator to change by an amount different from the amount of the retroactive adjustment. For example, assume that a corporation changes from the LIFO method of inventory pricing to the FIFO method, retroactively increasing net income for the immediately preceding year by $400,000 (see section 1051.27). Further assume that the corporation originally reported a net income of $800,000 in the prior year and had 800,000 shares of common stock outstanding. In addition, 200,000 shares of preferred stock were outstanding which were convertible into common stock on a one-for-one basis. The preferred stock is a common stock equivalent and paid a dividend of $1 per share. Earnings per share were originally reported as $.75 based on an earnings per share numerator of $600,000 ($800,000 net income less $200,000 preferred dividends) and a denominator of 800,000 common shares. The assumption

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of conversion in the original computation would have been anti-dilutive. Restated net income is $1,200,000 and restated earnings per share is $1.20 based on a numerator of $1,200,000 and a denominator of 1,000,000 shares (800,000 common shares outstanding plus 200,000 common shares for the assumed conversion of preferred stock). Although restatement increased net income and, therefore, the earnings per share numerator $400,000 in this case, the assumed conversion of the preferred stock increased the earnings per share numerator by another $200,000.

.006 In addition to a retroactive adjustment for a change in accounting principle under section 1051.27, the guidelines given above in this Interpretation apply to (a) retroactive restatement under section 1051.29-.30, (b) restatement of prior periods for a change in the reporting entity as described in section 1051.34-.35, (c) the correction of an error in previously issued financial statements as described in section 1051.36-.37, and (d) a prior period adjustment as described in sections 2010.17, 2014.11 and 2014.13-.14. These guidelines will likewise apply whenever an APB Opinion requires that it be applied retroactively, including Opinions which may be issued in the future.

.007 Also, these guidelines should be applied in computing the pro forma earnings per share amounts for the types of changes in accounting principle described in section 1051.19. Although these types of changes in accounting principle are not applied retroactively, sections 1051.19d and 1051.21 require that the pro forma effects of retroactive application be disclosed.

.008 A change in the earnings per share denominator (and perhaps numerator) from that originally used in the computation may create certain complications in reporting the effect of a retroactive change. These complications may be illustrated by considering the data in the table below, for the examples presented earlier in this Interpretation.

	Warrant Example	Convertible Preferred Stock Example
Net income as previously reported	$ 200,000	$ 800,000
Adjustment for retroactive change	(290,000)	400,000
Net income (loss) as adjusted	$ (90,000)	$1,200,000
Earnings per share amounts:		
As previously reported	$ .20[a]	$ .75[c]
Effect of retroactive change	(.30)	.45
As adjusted	$(.10)[b]	$1.20[d]

Computational Notes:

(a) $200,000 ÷ (900,000 + 100,000) shares

(b) $90,000 ÷ 900,000 shares

(c) ($800,000 — $200,000) ÷ 800,000 shares

(d) $1,200,000 ÷ (800,000 + 200,000) shares

.009 In both of the above examples, the earnings per share amounts shown for "effect of retroactive change" are computed by subtracting the previously reported amounts from the adjusted amounts. Determining the per share amount of the change by subtraction comprehends the effects of any necessary changes in the denominator and the numerator by reason of retroactive application.

[Issue Date: March, 1973]

2. EPS for "Catch-up" Adjustment

.010 *Question*—Section 1051.20 requires the per share amount of the cumulative effect of most accounting changes (see sections 1051.18 and 1051.19) to be shown on the face of the income statement similar to the manner in which an extraordinary item would be shown. Footnote 10, section 2011.30, giving an exception to the anti-dilution prohibition in primary earnings per share computations, states that: The presence of a common stock equivalent or other dilutive securities together with income from continuing operations and extraordinary items may result in diluting one of the per share amounts which are required to be disclosed on

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the face of the income statement—i.e., income from continuing operations, income before extraordinary items and before the cumulative effect of accounting changes, if any, and net income—while increasing another. In such a case, the common stock equivalent or other dilutive securities should be recognized for all computations even though they have an anti-dilutive effect on one of the per share amounts. Footnote 16, section 2011.40, gives a similar reference for fully diluted computations. How does reporting the cumulative effect of an accounting change in a manner similar to an extraordinary item affect the application of these two footnotes in computing earnings per share?

.011 *Interpretation*—The cumulative effect of an accounting change (sometimes referred to as a "catch-up" adjustment) is considered the same as an extraordinary item, whether or not extraordinary items are present, in computing earnings per share. Therefore, a common stock equivalent which has a dilutive effect on the primary earnings per share computation for (a) income from continuing operations, if discontinued operations are reported, or (b) income before extraordinary items (if any) and the cumulative effect of a change in accounting principle or (c) net income should be recognized in all computations of primary earnings per share for the period. Likewise, a common stock equivalent or other potentially dilutive security which has a dilutive effect on the fully diluted earnings per share computation for either (a) income from continuing operations, if discontinued operations are reported, or (b) income before extraordinary items (if any) and cumulative effect of a change in accounting principle or (c) net income should be recognized in all computations of fully diluted earnings per share for the period. Note that, under these exceptions to the anti-dilution prohibitions of section 2011, a common stock equivalent or other potentially dilutive security may have an anti-dilutive effect on "a", "b" or "c" but not on all. The per share amount of an extraordinary item or a "catch-up" adjustment is always computed by using the same denominator used to compute the other earnings per share amounts. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.]

.012 However, the exceptions to the anti-dilution prohibitions do not permit an assumed exercise, conversion,

etc., to cause fully diluted net income (loss) per share to be anti-dilutive in relation to primary net income (loss) per share. That is, the assumed exercise, conversion, etc., of a security may have an anti-dilutive effect within primary earnings per share or within fully diluted earnings per share, but the assumed exercise, conversion, etc., should not have the effect of increasing (decreasing) the fully diluted net income (loss) per share amount to more (less) than the primary net income (loss) per share amount. (See footnote 5, section U2011.016, *Computing Earnings per Share.*)

.013 Although the "catch-up" adjustment is considered the same as an extraordinary item in computing earnings per share, the earnings per share reporting requirement for the two items is different. Section 2011 does not require that per share amounts be reported for extraordinary items, although this presentation may generally be desirable (see Interpretation 16, section U2011.084-.086, *Computing Earnings per Share*). Section 1051.20 does require per share data for a "catch-up" adjustment to be shown on the face of the income statement. Preferably, when both an extraordinary item and a "catch-up" adjustment are reflected in net income for a period, per share data for both should be presented on the face of the income statement.

[Issue Date: March, 1973]

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AC Section U1091

Accounting for Business Combinations: Accounting Interpretations of Section 1091

1. Ratio of Exchange

.001 *Question*—Section 1091.46a defines the initiation date for a business combination as the earlier of (1) the date the major terms of a plan, including the ratio of exchange of stock, are announced publicly or otherwise formally made known to the stockholders of any one of the combining companies or (2) the date that stockholders of a combining company are notified in writing of an exchange offer. Does the announcement of a formula by which the ratio of exchange will be determined in the future constitute the initiation of a plan of combination?

.002 *Interpretation*—Yes, the actual exchange ratio (1 for 1, 2 for 1, etc.) need not be known to constitute initiation of a business combination so long as the ratio of exchange is absolutely determinable by objective means in the future. A formula would usually provide such a determination.

.003 A formula to determine the exchange ratio might include factors such as earnings for some period of time, market prices of stock at a particular date, average market prices for some period of time, appraised valuations, etc. The formula may include upper and/or lower limits for the exchange ratio and the limits may provide for adjustments based upon appraised valuations, audit of the financial statements, etc. Also, the formula must be announced or communicated to stockholders as specified by section 1091.46a to constitute initiation.

.004 If a formula is used after October 31, 1970 to initiate a business combination which is intended to be accounted for by the pooling of interests method, the actual exchange ratio would have to be determined by the consummation date and therefore no later than one year after the initiation date to meet the conditions of section 1091.47a.

Also, changing the terms after October 31, 1970 of a formula used to initiate a business combination before November 1, 1970 would constitute the initiation of a new plan of combination (see section 1091.47, footnote 6).

[Issue Date: December, 1970.]

2. Notification to Stockholders

.005 *Question*—Section 1091.46a specifies that a business combination is initiated on the earlier of (1) the date major terms of a plan are formally announced or (2) the date that stockholders of *a* combining company are notified in writing of *an* exchange offer. Does communication in writing to a corporation's own stockholders that the corporation plans a future exchange offer to another company without disclosure of the terms constitute initiation of a business combination?

.006 *Interpretation*—No. Section 1091.46a defines "initiation" in terms of two dates. The first date is for the announcement of an exchange offer negotiated between representatives of two (or more) corporations. The second date is for a tender offer made by a corporation directly or by newspaper advertisement to the stockholders of another company. It is implicit in the circumstances of a tender offer that the plan is not initiated until the stockholders of the other company have been informed as to the offer and its major terms, including the ratio of exchange.

.007 Therefore, in the second date specified for initiation in section 1091.46a, "*a* combining company" refers to the company whose stockholders will tender their shares to the issuing corporation. "*An* exchange offer" means the major terms of a plan including the ratio of exchange (or a formula to objectively determine the ratio).

.008 A corporation may communicate to its own stockholders its intent to make a tender offer or to negotiate on the terms of a proposed business combination with another company. However, intent to tender or to negotiate does not constitute "initiation." A business combination is not initiated until the major terms are "set" and announced publicly or formally communicated to stockholders.

[Issue Date: December, 1970.]

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3. Intercorporate Investment Exceeding 10 Per Cent Limit

.009 *Question*—Section 1091.46b (the "independence" condition) states that the pooling of interests method of accounting for a business combination may not be applied if *at* the dates the plan of combination is initiated and consummated the combining companies hold as intercorporate investments more than 10 per cent in total of the outstanding voting common stock of any combining company. Would an intercorporate investment of 10 per cent or less *at* the initiation and consummation dates but exceeding 10 per cent *between* these dates (for example, through a cash purchase and subsequent sale of the voting common stock of a combining company) prohibit accounting for a business combination under the pooling of interests method?

.010 *Interpretation*—Section 1091.46b would not be met if *between* the initiation and consummation dates combining companies hold as intercorporate investments more than 10 per cent of the outstanding voting common stock of any combining company even though the intercorporate investments do not exceed 10 per cent *at* either the initiation or consummation date. Although the section mentions only the initiation and consummation dates, intercorporate investments exceeding 10 per cent in the interim would violate the spirit of the independence condition and the business combination would be an acquisition accounted for under the purchase method. For the 10 per cent computation, however, intercorporate investments exclude voting common stock that is acquired after the date the plan of combination is initiated in exchange for the voting common stock issued to effect the combination.

[Issue Date: December, 1970.]

4. Consummation Date for a Business Combination

.011 *Question*—Sections 1091.46-.48 specify certain conditions which require a business combination to be accounted for by the pooling of interests method. Among these conditions in sections 1091.46b and 1091.47b are quantitative measurements which are to be made on the consummation date. When does the "consummation date" occur for a business combination?

.012 *Interpretation*—A plan of combination is consummated on the date the combination is completed, that is,

the date assets are transferred to the issuing corporation. The quantitative measurements specified in sections 1091.46b and 1091.47b are, therefore, made on the date the combination is completed. If they and all of the other conditions specified in sections 1091.46-.48 are met on that date, the combination must be accounted for by the pooling of interests method.

.013 It should not be overlooked that section 1091.47a states the plan of combination must be *completed* in accordance with a specific plan within one year after it is initiated unless delay is beyond the control of the combining companies as described in that paragraph. Therefore, ownership of the issuing corporation's common stock must pass to combining stockholders and assets must be transferred from the combining company to the issuing corporation within one year after the initiation date (unless the described delay exists) if the business combination is to be accounted for by the pooling of interests method. Physical transfer of stock certificates need not be accomplished on the consummation date so long as the transfer is in process.

.014 If any of the conditions specified in sections 1091.46-.48 are not met, a business combination is an acquisition which must be accounted for by the purchase method. Section 1091.93 specifies that the date of acquisition should ordinarily be the date assets are received and other assets are given or securities are issued, that is, the consummation date. However, this paragraph allows the parties for convenience to designate the end of an accounting period falling between the initiation and consummation dates as the effective date for the combination.

.015 The designated effective date is not a substitute for the consummation date in determining whether the purchase or pooling of interests method of accounting applies to the combination. In designating an effective date as some date prior to the consummation date, the parties would automatically be anticipating that the business combination would be accounted for as a purchase since sections 1091.51 and 1091.61 specify that a business combination accounted for by the pooling of interests method must be recorded as of the date the combination is consummated.

[Issue Date: December, 1970.]

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5. Pooling Not Completed Within One Year

.016 *Question*—Section 1091.47a specifies that a condition for a business combination to be accounted for by the pooling of interests method is for the combination to be completed in accordance with a specific plan within one year after the plan is initiated unless delay is beyond the control of the combining companies. This paragraph also indicates that new terms may be offered if earlier exchanges of stock are adjusted to the new terms. If completion of a business combination is delayed beyond one year, would the offering of new terms during the delay period meet the condition of paragraph .47-a for a business combination to be accounted for by the pooling of interests method?

.017 *Interpretation*—New terms may be offered under the conditions of paragraph .47-a more than one year after the initiation date if delay in completion is beyond the control of the combining companies because of certain circumstances and earlier exchanges of stock are adjusted to the new terms (but see section 1091.47, footnote 6 for plans in effect on October 31, 1970). However, the only delays permitted under paragraph .47-a are proceedings of a governmental authority and litigation.

.018 Proceedings of a governmental authority for this purpose include deliberations by a federal or state regulatory agency on whether to approve or disapprove a combination where the combination cannot be effected without approval. They do *not* include registration of the securities with the SEC or a state securities commission. Litigation for this purpose means, for example, an antitrust suit filed by the Justice Department or a suit filed by a dissenting minority stockholder to prohibit a combination.

[Issue Date: December, 1970.]

6. Registered Stock Exchanged for Restricted Stock

.019 *Question*—The pooling of interests method of accounting for a business combination is required by section 1091 if the conditions specified in paragraphs .46 through .48 are met showing that stockholder groups have combined their rights and risks. Would the exchange of unrestricted voting common stock of the issuing corporation for the shares owned by a substantial common stockholder of a combining company whose stock was restricted as to voting

or public sale indicate the conditions were not met if the stock issued could be sold immediately?

.020 *Interpretation*—Stockholder groups have combined their rights and risks so long as stockholders holding substantially all classes of the voting common stock in the combining company receive shares of the majority class of voting common stock of the issuing corporation exactly in proportion to their relative voting common stock interest before the combination was effected. The fact that unrestricted voting common stock is exchanged for stock previously held in a voting trust would not negate accounting for a business combination by the pooling of interests method. Likewise, the fact that "registered" voting common stock of the issuing corporation is exchanged for "restricted" voting common stock of the combining corporation also would not negate accounting for a business combination by the pooling of interests method.

[Issue Date: December, 1970.]

7. Pooling Under "Old Rules"

.021 *Question*—Section 1091.97 states that business combinations initiated before November 1, 1970 and consummated on or after that date under the terms prevailing on October 31, 1970 may be accounted for in accordance with section 1091 *or* the applicable previous pronouncements of the Board or its predecessor committee. Paragraph .97 also contains a reference to paragraph .47-a which, among other things, states that a combination must be completed within one year after the plan is initiated to be accounted for by the pooling of interests method. Does this mean a business combination initiated before November 1, 1970 must be consummated within one year after it was initiated to be accounted for as a pooling of interests under the "old rules"?

.022 *Interpretation*—No, a business combination initiated before November 1, 1970 need only be consummated under the terms in effect on October 31, 1970 to be accounted for under the "old rules." There is no time limit for consummating the combination.

.023 The reference to paragraph .47-a is intended to call attention to the discussion of a change in terms in that

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paragraph and to footnote 6 which specifies that an adjustment after October 31, 1970 in the terms of exchange in effect on October 31, 1970 always constitutes initiation of a new plan. A new plan of combination, naturally, would be subject to the provisions of section 1091.

.024 To require a business combination initiated before November 1, 1970 to be consummated within one year after initiation would be retroactive application of section 1091. For example, a business combination initiated on December 31, 1969 would need to be consummated no later than December 31, 1970 if the section were retroactive. The section was not intended to be retroactive and retroactive application is in fact prohibited by paragraph .98 for business combinations consummated before November 1, 1970.

[Issue Date: December, 1970.]

8. Applying Purchase Accounting

.025 *Question*—Section 1091 clearly applies when one corporation obtains at least 90 per cent of the voting common stock of another corporation, whether through a purchase or a pooling of interests. Does the section also apply when one corporation acquires less than 90 per cent of the voting common stock of another corporation?

.026 *Interpretation*—Section 1091 discusses a 90 per cent "cutoff" (paragraph .47-b) only as one of the conditions to be met to account for a business combination by the pooling of interests method. If this condition—or any other condition in paragraphs .46 through .48—is not met, a business combination must be accounted for by the purchase method.

.027 The section does not create new rules for purchase accounting. The purchase section (paragraphs .66 through .96) merely discusses valuation techniques in much greater detail than is given in prior APB Opinions and Accounting Research Bulletins. Thus, section 1091 provides more guidance for the application of purchase accounting, whether the item purchased is an entire company, a major portion of the stock of a company or a manufacturing plant and regardless of whether the consideration given is cash, other assets, debt, common or preferred stock or a combination of these.

.028 An investment by a corporation in the voting common stock of another company which does not meet the 90 per cent condition must be accounted for as a purchase. The purchase method of accounting applies even though the investment is acquired through an exchange of the voting common stock of the companies.

.029 The acquisition by a corporation of voting control over another corporation creates a parent-subsidiary relationship. Generally, domestic subsidiaries either are consolidated or are included in consolidated financial statements under the equity method of accounting (see sections 5131 and 2051).

.030 Since a controlling interest is usually considered to be more than 50 per cent of the outstanding voting stock in another corporation, the fair value of the assets and liabilities of the subsidiary would be determined when control is acquired if the resulting subsidiary is either consolidated in the financial statements or included under the equity method of accounting. Also, section 5141 specifies the appropriate accounting for intangible assets, if any, recognized for these cases.

.031 In addition, the subsequent acquisition of some or all of the stock held by minority stockholders of a subsidiary is accounted for by the purchase method (see sections 1091.05 and 1091.43). Thus, after a business combination has been completed or a controlling interest in a subsidiary has been obtained, the acquisition of some or all of the remaining minority interest is accounted for by the purchase method. The purchase method applies even though the minority interest is acquired through an exchange of common stock for common stock, including the acquisition of a minority interest remaining after the completion of a business combination accounted for by the pooling of interests method.

[Issue Date: April, 1971.]

9. "Two-Year" Provisions at Effective Date

.032 *Question*—Sections 1091.46a and 1091.47c specify conditions to be met for two years prior to the initiation of a business combination which is to be accounted for by the pooling of interests method. Since the section applies to combinations initiated after October 31, 1970, must the con-

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ditions of paragraph .46-a (each company is autonomous) and paragraph .47-c (no changes in equity interests) be met for a combination initiated in November 1970 to be accounted for by the pooling of interests method?

.033 *Interpretation*—No, a corporation which has had a change in the equity interest in its voting common stock or which was a division that was spun-off as a separate corporation prior to November 1, 1970 could be a party to a business combination initiated on or after that date and meet the conditions for accounting by the pooling of interests method without regard to the two-year period.

[Issue Date: April, 1971.]

10. Effect of Termination

.034 *Question*—Section 1091.46a defines the initiation of a plan of combination as the date the major terms of an exchange offer are announced publicly or communicated to stockholders even though the plan is still subject to approval of stockholders and others. What is the effect of termination of a plan of combination prior to approval by stockholders and the subsequent resumption of negotiations between the parties?

.035 *Interpretation*—Paragraph .47-a specifies that a combination must be completed in accordance with *a specific plan*. Therefore, if negotiations are formally terminated after a plan has been initiated (as defined in paragraph .46-a), the subsequent resumption of negotiations always constitutes a new plan. Formal announcement of the major terms of the new plan constitutes a new initiation, even if the terms are the same as the terms of the old plan. Any shares of stock exchanged under the old plan become subject to the conditions of paragraphs .46-b and .47-b (the 10 per cent and 90 per cent tests) upon initiation of the new plan.

[Issue Date: April, 1971.]

11. Use of Restricted Stock to Effect a Business Combination

.036 *Question*—Section 1091.47b states as a condition for accounting for a business combination by the pooling of interests method that a corporation may issue only common stock with rights *identical* to those of the majority of its outstanding voting common stock in exchange for the voting

common stock of another company. Would restrictions on the sale of the shares of common stock issued result in different rights for these shares?

.037 *Interpretation*—The "rights" pertinent to paragraph .47-b are those involving relationships between stockholders and the corporation rather than between the stockholders and other parties. The "rights" therefore pertain to voting, dividends, liquidation, etc., and not necessarily to a stockholder's right to sell stock. Restrictions imposed on the sale of the stock to the public in compliance with governmental regulations do not ordinarily cause the "rights" to be different, but other restrictions may create different rights.

.038 For example, voting common stock issued by a publicly held corporation to effect a business combination may be restricted as to public sale until a registration with the SEC or a state securities commission becomes effective. If a registration were in process or the issuing corporation agreed to register the stock subsequent to the combination, the rights of the stock would not be different because of the restriction.

.039 However, a restriction imposed by the issuing corporation upon the sale of the stock in the absence of a governmental regulation would probably create different rights between previously outstanding and newly issued stock. Such a restriction might also indicate the previously separate stockholder groups would not be sharing the same risks in the business combination (see paragraph .45 and introductory statements in paragraphs .46 and .47). Likewise, a restriction upon the sale of the stock to anyone other than the issuing corporation or an affiliate would not meet the "absence of planned transactions" condition specified in paragraph .48-a.

[Issue Date: April, 1971.]

12. Warrants May Defeat Pooling

.040 *Question*—May a business combination be accounted for by the pooling of interests method if the issuing corporation exchanges voting common stock *and* warrants for the voting common stock of a combining company?

.041 *Interpretation*—Section 1091.47b specifies that in a business combination accounted for by the pooling of

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interests method a corporation may issue *only* common stock in exchange for at least 90 per cent of the common stock of another company. Therefore, a *pro rata* distribution of warrants of the issuing corporation to all stockholders of a combining company would not meet this condition and the business combination would be accounted for as a purchase.

.042 In some cases, however, warrants may be used in a business combination accounted for by the pooling of interests method. Warrants (as well as cash or debt) could be used, for example, to acquire up to 10 per cent of the common stock of a combining company under paragraph .47-b and the combination could still qualify as a "pooling" so long as the common stock acquired plus other intercorporate investments plus any remaining minority interest would allow the 90 per cent test to be met.

.043 Warrants may be issued in exchange for the combining company's outstanding preferred stock or debt.

.044 The issuing corporation may exchange its warrants for the combining company's outstanding warrants. Any warrants issued could not provide for the purchase of a greater number of shares than could be obtained if the warrants were exercised. For example, if the issuing corporation will exchange three of its common shares for each of the combining company's common shares outstanding and the combining company has warrants outstanding allowing the holders to purchase two common shares per warrant, each warrant issued in exchange for the outstanding warrants could provide for the purchase of no more than six of the issuing corporation's common shares. (It should be noted that warrants issued by either company in contemplation of effecting the combination might not meet the conditions of paragraph .47-c.)

[Issue Date: April, 1971.]

13. Two-Class Common for Pooling

.045 *Question*—Section 1091.47b specifies that a corporation must issue common stock "with rights identical to those of the majority class of its outstanding voting common stock" in a business combination which is to be accounted for by the pooling of interests method. Could the

common stock issued be designated as a class of stock different from majority class (for example, Class A if the majority class has no class designation) and meet this condition?

.046 *Interpretation*—Paragraph .47-b does not prohibit designating the common stock issued as a different class if it has *rights identical* to those of the majority class of outstanding voting common stock. Thus, the different class must have the same voting, dividend, liquidation, preemptive, etc., rights as the majority class with the stipulation that these rights cannot be changed unless a corresponding change is made in the rights of the majority class.

.047 Issuing a different class of common stock with rights identical to other common stock would generally serve no useful purpose. It would be suspected that the parties might have secretly agreed that they would in the future change the rights of the different class to restrict voting; grant a preference in liquidation; or increase, guarantee or limit dividends.

[Issue Date: April, 1971.]

14. Contingent Shares Defeat Pooling

.048 *Question*—Section 1091.47g specifies that in a business combination to be accounted for by the pooling of interests method a corporation may not (1) agree to issue additional shares of stock at a later date or (2) issue to an escrow agent shares which will later be transferred to stockholders or returned to the corporation. Would this condition be met if the corporation issued some maximum number of shares to stockholders of the combining company under an agreement that part of the shares would be returned if future earnings are below a certain amount or the future market price of the stock is above a stipulated price?

.049 *Interpretation*—No, contingent shares based on earnings, market prices and the like require a business combination to be accounted for as a purchase. Paragraph .47-g states that the combination must be "resolved at the date the plan is consummated."

The only contingent arrangement permitted under paragraph .47-g is for settlement of a contingency pending at consummation, such as the later settlement of a lawsuit. A contingent arrangement would also be permitted for an

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additional income tax liability resulting from the examination of "open" income tax returns.

[Issue Date: April, 1971.]

15. Paragraph .99 Is Not Mandatory

.050 *Question*—Section 1091 requires business combinations meeting the conditions of paragraphs .46 through .48 to be accounted for by the pooling of interests method and all other business combinations to be accounted for by the purchase method. However, paragraph .99 provides a "grandfather clause" permitting certain exceptions to the pooling conditions for business combinations which meet the conditions of that paragraph. Under paragraph .99 the accounting treatment is: (1) the excess of cost of the investment in common stock acquired prior to November 1, 1970 over equity in net assets when the stock investment was acquired is allocated to identifiable assets and goodwill regardless of the percentage of ownership on October 31, 1970 and (2) the pooling of interests method is applied for the common stock issued in the combination if the combination meets the conditions for accounting by the pooling of interests method. That is, the combination is accounted for as a "part-purchase, part-pooling." Is the application of paragraph .99 mandatory for a busines combination meeting the conditions of that paragraph?

.051 *Interpretation*—No, the accounting described in paragraph .99 is an election available to an issuing corporation to apply the pooling of interests method to account for a business combination not otherwise meeting the conditions of paragraphs .46-b and .47-b. Paragraph .99 specifies "the resulting business combination *may* [emphasis added] be accounted for by the pooling of interests method provided. . . ."

.052 Paragraph .99 applies only for intercorporate investments held at October 31, 1970. The provision was inserted to avoid retroactivity by allowing pooling of interest accounting for a combination that would not have met the conditions of paragraphs .46-b and .47-b because an intercorporate investment held at October 31, 1970 then was near or exceeded 10 per cent of the outstanding voting common stock of the combining company. [As amended, effective November 1, 1975, by FASB Statement No. 10.] (See section 1092.)

.053 A business combination meeting all of the conditions of paragraphs .46 through .48 as well as the conditions of paragraph .99 would be accounted for by the pooling of interests method. Paragraph .99 would not apply and the intercorporate investment would be accounted for as described in paragraph .55. A business combination meeting the conditions of paragraph .99 but not otherwise meeting the conditions of paragraphs .46-b and .47-b may either be accounted for as a "part-purchase, part-pooling" as described in paragraph .99 or as a purchase.

[Issue Date: April, 1971.]

16. Changes in Intercorporate Investments

.054 *Question*—How do sales of investments in another corporation's voting common stock owned at October 31, 1970 and acquisitions of additional investments of the same class of stock after that date affect computations under the "grandfather clause" in section 1091.99?

.055 *Interpretation*—Sales after October 31, 1970 of investments in another corporation's voting common stock which was owned at that date are always considered as reductions of the common stock to which the "grandfather clause" in paragraph .99 applies, in other words, on a first-in, first-out basis. This reduction is made even though the common stock sold is identified as having been acquired after October 31, 1970.

.056 The "grandfather clause" in paragraph .99 does not apply to acquisitions after October 31, 1970 of voting common stock of the same class as was owned at that date. Any stock so acquired is therefore subject to the conditions of paragraphs .46-b and .47-b.

[Issue Date: April, 1971.]

17. Intercorporate Investment at 10/31/70

.057 *Question*—Section 1091.99 contains a "grandfather clause" which exempts minority interests held on October 31, 1970 from certain provisions of the section in business combinations initiated after that date. The paragraph is written in terms of an intercorporate investment owned by the corporation which effects the combination by issuing voting common stock. Does this paragraph also apply to stock of the issuing corporation which is owned by the other combining company on October 31, 1970? [As amended,

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effective November 1, 1975, by FASB Statement No. 10.] (See section 1092.)

.058 *Interpretation*—Paragraph .99 was intended to exempt intercorporate investments owned on October 31, 1970 by all of the parties to the business combination in the circumstances described. Thus, stock of the issuing corporation which is owned by the other combining company on October 31, 1970 may be ignored in computing the 90 per cent condition described in paragraph .47-b.

.059 For example, assume that on October 31, 1970 Baker Company owned 500,000 of the 3,000,000 shares of the voting common stock of Adam Corporation. Subsequently, Adam Corporation initiated a business combination by offering the stockholders of Baker Company one share of Adam common for each share of Baker common outstanding. The combination was consummated in a single transaction within one year after initiation. Of the 1,000,000 Baker common shares outstanding at initiation and consummation, 950,000 shares were tendered to Adam Corporation. Assume also that the combination meets all of the conditions of paragraphs .46 through .48 to be accounted for by the pooling of interests method except the conditions of paragraph .46-b (no more than 10 per cent intercorporate investments) and paragraph .47-b (the 90 per cent condition). [As amended, effective November 1, 1975, by FASB Statement No. 10.] (See section 1092.)

.060 Under paragraph .99 as interpreted here, the business combination may be accounted for by the pooling of interests method since the 500,000 Adam shares owned by Baker Company need not be considered in applying the conditions of paragraphs .46-b and .47-b. Under the pooling of interests method, the 500,000 Adam shares would become treasury stock of Adam Corporation as specified by paragraph .55.

[Issue Date: April, 1971.]

18. Wholly Owned Subsidiary

.061 *Question*—Section 1091.46a states that a wholly owned subsidiary may distribute voting common stock of its parent corporation in a "pooling" combination if its parent would have met all of the conditions in paragraphs .46-.48 had the parent issued its stock directly to effect the

combination. As a practical matter, a parent may be unable to own all of a subsidiary's stock. State laws generally require a certain number of the directors of a corporation to own some of the corporation's shares, so a parent would not legally own a few "qualifying directors' shares" registered in the names of "inside" directors. Also, even though a parent attempts to purchase all of a subsidiary's shares owned by outsiders, a few shareholders may never be located and others may refuse to sell their shares for a reasonable amount. If a parent company owns *substantially all* of the outstanding voting stock of a subsidiary, will the subsidiary be considered "wholly" owned for purposes of applying paragraph .46-a?

.062 *Interpretation*—Yes, a subsidiary is considered "wholly" owned under paragraph .46-a if its parent owns substantially all of the subsidiary's outstanding voting stock. The subsidiary may therefore "pool" with another company by distributing the parent company's voting common stock if the parent would have met the conditions of paragraphs .46-.48 in a direct issuance.

.063 What constitutes "substantially all" of a subsidiary's voting stock will vary according to circumstances. Generally, the shares not owned by the parent would be expected to be an insignificant number, such as qualifying directors' shares. A parent might also be considered as owning "substantially all" of a subsidiary's voting stock if the parent had attempted to buy all of the stock but some owners either could not be located or refused to sell a small number of shares at a reasonable price. In no case, however, would less than 90 percent be considered "substantially all" (see section 1091.47b) and generally the percentage would be expected to be much higher.

.064 The reason for using the subsidiary as the combining company would also be important in determining if "substantially all" of its voting stock is owned by the parent. A parent would be expected to own all but a few of its subsidiary's shares, other than qualifying directors' shares, in a combination in which either the parent or subsidiary could engage if the parent is to be considered as owning "substantially all" of its subsidiary's voting stock. A somewhat greater percentage of outside owner-

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ship would be acceptable in a combination between a subsidiary authorized to operate in a state where the parent is not authorized to operate and another company operating in that state. An even larger outside ownership (but not more than 10 percent) would be acceptable in a regulated industry (where a subsidiary in the industry—but not its parent outside the industry—could combine with another company in the industry) when a subsidiary engages in a combination that its parent could not undertake directly.

[Issue Date: September, 1971.]

19. Equity and Debt Issued for Common Before Pooling

.065 *Question*—Section 1091.47b states that the issuing corporation may exchange only voting common stock for outstanding equity and debt securities of the other combining company that have been issued in exchange for voting common stock of that company during a period beginning two years preceding the date a ''pooling'' combination is initiated. What is the purpose of this provision?

.066 *Interpretation*—Section 1091.47c prohibits accounting for a business combination by the pooling of interests method if equity and/or debt securities have been issued by a combining company in exchange for or to retire its voting common stock in contemplation of effecting the combination within two years before the plan of combination was initiated or between the dates of initiation and consummation. In paragraph .47-b, there is an implied presumption that all such transactions of the other combining company were made in contemplation of effecting a combination, thereby violating the condition of paragraph .47-c. However, the issuance of voting common stock of the issuing corporation to the holders of such equity and debt securities of the other combining company in exactly the same ratio as their former holdings of voting common stock of the other combining company will restore the holders of the securities to their former position and, hence, will ''cure'' the violation of the condition of paragraph .47-c.

[Issue Date: September, 1971.]

20. Treasury Stock Allowed with Pooling

.067 *Question*—Section 1091.47d states as a condition for "pooling" that each of the combining companies may reacquire shares of voting common stock (as treasury stock) only for purposes other than business combinations. Also, paragraphs .47-c and .47-d of section 1091 include provisions related to the reacquisition of treasury stock within two years prior to initiation and between initiation and consummation of a business combination which is planned to be accounted for by the pooling of interests method. For what purposes may treasury stock be reacquired during this period?

.068 *Interpretation*—The statement "for purposes other than business combinations" means combinations initiated under section 1091 which are to be accounted for by the pooling of interests method. Therefore, acquisitions of treasury stock for specific purposes that are not related to a particular business combination which is planned to be accounted for by the pooling of interests method are not prohibited by the conditions of either paragraph .47-c or .47-d.

.069 In the absence of persuasive evidence to the contrary, however, it should be presumed that all acquisitions of treasury stock during the two years preceding the date a plan of combination is initiated (or from October 31, 1970 to the date of initiation if that period is less than two years) and between initiation and consummation were made in contemplation of effecting business combinations to be accounted for as a pooling of interests. Thus, lacking such evidence, this combination would be accounted for by the purchase method regardless of whether treasury stock or unissued shares or both are issued in the combination.

.070 The specific purposes for which treasury shares may be reacquired prior to consummation of a "pooling" include shares granted under stock option or compensation plans, stock dividends declared (or to be declared as a recurring distribution), and recurring distributions as provided in paragraph .47-d. Likewise, treasury shares reacquired for issuance in a specific "purchase" or to resolve an existing contingent share agreement from a prior business combination would not invalidate a concurrent "pool-

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ing." Treasury shares reacquired for these purposes should be either reissued prior to consummation or specifically reserved for these purposes existing at consummation.

.071 To the extent that treasury shares reacquired within two years prior to initiation or between initiation and consummation have not been reissued or specifically reserved, an equivalent number of shares of treasury stock may be sold prior to consummation to "cure" the presumed violation of paragraphs .47-c and .47-d. If the number of shares not reserved or disposed of prior to consummation of a combination is material in relation to the number of shares *to be issued* to effect the combination, the combination should be accounted for by the purchase method.

.072 Treasury shares reacquired more than two years prior to initiation may be reissued in a "pooling." Also, "tainted" treasury shares purchased within two years prior to initiation or between intiation and consummation and not disposed of or reserved may be reissued in a "pooling" if not material in relation to the total number of shares issued to effect the combination. Treasury shares reissued in a "pooling" should be accounted for as specified in section 1091.54.

.073 It should be noted that earnings and market price contingencies were permitted in both "purchases" and "poolings" under "old rules." These contingencies in a combination consummated under section 1091 require the combination to be accounted for as a "purchase." Although "liability-type" contingencies may exist in a "pooling" as specified in paragraph .47-g, treasury stock may not be reacquired to satisfy such a contingency.

[Issue Date: September, 1971.]

21. Pooling with "Bailout"

.074 *Question*—Section 1091.48a specifies that a combined corporation may not agree to directly or indirectly retire or reacquire all or part of the common stock issued to effect a business combination and paragraph .48-b specifies that a combined corporation may not enter into financial arrangements for the benefit of the former stockholders of a combining company if a business combination

is to be accounted for by the pooling of interests method. Would an arrangement whereby a third party buys all or part of the voting common stock issued to stockholders of a combining company immediately after consummation of a business combination cause the combination to not meet these conditions?

.075 *Interpretation*—The fact that stockholders of a combining company sell voting common stock received in a business combination to a third party would not indicate failure to meet the conditions of paragraphs .48-a and .48-b. "Continuity of ownership interests," a criterion for a pooling of interests under ARB No. 48, is *not* a condition to account for a business combination by the pooling of interests method under section 1091. The critical factor in meeting the conditions of paragraphs .48-a and .48-b is that the voting common stock issued to effect a business combination remains outstanding outside the combined corporation without arrangements on the part of any of the corporations involving the use of their financial resources to "bailout" former stockholders of a combining company or to induce others to do so.

.076 Either the combined corporation or one of the combining companies may assist the former stockholders in locating an unrelated buyer for their shares (such as by introductions to underwriters) so long as compensation or other financial inducements from the corporation are not in some way involved in the arrangement. If unregistered stock is issued, the combined corporation may also agree to pay the costs of initial registration.

[Issue Date: September, 1971.]

22. Disposition of Assets to Comply with an Order

.077 *Question*—As a condition to account for a business combination by the pooling of interests method, section 1091.48c prohibits the planned disposal of a significant part of the assets of the combining companies within two years after the consummation date other than disposals in the ordinary course of business and eliminations of duplicate facilities or excess capacity. Likewise, paragraph .47-c prohibits a change in the equity interests of the voting common stock—such as through the "spin-off" of a division or a subsidiary—in contemplation of effecting a "pooling"

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combination either within two years before initiation or between initiation and consummation. Does a prior or a planned disposition of a significant part of the assets of a combining company to comply with an order of a governmental authority or judicial body constitute a violation of this condition?

.078 *Interpretation*—No. The prior or planned disposition of a significant part of the assets of a combining company (even though in contemplation of effecting or planned subsequent to a combination) does not negate accounting for a business combination as a "pooling" if the disposition is undertaken to comply with an order of a governmental authority or judicial body or to avoid circumstances which, on the basis of available evidence, would result in the issuance of such an order. This is generally consistent with paragraph .46-a (autonomy of combining companies) which permits subsidiaries disposed of in compliance with an order of a governmental authority or judicial body to be considered autonomous for purposes of that condition.

.079 Any gain or loss resulting from a disposal within two years after consummation of a pooling of interests should be accounted for in accordance with sections 1091.59-.60.

[Issue Date: September, 1971.]

23. Retroactive Disclosure of Pooling

.080 *Question*—Section 1091.61 specifies that a business combination accounted for by the pooling of interests method should be recorded as of the date the combination is consummated. This paragraph prohibits a combining company from retroactively reflecting in the financial statements for the current year a combination consummated after the close of the year but before financial statements are issued. However, this paragraph requires a corporation to disclose *as supplemental information, in notes to financial statements or otherwise, the substance of a combination consummated before financial statements are issued and the effects of the combination on reported financial position and results of operations.* Could this disclosure be in the form of a statement with side-by-side columns reporting financial data for (1) the issuing corporation and (2) the

combined corporations, and, perhaps, (3) the other combining company?

.081 *Interpretation*—Section 1091 does not prohibit the side-by-side columnar format described above, nor alternatively, does it prohibit an above-and-below columnar format. The term *or otherwise* included in paragraph .61 is sufficiently broad to permit disclosure of the information on the face of the financial statements in either side-by-side or above-and-below columns.

.082 Because section 1091 prohibits retroactive pooling for a combination completed after the close of the year but before the financial statements are issued, however, the individual columns in the presentation should be separately identified as primary or supplemental information. That is, data for the issuing corporation would be identified as the primary financial statements and data for the combined corporation would be identified as supplemental information. If presented, data for the combining company would also be identified as supplemental information.

.083 It might be noted that a side-by-side presentation will disclose information in greater detail than is required by paragraph .65 (which requires that only revenue, net income, earnings per share and the effects of anticipated changes in accounting methods be disclosed as if the combination had been consummated at the date of the financial statements). Although both paragraphs .61 and .65 specify disclosure in *notes* to the financial statements and paragraph .65 specifies only *note* disclosure without the *or otherwise* provision, this paragraph refers back to paragraph .61 so the columnar format is not prohibited by paragraph .65 as long as the information is properly identified as primary and supplemental.

.084 Information for the combined corporation identified as supplemental information (as described above) would be reported as primary information in statements for the following period when the combination was consummated if comparative financial statements are presented. Reporting and disclosure requirements for the period when a business combination is consummated and for prior periods are contained in paragraphs .51-.58, .63 and .64.

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.085 Notes to the statements and other disclosures which are included in the statements are a part of the financial statements. Accordingly, the auditor's opinion—unless appropriately modified—would apply to disclosure (in notes to the statements or in columnar format) of the substance of a combination consummated after the close of the year but before the financial statements were issued. The auditor's opinion might be modified, however, to disclaim an opinion on the supplemental information if it had not been included in the auditor's examination.

[Issue Date: September, 1971.]

24. "Grandfather" for Subsidiaries

.086 *Question*—Section 1091.46a prohibits use of pooling accounting for a business combination initiated after October 31, 1970 (the effective date of section 1091) which involves an entity which was a "subsidiary." However, notes to APB Opinions state that they are not intended to be retroactive. Section 1091.46a appears to impose a retroactive effect on subsidiaries with significant minority interests that may have been considering engaging in pooling combinations. Was this intended?

.087 *Interpretation*—Section 1091.46a was not intended to have the retroactive effect described above. Subsidiaries which had a *significant* outstanding minority interest at October 31, 1970 may take part in a pooling combination providing the significant minority also exists at the initiation of the combination. In addition, the combination must meet all of the other pooling conditions specified in sections 1091.46 through 1091.48 both directly and indirectly (i. e., the parent company cannot take actions on behalf of the subsidiary that the subsidiary could not take itself). [As amended, effective November 1, 1975, by FASB Statement No. 10.] (See section 1092.)

.088 For purposes of this Interpretation, a significant minority means that at least 20 percent of the voting common stock of the subsidiary is owned by persons not affiliated with the parent company.

.089 This "grandfathering" is consistent with section 1091.99 and applies both to combinations where the subsidiary with a significant minority interest is the issuing

corporation and those where it is the other combining company. However, it does not permit a pooling between a subsidiary and its parent.

[Issue Date: November, 1971.]

25. All Shares Must Be Exchanged to Pool

.090 *Question*—Section 1091.47b specifies that an issuing corporation must exchange only voting common stock for at least 90 percent of the voting common stock interest of a combining company to account for the combination as a pooling of interests. Section 1091.47 permits cash or other consideration to be exchanged for the remaining shares or they may continue outstanding as a minority interest. Under section 1091.47b, assuming the issuing corporation exchanges common stock for at least 90 percent of the common stock of the combining company, may an individual common shareholder of the combining company exchange some of his shares for shares of the issuing corporation and either retain the balance of his shares or sell the shares to the issuing corporation for cash?

.091 *Interpretation*—If a business combination is to be accounted for as a pooling of interests, each common shareholder of the combining company must either agree to exchange *all* of his shares for common shares of the issuing corporation or refuse to exchange *any* of his shares.

.092 It would be contrary to the "pooling" concept expressed in section 1091 for an individual shareholder of a combining company to exchange some of his shares and keep some of his shares in a pooling of interests or for the issuing corporation to exchange common stock for some of an individual shareholder's shares and pay cash for some of his shares. The "pooling" concept would be violated in these cases even though the issuing corporation exchanged its common stock for at least 90 percent of the common stock of the combining company as required by section 1091.47b.

.093 Theoretically two or more *entire* common stockholder groups join together as a single entity in a pooling of interests to share the combined risks and rights represented by the previously independent interests without the distribution of corporate assets to *any* of the common stock-

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holders (see section 1091.45). Section 1091.46 states as an attribute of "pooling" that independent ownership interests are combined in their entirety. Section 1091.46 indicates that combining only selected assets or ownership interests would be more akin to disposing of or acquiring interests than to sharing rights and risks. Section 1091.47 states that acquisitions of common stock for assets or debt and other transactions that reduce the common stock interest are contrary to the idea of combining existing stockholder interests.

.094 Section 1091 permits the theoretical concept of "pooling" to be modified only within strict limits to accommodate practical obstacles that may be encountered in many combinations. Thus, the 90 percent "test" in section 1091.47b recognizes that, as a practical matter, some shareholders of a combining company may refuse to exchange their shares even though most shareholders agree to a combination.

.095 Section 1091.47b permits cash or other consideration to be distributed by the issuing corporation for shares held by these dissenting shareholders of the combining company. However, a shareholder who assents to exchange part of his shares can hardly be considered a dissenting shareholder.

.096 In addition, the exchange by an individual shareholder of a combining company of only part of his shares for common stock of the issuing corporation would not meet section 1091.47e. Section 1091.47e states that each individual shareholder who exchanges his stock must receive a voting common stock interest in proportion to his relative voting common stock interest in the combining company before the combination.

.097 Usually the determination of whether or not a shareholder of a combining company is exchanging all of his shares for common stock of the issuing corporation will be made at consummation. However, transactions prior to consummation between the issuing corporation and a shareholder of a combining company who exchanges shares at consummation may also preclude a "pooling." In the absence of persuasive evidence to the contrary, it should be presumed that the purchase was made in contemplation of

effecting the combination (see section 1091.47c) if the issuing corporation purchased shares of a combining company within two years prior to initiation and before consummation from a shareholder who also exchanges shares at consummation.

.098 To overcome another purely practical problem, section 1091.47b also allows cash or other consideration to be distributed by the issuing corporation in lieu of fractional shares. There is no essential difference between the payment of cash to a common shareholder for a fraction of a share and the payment of cash for some of his shares. Therefore, the payment of more than a reasonable amount of cash to a shareholder for a fractional share would also be contrary to the "pooling" concept expressed in section 1091. Thus, the payment for fractional shares among shareholders must be reasonable in amount and should be proportional to each shareholder's fractional share interest.

[Issue date: November, 1971.]

26. Acquisition of Minority Interest

.099 *Question*—How should a corporation account for the acquisition of all or part of the minority interest of a subsidiary?

.100 *Interpretation*—Section 1091.05 states, "The acquisition of some or all of the stock held by minority shareholders of a subsidiary is not a business combination, but paragraph .43 of this section specifies the applicable method of accounting." Paragraph .43 states that the acquisition of some or all of the stock held by minority stockholders of a subsidiary—whether acquired by the parent, the subsidiary itself, or another affiliate—should be accounted for by the purchase method. Thus, purchase accounting applies when (a) a parent exchanges its common stock or assets or debt for common stock held by minority shareholders of its subsidiary, (b) the subsidiary buys as treasury stock the common stock held by minority shareholders, or (c) another subsidiary of the parent exchanges its common stock or assets or debt for common stock held by the minority shareholders of an affiliated subsidiary.

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.101 In addition, section 1091.46b precludes pooling when the combining companies hold as intercorporate investments more than 10 percent of the outstanding voting common stock of any combining company (except when section 1091.99 applies, as discussed later). Therefore, pooling is precluded in the exchange by a subsidiary of its common stock for the outstanding voting common stock of its parent (usually referred to as a "downstream merger"). Instead, purchase accounting applies and the transaction should be accounted for as if the parent had exchanged its common stock for common stock held by minority shareholders of its subsidiary. (Whether a parent acquires the minority or a subsidiary acquires its parent, the end result is a single shareholder group, including the former minority shareholders, owning the consolidated net assets.) The same would be true if a new corporation exchanged its common stock for the common stock of the parent and the common stock of the subsidiary held by minority shareholders.

.102 An exception to the requirement for purchase accounting in the acquisition of a minority interest may exist in some rare cases under section 1091.99. This paragraph permits pooling accounting to be elected on a "grandfather" basis under certain conditions, one condition being a combination in which one corporation owns no more than 50 percent of the voting *common* stock of the other combining company. Since a parent company may control a subsidiary even though the parent owns less than 50 percent of the subsidiary's voting common stock (e.g., by owning voting preferred stock in addition to voting common stock—see section 2051.03), the exchange by the parent of its voting common stock for the voting common stock of the subsidiary owned by outsiders could qualify for pooling accounting. However, it should be noted that section 1091.99 would require the parent to allocate the excess of the cost of its previously existing investment over its proportionate equity in the subsidiary's net assets to the subsidiary's identifiable assets (and to goodwill, if any) based on fair values at the consummation date.

[Issue Date: December, 1971]

27. Entities Under Common Control in a Business Combination

.103 *Question*—Section 1091.05 states that the provisions of section 1091 should be applied as a general guide in a business combination involving one or more unincorporated businesses. Section 1091.46a requires that each company in a pooling be autonomous and have not been a subsidiary or division for two years prior to initiation. How does section 1091 apply to a combination involving one entity controlled by one or a few individuals who control several other entities?

.104 *Interpretation*—A proprietorship or a partnership may be a party to a business combination accounted for under section 1091 as stated in the first sentence of section 1091.05. Many of these entities are very similar, except for legal form of organization, to a closely held corporation. Often a single individual may own one or more proprietorships and also may own the controlling interest in one or more corporations and in addition may have an interest in one or more partnerships.

.105 Considerable judgment will usually be required to determine the substance of a combination involving one (or more) of several companies under common control. For example, it may be necessary to look beyond the form of the legal organizations to determine substance when an unincorporated business or a closely held corporation owned by one or a few individuals who also control other entities is involved since the dividing lines may not be as "sharp" as they would be in publicly held corporations with wide ownership interests.

.106 An individual who owns two separate businesses organized as corporations theoretically is a "parent" with two "subsidiaries." The same would be true if the businesses were organized as two proprietorships or as one proprietorship and one corporation. To apply section 1091.46a to a combination involving one of these businesses, however, the relationship between the two businesses is more important than the fact that each business is theoretically a subsidiary, because section 1091.46a precludes fragmenting a business and pooling only a part of the business. The following examples demonstrate these points.

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.107 If both businesses are grocery stores, a combination involving only *one* business should presumably be accounted for as a purchase because the two stores presumably are part of a single kind of business and the two separate legal organizations should be ignored.

.108 On the other hand, if one business is a grocery store and the other is an automobile dealership, a combination involving only one business would be accounted for as a pooling of interests if all other conditions of sections 1091.46-.48 are met because the individual is operating two unrelated businesses. In these examples, a "line of business" is an indicator of a single business.

.109 Also, a combination involving two or more businesses owned by one individual must be accounted for by a single method. For example, if both the grocery store and the automobile dealership are to be combined with another unrelated company, one could *not* be a purchase and the other a pooling. (Section 1091.47b discusses a combination of more than two companies and section 1091.43 states the two methods are not alternatives in accounting for the same combination.)

.110 In general, the same guidelines apply to a business with a few owners rather than an individual owner. They would apply, for example, to two partnerships having the same partners, two closely held corporations having the same stockholders, or to a partnership and a closely held corporation whose stockholders are the partners in the partnership. If the various individuals are all members of one family, the effect may be the same (but is not always the same) as if there were only an individual owner rather than several partners and/or several stockholders.

.111 Because the ratios of ownership of the different businesses may differ or the ownership groups may overlap but be different, however, several owners of different businesses create complexities which are not present if there is a single owner. Because of the diversity of the situations which might be encountered in practice, stating guidelines beyond those given above is impossible.

[Issue Date: December, 1971]

28. Pooling by Subsidiary of Personal Holding Company

.112 *Question*—A single individual may control other corporations (for federal income tax reasons) through a personal holding company. Section 1091.46a requires that each company in a pooling be autonomous and have not been a subsidiary or division for two years prior to the initiation of a combination. Does this preclude a pooling by a corporation which is controlled by a personal holding company?

.113 *Interpretation*—The legal form may sometimes be ignored in a combination involving a subsidiary of a personal holding company. Under section 1091.46a a personal holding company is technically a parent corporation and the corporations it controls are technically subsidiaries. In many cases, a parent-subsidiary relationship does in fact exist and should be considered as such in applying section 1091.46a if the personal holding company or any of its subsidiaries is involved in a business combination.

.114 In other cases, a personal holding company is a convenience established for federal income tax reasons and the various "subsidiaries" are in fact operated by the "owners" as if the personal holding company did not exist. In a combination involving such a "subsidiary," the personal holding company may be disregarded and the various "subsidiaries" considered autonomous in applying section 1091.46a. However, the guidelines described in Accounting Interpretation No. 27, "Entities Under Common Control in a Business Combination," should be applied in determining the appropriate method of accounting for the combination and all other conditions of sections 1091.46-.48 must be met in a pooling.

[Issue Date: December, 1971]

29. Option May Initiate Combination

.115 *Question*—Section 1091.46a specifies the requirements for initiation of a business combination. Does an option to exchange substantially all of their shares at a future date (for example, three years hence) granted by the shareholders of a closely held company to another company constitute the initiation of a business combination?

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.116 *Interpretation*—An option that *requires* unilateral performance by either party or bilateral performance by both parties constitutes initiation. Thus, if one company is required to issue stock upon the tendering of shares by the shareholders of another company or if the shareholders are required to tender their shares upon demand, the date the option is granted is the initiation date. The combination must be consummated within one year thereafter to be accounted for by the pooling of interests method (see section 1091.47a).

.117 However, an agreement which grants only the right of "first refusal" does not constitute initiation. This would be the case, for example, where the stockholders of a closely held company agree to negotiate with one company before negotiating with any other company if the shareholders should in the future decide to consider entering into a business combination. Neither party may be obligated to perform, however, or to pay damages in the absence of performance.

.118 The payment of cash or other consideration by either company for a "first refusal" agreement would also be contrary to the pooling concept expressed in section 1091. Individual shareholders, however, may pay cash to obtain the agreement so long as company resources are not directly or indirectly involved.

[Issue Date: December, 1971]

30. Representations in a Pooling

.119 *Question*—Section 1091.47g specifies that in a business combination accounted for as a pooling of interests there can be no agreement to contingently issue additional shares of stock or other consideration at a later date and no escrowing of shares until a contingency is resolved. This paragraph allows, however, revision of the number of shares issued upon the settlement of a contingency at an amount different from that recorded by a combining company. May an issuing company reserve or escrow some shares against the representations of the management of a combining company in a pooling?

.120 *Interpretation*—Section 1091.47g is intended to require purchase accounting when an earnings or market

price contingency agreement is present in a business combination. However, this paragraph does not prohibit certain kinds of contingency agreements in a pooling so long as they provide for the sharing of rights and risks arising after consummation and are not in effect earnings or market price contingency agreements.

.121 A contingency agreement which is not prohibited in a pooling may provide for the reservation by the issuing company of a portion of the shares being issued, the issuance of additional shares, the return of shares by former shareholders of the combining company, or the issuance of shares to an escrow agent who will subsequently transfer them to the former shareholders of the combining company or return them to the issuing company. (Note that the former shareholders of the combining company must be able to vote any shares issued, reserved, or escrowed to meet the condition of section 1091.47f.)

.122 The most common type of contingency agreement *not* prohibited in a pooling by section 1091.47g is the "general management representation" which is present in nearly all business combinations. In such a representation, management of a combining company typically warrants that the assets exist and are worth specified amounts and that all liabilities and their amounts have been disclosed. The contingency agreement usually calls for an adjustment in the total number of shares exchanged up to a relatively small percentage (normally about 10 percent) for variations from the amounts represented, but actual adjustments of the number of shares are rare.

.123 A contingency agreement for a "general management representation" does not violate section 1091.47g if it provides for a substantial sharing of rights and risks beginning with consummation and the complete sharing within a reasonable period of time. In this light, the contingency agreement is merely a device to provide time for the issuing company to determine that the representations are accurate so it does not share risks arising prior to consummation. Although the time required will vary with circumstances, these determinations should be completed within a few months following consummation of the combination. In any case, the maximum time should not extend

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beyond the issuance of the first independent audit report on the company making the representations following consummation of the combination. Thereafter, the combined shareholder interests share the risks of inventory obsolescence, collection of receivables, etc. However, if the complete sharing of risks is unduly delayed or if the risk sharing is not substantial at consummation, a "general management representation" may in effect indicate an earnings contingency agreement.

.124 Section 1091.47g specifically allows certain contingency agreements in a pooling to cover specific situations whose outcome cannot be reasonably determined at consummation and perhaps even for several years thereafter. Although management of a combining company may make specific representations as to these contingencies that are known at the consummation of a pooling and as to those which may arise within a reasonable period thereafter, the combined shareholder interests are expected to share the risks and rights of all other contingencies if section 1091.47g is to be met. Likewise, the former shareholders of a combining company must be able to vote any shares issued, reserved, or escrowed for a specific contingency until it is finally resolved if section 1091.47f is to be met. The contingency agreement may provide, however, that any dividends during the contingency period on contingent shares "follow" the shares when the contingency is resolved.

.125 It should also be noted that any change in the number of shares (as originally recorded for a pooling of interests) upon the final resolution of either a general or a specific representation contingency is recorded as an adjustment to stockholders' equity (see section 1091.53). The effect of the resolution of a contingency involving an asset or liability, whether or not previously recorded,

→ *The next page is 12,633-3.* ←

is reflected currently in net income or as a prior period adjustment in accordance with section 2014. In no case may a contingency agreement for either a general or a specific representation in a pooling be used as a means of relieving current or prior net income of an amount which should be reflected therein. [As amended, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.] (See section 2014.)

[Issue Date: December, 1971]

31. Employment Contingencies in a Pooling

.126 *Question*—Section 1091.47g stipulates that in a business combination accounted for as a pooling of interests there can be no agreement for contingent issuance of additional shares of stock or distribution of other consideration to the former stockholders of a combining company. Would the granting of an employment contract or a deferred compensation plan by the combined corporation to former stockholders of a combining company cause this condition to not be met?

.127 *Interpretation*—An employment contract or a deferred compensation plan granted by the combined corporation to former stockholders of a combining company would not automatically constitute failure of section 1091.47g. The critical factors would be the reasonableness of the arrangement and restriction of the arrangement to continuing management personnel. Generally, reasonable contracts or plans entered into for valid business purposes would meet section 1091.47g. Substance, however, is more important than form.

.128 As an example, the granting of employment contracts to former stockholders of a combining company who were active in its management and who will be active in management of the combined corporation would meet section 1091.47g if the contracts are reasonable in relation to existing contracts granted by the issuing corporation to its management. However, the granting of employment contracts to former stockholders of a combining company who were not or will not be active in management probably indicates a contingent pay-out arrangement. Likewise,

"consultant" contracts for former stockholders might also indicate a contingent pay-out arrangement.

.129 Employment contracts and deferred compensation plans entered into by a combining company between the initiation and consummation dates may also cause a business combination to not meet section 1091.47g. For example, a combining company may not enter into a "contingency-type" compensation agreement *in contemplation* of the combination and meet section 1091.47g if the issuing corporation could not also enter into the same agreement under the paragraph.

[Issue Date: December, 1971]

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32. Stock Options in a Pooling

.130 *Question*—Section 1091.47g states that in a business combination accounted for as a pooling of interests the combined corporation may not agree to contingently issue additional shares of stock to the former stockholders of a combining company. Would this condition be violated if the combined corporation granted stock options to these stockholders?

.131 *Interpretation*—Generally, stock options granted by the combined corporation as current compensation to former stockholders of a combining company would not violate section 1091.47g. That is, the former stockholders of a combining company who are employees or directors of the combined corporation may participate in a stock option plan adopted by the combined corporation for its employees and/or directors.

.132 Section 1091.47g would be violated, however, if the stock option plan in reality is an arrangement to issue additional shares of stock at a relatively low cost to these former stockholders of the combining company to satisfy a contingency agreement. Also, a stock option plan to accomplish the same result adopted by the combining company prior to consummation but *in contemplation* of the combination would not meet sections 1091.47c and 1091.47g.

[Issue Date: December, 1971]

33. Costs of Maintaining an "Acquisitions" Department

.133 *Question*—A corporation maintains an "acquisitions" department to find, evaluate, and negotiate with possible merger candidates. The president of the corporation also spends a considerable portion of his time negotiating business combinations. Cost records are excellent and the total cost is determined for each investigation and negotiation, whether it is successful or unsuccessful. What accounting is specified by section 1091 for these costs?

.134 *Interpretation*—All "internal" costs associated with a business combination are deducted *as incurred* in determining net income under section 1091. This answer applies to costs incurred for both "poolings" (see section 1091.58) and "purchases" (see section 1091.76). Naturally, costs incurred in unsuccessful negotiations are also deducted as incurred.

.135 Section 1091.76 specifies that in a business combination accounted for by the purchase method the cost of a company acquired includes the *direct* costs of acquisition. These direct costs, however, are "out-of-pocket" or incremental costs rather than recurring internal costs which may be directly related to an acquisition. The direct costs which are capitalized in a purchase therefore include, for example, a finder's fee and fees paid to outside consultants for accounting, legal, or engineering investigations or for appraisals, etc. All costs related to effecting a pooling of interests, including the direct costs listed above, are charged to expense as specified in section 1091.58.

[Issue Date: December, 1971]

34. Forced Sale of Stock

.136 *Question*—A publicly held corporation wants to effect a business combination with a large closely held corporation and to account for the combination as a pooling of interests. Because management of the publicly held corporation prefers not to have a single stockholder owning a large block of its stock, the agreement to combine requires the majority stockholder of the closely held corporation to sell 25 percent of the voting common stock he receives immediately following consummation and to sell another 25 percent within one year thereafter. The stock is to be sold in public offerings and all of the shares will remain outstanding outside the combined corporation. Since section 1091 does not have the "continuity of ownership interests" criterion of ARB No. 48 as a condition for pooling, should this combination be accounted for as a pooling of interests or as a purchase?

.137 *Interpretation*—The combination is a purchase because of the *requirement* imposed on a shareholder to sell some of the voting common stock received. Any requirement imposed on a stockholder (other than by a government authority) either *to sell* or *to not sell* stock received in a business combination is contrary to the pooling concept expressed in section 1091 of the sharing of rights and risks by the previously independent stockholder interests. While such a requirement does not violate any spe-

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cific condition for pooling described in sections 1091.46-48, it violates the whole pooling concept of section 1091.

[Issue Date: January, 1972]

35. Registration Costs in a Purchase

.138 *Question*—If a company issues previously *registered* equity securities in a business combination accounted for by the purchase method, the fair value of the securities issued is credited to the capital accounts of the issuing corporation. However, if the securities issued have not been previously registered, section 1091.76 specifies that the costs of registering and issuing equity securities are a reduction of the otherwise determinable fair value of the securities. How should a corporation account for the costs of a registration which will not be undertaken until after the securities are issued?

.139 *Interpretation*—A publicly held company issuing *unregistered* equity securities in an acquisition with an agreement for subsequent registration should credit the fair value of the securities (the otherwise determinable fair value less registration costs) to its capital accounts. The present value of the estimated costs of registration should be accrued as a liability at the date of acquisition (see section 1091.88h) with an immediate charge to the assets acquired (in most cases, to "goodwill"). Any difference between the actual costs of registration and the amount accrued at the payment date (the original accrual plus imputed interest) would be an adjustment to the recorded goodwill. Total assets (including goodwill) and total capital will thereby be recorded at the same amounts as if previously registered securities had been issued except for any difference in fair value ascribed to restrictions prohibiting sale of the securities at time of issuance.

.140 Agreements for the subsequent registration of unregistered securities issued in business combinations often specify that the securities will be registered "piggyback" (that is, included in the registration of a planned future offering of other securities). In such a case, only the incremental costs of registering the equity securities issued in the acquisition would be accrued or subsequently charged to "goodwill" as described above and amortized

prospectively over the remaining term of the period of amortization of the initial goodwill.

[Issue Date: January, 1972]

36. No Pooling with Wholly Owned Sub

.141 *Question*—Company A initiated a combination by making a tender offer for Company B which was at the time an independent company. Company C, which owned a large interest in, but not control of, Company B, subsequently and without Company A's knowledge purchased all of the remaining outstanding voting common stock of Company B and operated Company B as a wholly owned subsidiary. Within one year of the date Company A made the tender offer, Company C tendered all of the voting common stock of Company B to Company A in exchange for voting common stock of Company A at the ratio of exchange of the tender offer. Section 1091.46a generally precludes accounting for a business combination by the pooling of interests method if one of the combining companies has been a subsidiary of another corporation within two years prior to initiation of the combination. Does the fact that Company B became a wholly owned subsidiary of Company C following initiation of the combination by Company A preclude pooling in this case?

.142 *Interpretation*—Yes, pooling is precluded and Company A should account for the combination as a purchase. (Company C, in effect, sold its wholly owned subsidiary B to Company A.) Section 1091.46a provides that a wholly owned subsidiary may pool only by distributing the stock of its parent company.

.143 Although section 1091.46a refers to not being a subsidiary "within two years before the plan of combination is initiated," the intent of the paragraph is that a combining company in a pooling has not been a subsidiary during a period beginning two years prior to initiation and ending at consummation of a combination.

[Effective for combinations consummated after May 31, 1972]

37. Combination Contingent on "Bailout"

.144 *Question*—Accounting Interpretation No. 21, section U1091.074-.076, "Pooling with 'Bailout'," issued in

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September 1971 indicates that former shareholders of a combining company may sell voting common stock received in a business combination accounted for as a pooling of interests. Would the accounting for a combination be affected by the fact that its consummation is contingent upon the purchase by a third party or parties of all or part of the voting common stock to be issued in the combination?

.145 *Interpretation*—Yes. A business combination should be accounted for as a purchase if its consummation is contingent upon the purchase by a third party or parties of *any* of the voting common stock to be issued. This would be the case, for example, if the parties to the combination have agreed that consummation of the combination will not occur until there is a commitment by a third party for a private purchase, a firm public offering, or some other form of a guaranteed market for all or part of the shares to be issued. Including such a contingency in the arrangements of the combination, either explicitly or by intent, would be considered a financial arrangement which is precluded in a pooling by section 1091.48(b).

.146 It should be noted that this accounting interpretation does not modify the previous interpretation, "Pooling with 'Bailout'," which states that shareholders may sell stock received in a pooling and that the corporation may assist them in locating an unrelated buyer for their shares. Although shareholders may sell stock received in a pooling, consummation of the business combination must first occur without regard to such a sale and cannot be contingent upon a firm commitment by the potential purchaser of the shares to be issued.

[Issue Date: November, 1972]

38. Several Companies in a Single Business Combination

.147 *Question*—How does section 1091 apply when more than two companies are involved in a single business combination?

.148 *Interpretation*—When more than two companies negotiate a combination which is contingent upon the mutual agreement by the several companies to the terms, the resulting combination is deemed a single business combination regardless of the number of companies involved. Each

company must meet all of the conditions of section 1091.46-.48 if the combination is to be accounted for by the pooling of interests method. In particular, sections 1091.46b and 1091.47b specify how the 10 percent and 90 percent tests should be made when more than two companies are involved in a single combination.

.149 Section 1091.43 specifies that a single method should be applied to account for an entire combination. Therefore, if any condition in section 1091.46-.48 is not met by any company, the entire combination would be accounted for by the purchase method.

.150 However, it should be noted that a corporation may be involved in more than one business combination at the same time and that different methods of accounting may apply to the different combinations.

[Issue Date: March, 1973]

39. Transfers and Exchanges Between Companies Under Common Control

.151 *Question*—Section 1091.05 states section 1091 does not apply to a transfer of net assets or to an exchange of shares between companies under common control. What are some examples of the types of transactions excluded from section 1091 by this provision and what accounting should be applied?

.152 *Interpretation*—In general, section 1091.05 excludes transfers and exchanges that do not involve outsiders. For example, a parent company may transfer the net assets of a wholly owned subsidiary into the parent company and liquidate the subsidiary, which is a change in legal organization but not a change in the entity. Likewise, a parent may transfer its interest in several partially owned subsidiaries to a new wholly owned subsidiary, which is again a change in legal organization but not in the entity. Also, a parent may exchange its ownership or the net assets of a wholly owned subsidiary for additional shares issued by the parent's partially owned subsidiary, thereby increasing the parent's percentage of ownership in the partially owned subsidiary but leaving all of the existing minority interest outstanding.

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.153 None of the above transfers or exchanges is covered by section 1091. The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting.

.154 It should be noted, however, that purchase accounting applies when the effect of a transfer or exchange is to acquire all or part of the outstanding shares held by the minority interest of a subsidiary (see section 1091.43). The acquisition of all or part of a minority interest, however acquired, is never considered a transfer or exchange by companies under common control. (See Interpretation No. 26, section U1091.099-.102, "Acquisition of Minority Interest.")

[Issue Date: March, 1973]

The next page is 12,701.

AC Section U2010

Reporting the Results of Operations: Accounting Interpretations of Section 2010

1. Losses Caused by Bankruptcies

.001 *Question*—Recent railroad bankruptcies raise the question of whether companies holding receivables from these railroads should account for losses arising from charging off such assets as ordinary losses or as extraordinary losses in determining net income. The Interstate Commerce Commission has ruled that railroads must write off certain past due payments from other railroads (e. g., interline receivables) as extraordinary losses. Is this accounting treatment appropriate in the annual reports to railroads' shareholders and in the annual reports to shareholders of other (nonrailroad) companies?

.002 *Interpretation*—No, section 2012.23 specifies that losses from receivables do *not* constitute extraordinary losses. The fact that the loss arises from a receivable from a company in bankruptcy proceedings does not alter this answer in any way. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

.003 Regulatory authorities often rule on the accounting treatment to be applied by companies under their jurisdiction. The above question is covered by section 6011.03-.04. An auditor should in his opinion take an exception to any loss from an interline receivable classified as an extraordinary item in a railroad's annual report to shareholders.

[Issue Date: February, 1971.]

→ *The next page is 12,751.* ←

AC Section U 2011

Computing Earnings per Share: Accounting Interpretations of Section 2011, Earnings per Share*

Issue date, unless otherwise indicated: July, 1970

INTRODUCTION

Comparison of APB Opinion No. 9 and Section 2011

.001 Section 2011, *Earnings per Share,* is an extension of the issues discussed in Part II, ''Computation and Reporting of Earnings Per Share,'' of APB Opinion No. 9.

.002 APB Opinion No. 9 included certain ''residual'' securities as the equivalent of common stock in earnings per share computations, established ''supplementary pro forma'' earnings per share for reporting what the effect on earnings per share would have been if all residual and contingently issuable securities had been issued, and strongly recommended that both earnings per share and supplementary pro forma earnings per share be disclosed in the income statement.

.003 Section 2011 supersedes Part II of APB Opinion No. 9, modifies the concept of residual securities and replaces the term *residual securities* with the new designation *common stock equivalents.* Under section 2011, dilutive common stock equivalents are included with outstanding common stock in computing ''primary'' earnings per share. Common stock, dilutive common stock equivalents and other potentially dilutive securities are included in computing ''fully diluted'' earnings per share.

.004 Section 2011 requires that earnings per share be presented on the face of corporate income statements or summaries of such statements with both the primary and fully diluted amounts presented when potential dilution of earnings per share exists. Also, section 2011 specifically

* See section 2083, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises.*

prohibits including anti-dilutive[1] securities in earnings per share computations (except in special situations to be discussed later) while APB Opinion No. 9 discussed dilution but did not specifically prohibit anti-dilution.

Interpretation of Section 2011

.005 These Accounting Interpretations are intended to explain the provisions of section 2011. They do not in any way amend or modify section 2011. They do not presume to answer all questions which might be raised in applying section 2011 but rather are addressed to questions raised since section 2011 was issued.

.006 Some Interpretations are concerned with simple situations; others are concerned with rather complex situations. And just as APB Opinions are not necessarily applicable to immaterial items, these Interpretations do not necessarily apply to immaterial items. In many cases the refinements described will be material, but in many other cases they will not. When the difference is not significant, the refinements need not be applied. For example, the quarterly share averaging procedure for options and warrants described in Interpretations 58-62 need not be used when the market price of common stock is stable throughout the year and always above the exercise price. In such a case the treasury stock method could be applied on an annual basis.

.007 Although the Interpretations are not binding on Institute members, they reflect informed consideration of the situations posed and express what the Institute staff believes to be the preferred practices for earnings per share computations under section 2011.

Arrangement

.008 These Interpretations of section 2011 are divided into two parts. Part I is an overview of section 2011. Although Part I summarizes the basic provisions of section 2011, familiarity with section 2011 is assumed and terms used in section 2011 are not defined in this part. Part I also serves as a brief description of the underlying concepts of section 2011. Part II contains definitional Interpretations followed by individual Interpretations in question and answer form. The Interpretations are numbered sequentially and are arranged generally in the order in

[1] See Interpretation 5 for the definition of an anti-dilutive security.

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which the topics appear in Part I. Exhibits follow Part II. A cross-reference table which lists each section 2011 paragraph cited (as explained below) and the location of the citation, is included in Appendix D, page 5841.

.009 Numbers appearing in brackets at the end of paragraphs indicate references (in numerical order) to paragraph numbers in section 2011 (and its appendixes) relevant to the material being discussed.

PART I: AN OVERVIEW OF SECTION 2011

Presentation of Earnings per Share

.010 Section 2011 requires nearly all corporations[2] to report earnings per share data on the face of income statements or earnings summaries issued for periods beginning after December 31, 1968. Each presentation must include per share data for income or loss before extraordinary items (if extraordinary items are reported on the income statement) and per share data for net income or loss. Corporations with capital structures containing securities that do not, in the aggregate, dilute earnings per share 3% or more need present only earnings per common share. This exception for corporations whose securities do not dilute earnings per share by at least 3% is based upon the immateriality of dilution of less than 3%. In section 2011 the Board specified the point at which dilution becomes material rather than allowing different judgments to determine different levels of materiality. All other corporations are required to have the "dual" presentation of primary earnings per share and fully diluted earnings per share. All computations of earnings per share data are to be based on a weighted average of shares assumed to be outstanding during the period. [*.12, .13, .14, .15, 2011A.02*]

Assumptions

.011 Earnings per share computations for corporations with complex capital structures are based on various assumptions which are required by section 2011. These assumptions are made to reflect (1) what a corporation's earnings per share would have been if common stock had been issued to replace all dilutive securities considered to be the equivalent of common stock and (2) the additional

[2] See Interpretation 9 for the exceptions.

dilution which would have resulted if common stock had been issued to replace all of the corporation's other potentially dilutive securities.[3] [*.20, .24-.27, .41*]

.012 Assumptions to be made are specified for exercise, conversion, and issuance of securities, prices to be used, and methods to be applied to reflect the dilution which would have resulted if the transactions and events underlying those assumptions had actually occurred. Although specific methods for applying the assumptions are designated, the Board realized that the events and transactions assumed for the computations might not actually occur. Rather, the Board specified the assumptions and the methods as a practical approach to obtaining comparable determinations of earnings per share. [*.34, .36*]

Classification of Securities

.013 The advent of securities which are not common stock in form but which enable their holders to obtain common stock modifies some of the traditional relationships among securities. While common stock is regarded as the basic equity security and nonconvertible preferred stock and nonconvertible debt are regarded as senior securities, those securities which enable their holders to obtain common stock are classified as either *common stock equivalents* or as *other potentially dilutive securities* for earnings per share computations. This classification is made at time of issuance and does not change thereafter.[4] [*.25, .28, .41*]

.014 A security is classified solely for purposes of determining earnings per share. The accounting for securities, their presentation in the financial statements, and the determination of book value per share are not affected by the classification of securities for earnings per share computations. [*.39*]

.015 Common stock equivalents are included in both primary and fully diluted earnings per share computations. Other potentially dilutive securities are included only in fully diluted earnings per share computations. However, common stock equivalents and other potentially dilutive

[3] See Interpretation 3 for the special context in which the term *other potentially dilutive securities* is used in these Accounting Interpretations of section 2011. The term is not used in section 2011.

[4] Except as explained in Interpretations 29 and 30.

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securities are included in the *computations* only when their effect is dilutive. Both are excluded from the *computations* whenever their effect is anti-dilutive except in the situations described in the following paragraph. Thus, a security retains its status as a common stock equivalent or as an other potentially dilutive security after its classification has been determined, but it may enter earnings per share computations in one period and not in another period. [*.15, .30*]

Anti-dilutive Securities

.016 Anti-dilutive securities are excluded from earnings per share computations unless (1) common stock was issued during the period on an anti-dilutive exercise or conversion or (2) a security is anti-dilutive in earnings per share for income before extraordinary items but is dilutive in earnings per share for net income or vice versa [5] or (3) an aggregate computation is required which has a net dilutive effect but which may include anti-dilutive securities or anti-dilutive computations.[6] All other anti-dilutive securities are excluded from earnings per share computations even when some anti-dilutive securities are included in the computation because of one or more of the above exceptions. In an aggregate computation, only when the net result is dilutive may anti-dilutive securities be included in the earnings per share computation. [*.14, .30, .30 fn. 10, .38, .40, .41*]

Primary Earnings per Share

.017 Primary earnings per share data are based upon outstanding common stock and common stock assumed to

[5] Note that primary earnings per share for income from continuing operations or primary earnings per share for income before extraordinary items and the cumulative effect of accounting changes may be anti-dilutive when common stock equivalents are present together with discontinued operations, and/or extraordinary items and/or accounting changes. The common stock equivalents may have an anti-dilutive effect upon one of these amounts so long as the effect is dilutive upon the other amounts. The same type of anti-dilution may be reflected *within* fully diluted earnings per share when common stock equivalents and other potentially dilutive securities are present together with discontinued operations, and/or extraordinary items and/or accounting changes. However, fully diluted earnings per share for net income would *not* be anti-dilutive with respect to primary earnings per share for net income unless the anti-dilution is caused by actual exercises or conversions. (See also section 2011.30, footnote 10.) [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.]

[6] For example, an aggregate computation is required by section 2011.38 when the number of common shares issuable upon the exercise of all options, warrants, and their equivalents exceed 20% of the number of common shares outstanding at the end of the period for which the computation

be outstanding to reflect the dilutive effect of common stock equivalents. Convertible securities which yield less than two-thirds of the bank prime interest rate at the time of issuance are classified as common stock equivalents. Convertible securities issued with the same terms as those of an outstanding common stock equivalent are classified as common stock equivalents regardless of their yield. Outstanding convertible securities which are not common stock equivalents become common stock equivalents if another convertible security with the same terms is issued and is classified as a common stock equivalent. [*.28, .33*]

.018 Convertible securities which allow or require the payment of cash at conversion are considered the equivalents of warrants. Options, warrants and their equivalents, stock purchase contracts, and certain agreements to issue common stock in the future are classified as common stock equivalents. Some participating securities and two-class common stocks are also classified as common stock equivalents. [*.27, .37*]

Fully Diluted Earnings per Share

.019 Fully diluted earnings per share data are based on outstanding common stock and common stock assumed to be outstanding to reflect the maximum dilutive effect of common stock equivalents and other potentially dilutive securities. Thus, convertible securities, options, warrants, stock purchase contracts, participating securities, two-class common stocks and agreements to issue stock in the future are included in the computation of fully diluted earnings per share. The difference between the primary and the fully diluted earnings per share amounts is the additional dilution resulting from other potentially dilutive securities outstanding. [*.16, .40*]

Earnings Applicable to Common Stock

.020 To compute earnings per share, net income must often first be adjusted to determine earnings applicable to common stock. The adjustments to net income do not in any way change reported net income but rather are made to compute the earnings for the period to which common stock has a claim. Corporations with nonconvertible pre-

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is being made. An aggregate computation would also be made for an anti-dilutive option which must be exercised before a dilutive option may be exercised. (See Interpretation 49.)

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ferred stock, for example, must deduct any preferred dividends paid, declared, or accumulated for the period in adjusting net income to determine earnings applicable to common stock. [*.39, 2011A.05*]

.021 Only dividends which are applicable to the period covered by the income statement would be deducted. Dividends declared or accumulated during a prior period and paid during the period covered by the income statement are not deducted since they were considered in computing earnings applicable to common stock during the prior period and their payment merely retires the liability.

.022 Corporations with common stock equivalents or other potentially dilutive securities may have to make more complex adjustments or may not make some adjustments which would otherwise be made. For example, interest, less tax effect, on convertible bonds deducted in arriving at net income would be added back to net income to determine earnings applicable to common stock when the convertible bonds are assumed to be converted. Since dividends on convertible preferred stock are not deducted in arriving at net income, they would not be added back to net income to determine earnings applicable to common stock when convertible preferred stock is assumed to be converted. [*2011A.06, 2011A.07*]

Convertible Securities

.023 Convertible securities are included in earnings per share computations under the "if converted" method. Under this method, the security is assumed to have been converted into common stock at the beginning of the period being reported upon (or time of issuance of the security, if later). The common stock which would have been issued upon conversion is considered outstanding from the date of the assumed conversion. Interest deductions applicable to convertible debt reduced by the income taxes attributable to such interest are added back to net income because the interest would not have been incurred if the debt had been converted into common stock. Nondiscretionary adjustments based on net income or income before taxes (for items such as profit sharing or royalty agreements, etc.) are recomputed after the interest adjustment is made. Any difference (less income tax) from the amount originally computed is also included in the adjusted net income. [*2011A.06*]

.024 Convertible securities which *require* the payment of cash at conversion are considered the equivalent of warrants for computational purposes. Both the treasury stock method and the if converted method must be applied. Convertible securities which *permit* the payment of cash as an alternative at conversion are also considered the equivalent of warrants. But when conversion without the payment of cash would be more advantageous to the holder with this alternative, only the if converted method is applied. No proceeds would be received to which the treasury stock method could be applied. [*.35, .37*]

.025 When conversion is not assumed because the result would be anti-dilutive, dividends declared for the period (or accumulated for the period even though not declared) are deducted from net income to determine earnings applicable to common stock. [*.30, .40, 2011A.05*]

Options and Warrants

.026 The basic method for including options and warrants and their equivalents in earnings per share computations is the treasury stock method. Under this method, exercise of options and warrants and their equivalents is assumed at the beginning of the period (or time of issuance, if later). Shares of common stock are assumed to be issued and the proceeds from exercise are assumed to be used to purchase common stock at the exercise date. Common stock outstanding is assumed to increase by the difference between the number of shares issued and the number of shares purchased. The provision against reflecting antidilution in earnings per share computations generally prohibits the assumption of exercise of any option or warrant or their equivalents when the assumed purchased price of the common stock is below the exercise price of the option or warrant. [*.36, .42*]

.027 Section 2011 recommends as a practical matter that exercise not be assumed for earnings per share computations until the market price of the common stock has been higher than the exercise price for substantially all of three consecutive months ending with the last month of the period for which the share computation is being made. Thus, exercise need not be assumed until this three-month test has once been met. [*.36*]

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.028 After the test has been met, however, an ending market price which is above the average market price is used for fully diluted computations if the result is dilutive. Therefore, options and warrants may be reflected in fully diluted earnings per share even though they are not reflected in primary earnings per share. Options and warrants may also be included in the computations in some periods but not be included in other periods. [*.42*]

.029 Some warrants require or permit the tendering of debt or other securities in payment of all or part of the exercise price. Upon the assumed exercise of such warrants, the debt or other securities are assumed to be tendered (unless tendering cash would be more advantageous to the warrant holder when permitted and the treasury stock method is applied). Interest, net of income tax, on any debt tendered is added back to net income. The treasury stock method is applied for proceeds assumed to be received in cash. [*.37*]

.030 The proceeds from the exercise of some warrants must be applied to retire debt under the terms of the debt. Upon the assumed exercise of such warrants, the proceeds are applied to purchase the debt at its market price rather than to purchase common stock under the treasury stock method. The treasury stock method is applied, however, for excess proceeds from the assumed exercise. Interest, net of income tax, on any debt assumed to be purchased is added back to net income.

.031 Some convertible securities require or permit the payment of cash upon conversion and are considered the equivalent of warrants. The treasury stock method must be applied to purchase common stock from proceeds assumed to be received. The if converted method must also be applied for the convertible security.

.032 The application of the treasury stock method is modified when the number of common shares which would be issued if all outstanding options and warrants and their equivalents were exercised exceeds 20% of the number of common shares outstanding at the end of the period. This 20% test is based only on common shares actually outstanding, not considering any assumed conversion or contingently issuable shares. [*.38*]

.033 When the 20% test is met, *all* options and warrants and their equivalents are assumed to be exercised (or converted) regardless of whether each would be dilutive or anti-dilutive. The treasury stock method is first applied to purchase no more than 20% of the number of common shares outstanding at the end of the period with the proceeds from exercise. The balance of any proceeds remaining after applying the treasury stock method is then applied to reduce any short-term or long-term debt of the issuer to the extent that the debt may be retired. Finally, any remaining balance of proceeds is assumed to be invested in U. S. government securities or commercial paper. Appropriate recognition is given to any necessary interest adjustments (and related income tax effect) for both debt retirement and investment in determining earnings applicable to common stock. [*.35, .38*]

.034 The results of the foregoing computations are then aggregated. If the net aggregate effect is dilutive, *all* of these computations enter into earnings per share computations. However, *all* are omitted if the net aggregate effect is anti-dilutive. (See Interpretation 74 for a description of the distinction between the 20% test and the 20% limitation.)

Delayed Effectiveness and Changing Rates or Prices

.035 Some convertible securities are not convertible until a future date or their conversion rates may increase or decrease in the future. Similarly, some options or warrants are not exercisable until a future date or their exercise prices may increase or decrease in the future. [*2011A.11*]

.036 For primary earnings per share computations, the conversion rate or exercise price in effect for the period presented is used. If the holder does not have the right to convert or exercise the security until after that period, the earliest effective conversion rate or exercise price during the five years following the close of the period is used. [*2011A.12*]

.037 For fully diluted earnings per share computations, the most advantageous conversion rate or exercise price (to the security holder) becoming effective within ten years following the close of the period being reported upon is used. [*2011A.13*]

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Other Securities

.038 Although section 2011 does not describe in depth the treatment to be accorded to other types of securities, they were contemplated by section 2011 and some guidelines given. The earnings per share treatments of two-class common stock, participating securities, common stock issuable in the future upon the satisfaction of specified conditions, securities of subsidiaries, and options or warrants to purchase convertible securities are discussed in the Interpretations which follow in Part II. Situations or securities not expressly covered in section 2011 should be dealt with in accordance with their substance following the guidelines and criteria of section 2011 and these Accounting Interpretations. [*.43*]

Restatement of Previously Reported Data

.039 The earnings per share amounts reported in a prior period generally will be reported at the same amounts when that prior period is included in a later comparative income statement. Section 2011 specifically prohibits retroactive restatement (1) for changes in market prices of common stock when the treasury stock method has been applied for options and warrants, (2) when conversion rates of convertible securities or exercise prices of options or warrants change, (3) when convertible securities are actually converted, and (4) for primary earnings per share, when the number of shares issued upon the attainment of increased earnings levels differs from the number of shares previously considered outstanding. [*.22, .36, .41, 2011A.12, 2011A.17*]

.040 Section 2011 requires retroactive restatement (1) to give effect to prior period adjustments,[7] (2) to give effect to stock dividends, stock splits, and reverse splits, including those occurring after the close of the period being reported upon, (3) to give effect to a pooling of interests, (4) to give effect to changes in the number of shares contingently issuable or issued when such changes are caused by changes in market prices of the stock, and (5) to give effect to a reduction in the number of shares contingently issuable

[7] See section 2014, Prior Period Adjustments. [As amended, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.] (See section 2014.)

when the term of an agreement to issue additional shares expires and the conditions have not been met.[8] [*.18, 2011A.03, 2011A.04, 2011A.17, 2011A.18*]

.041 Section 2011 recommends retroactive restatement of earnings per share data for periods beginning before January 1, 1969 when such data are presented in comparative income statements including a period beginning after December 31, 1968 and election "b" of section 2011.46 has been made. Retroactive restatement of such data is required, however, when election "a" of section 2011.46 has been made. Otherwise, part of the data would conform to the provisions of Part II of APB Opinion No. 9 which is superseded by section 2011. [*.45, .46*]

Business Combinations and Reorganizations

.042 A business combination accounted for as a purchase of another business should, in the weighted average of shares, give effect to additional securities issued only from the date of acquisition. Results of operations of the acquired business are also included in the statement of income only from the date of acquisition. [*2011A.04*]

.043 In a pooling of two or more corporations, the weighted average outstanding securities of the constituent corporations adjusted to the equivalent securities of the surviving corporation should be used for the earnings per share computation for all periods presented. The results of operations of the constituent businesses are also combined for all periods presented.

.044 After a reorganization or quasi-reorganization, the earnings per share computations should be based on an analysis of the particular transaction applying the guidelines of section 2011.

Disclosure

.045 Disclosure is required to explain the rights and privileges of the holders of the various securities outstanding; the bases upon which primary and fully diluted earnings per share were computed; the number of shares issued upon conversion, exercise or satisfaction of required con-

[8] But note that restatement is prohibited for primary earnings per share when increased earnings levels are attained and shares are issued which were not previously considered outstanding for prior primary computations. (See point 4 in the preceding paragraph and section 2011A.17.)

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ditions; and other information necessary for a clear understanding of the data presented. (For example, if the fully diluted amount is the same as the primary amount because certain anti-dilutive securities which are not common stock equivalents are omitted from the fully diluted computation, that fact would be disclosed.) [*.15-.16, .19, .20*]

Supplementary Data

.046 Supplementary earnings per share data [9] are to be furnished for the latest period when conversion occurs and primary earnings per share would have increased or decreased at least 3% if the conversion had occurred at the beginning of the period. Supplementary data are also to be furnished when common stock or common stock equivalents are sold and the proceeds are used to retire preferred stock or debt. It may also be desirable to furnish supplementary earnings per share data for each period presented giving the cumulative retroactive effect of all such issuances. [*.14 fn. 4, .22-.23*]

.047 Supplementary data show what primary earnings per share would have been if the situations described above had occurred at the beginning of the period being reported upon rather than during the period. Thus, supplementary data are helpful for reflecting the trend of earnings per share data when primary amounts are affected by an increase in the number of shares included in the computation without an increase in the capital employed in the business.

Effective Date

.048 Section 2011 is effective for fiscal periods beginning after December 31, 1968. Earnings per share must therefore be reported on the faces of all income statements for periods beginning January 1, 1969 and thereafter. Securities are to be classified under the provisions of section 2011 regardless of the time of issuance except that an election is granted for securities with a time of issuance prior to June 1, 1969 for computing primary earnings per share to either:

[9] Supplementary earnings per share data should not be confused with fully diluted earnings per share. As used in section 2011, "supplementary earnings per share data" are additional data which are disclosed in a note. (APB Opinion No. 9 used the term "supplementary pro forma earnings per share" to describe data which are described as "fully diluted earnings per share" in section 2011.)

(a) classify all such securities under the provisions of section 2011, i. e., apply section 2011 retroactively regardless of when the securities were issued, or

(b) classify all securities outstanding[10] at May 31, 1969 as common stock equivalents if they were residual securities under APB Opinion No. 9.

All securities subject to the election must be classified under election "a" or all securities must be classified under election "b." The election may not be changed after it is made. Thus, the classification of all securities issued prior to June 1, 1969 once determined under election "a" or election "b" never change.[11] All securities with a time of issuance after May 31, 1969 must be classified under the provisions of section 2011. [*.45, .46*]

.049 Election "b" allows a corporation to ignore options and warrants issued before June 1, 1969 in primary earnings per share computations unless they were considered residual securities under APB Opinion No. 9. The election was provided because the Board has traditionally not made its Opinions retroactive. Section 2011 therefore does not apply new rules to securities which were issued under a prior section and which were already outstanding when section 2011 was issued.

.050 The election applies only to primary earnings per share computations. Fully diluted earnings per share computations include all common stock equivalents and other potentially dilutive securities without regard to the election. However, supplementary pro forma earnings per share determined under APB Opinion No. 9 are not necessarily the same[12] as fully diluted earnings per share determined under section 2011. Therefore, the Board recommends that previously reported earnings per share data be restated when reported in comparative income statements including an earnings per share amount computed under

[10] Securities no longer outstanding at May 31, 1969 are classified as common stock equivalents if they were residual securities under APB Opinion No. 9 at the statement date. This applies only for income statements for periods prior to May 31, 1969 when such income statements are subsequently included in comparative income statements after that date.

[11] See Interpretations 29 and 30 for exceptions.

[12] Although pro forma earnings per share and fully diluted earnings per share could be the same, they might be different. Any differences would result principally from the anti-dilution provisions of section 2011 and from different computational methods for options and warrants.

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the provisions of section 2011 if election "b" of section 2011.46 has been made. Restatement for all prior periods presented is accomplished by retroactively applying (1) the security classifications determined under election "b" and (2) the computational methods prescribed by section 2011. [*.45, .46*]

.051 Both primary and fully diluted earnings per share amounts for prior periods must be retroactively restated if election "a" of section 2011.46 has been made when the prior period data are reported in comparative income statements including earnings per share data computed under the provisions of section 2011.

PART II: ACCOUNTING INTERPRETATIONS OF SECTION 2011

DEFINITIONAL INTERPRETATIONS

1. Security

.052 The term *security* is used in sections 2010, 2011 and in these Interpretations in a broad context to include instruments not usually considered to be securities. Securities are usually thought of as being common stocks, preferred stocks (both nonconvertible and convertible), bonds (both ordinary and convertible), and warrants. In a broad context, the term *security* also includes all debt instruments, options to purchase stock (or other securities), stock purchase contracts, stock subscriptions, and agreements to issue stock (or other securities) at a future date. Several securities may be included in a single instrument, which may or may not be separable. [*.27, .37*]

2. Common Stock Equivalents

.053 A common stock equivalent is defined by section 2011 as: "A security which, because of its terms or the circumstances under which it was issued, is in substance equivalent to common stock." (See section 2011D.05.) A common stock equivalent is not common stock in form but rather derives a large portion of its value from its common stock characteristics or conversion privileges. Such a security typically contains provisions enabling its holder to become a common stockholder. Its value tends to change with changes in the value of the common stock to which it is related. Examples of common stock equivalents are: options

and warrants, preferred stock or debt convertible into common stock if the stock or debt yields less than 66⅔% of the bank prime interest rate at time of issuance, and agreements to issue common stock with the passage of time as the only condition to issuance. [*.25, .27, .33, .35*]

3. Other Potentially Dilutive Securities

.054 *Other potentially dilutive securities* is a term used in this Interpretation to designate a classification of securities which are similar to common stock equivalents but which for one reason or another do not meet the tests for common stock equivalents under section 2011.[13] Other potentially dilutive securities are included only in fully diluted earnings per share computations while common stock equivalents are, in effect, included in both primary and fully diluted earnings per share computations.

.055 Examples of other potentially dilutive securities are convertible senior securities (convertible preferred stock and convertible debt) and options or warrants issued prior to June 1, 1969 if election "b" of section 2011.46 is made[14] and the options or warrants were not classified as residual securities under APB Opinion No. 9. [*.41, .46*]

4. Dilution—Dilutive Security

.056 Dilution, as used in section 2011, is a reduction of the amount which would otherwise be reported as earnings per share. A dilutive security is a security which results in a decrease in the amount reported as earnings per share. As explained in Interpretations 5 and 15, there is no dilution of net loss per share when a corporation reports a net loss on its income statement. [*.14 fn. 4, .30, .40*]

.057 A dilutive security increases the number of common shares which are considered to be outstanding during

[13] The term is not used in section 2011 in this strict context. *Potentially dilutive securities,* as that term is used in section 2011, includes common stock equivalents. (For example, see section 2011.14.) Section 2011 discusses convertible senior securities which are not common stock equivalents and other contingent issuances which are not common stock equivalents. Securities which are *not* common stock equivalents but which enable their holders to obtain common stock are described in these Interpretations as "*other* potentially dilutive securities." Therefore, convertible senior securities described in section 2011 are classified as "other potentially dilutive securities" in these Interpretations.

[14] See Interpretation 46 for an explanation of why these options and warrants are not classified as common stock equivalents.

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the period for which the earnings per share computation is being made. Thus, a dilutive security increases the denominator used in the earnings per share computation. Earnings applicable to common stock, the numerator in the computation, may also increase. But so long as the numerator increase per additional denominator share is less than earnings per outstanding share, the security will be dilutive. [*2011A.06*]

5. Anti-Dilution—Anti-Dilutive Security

.058 Anti-dilution is an increase in the amount which would otherwise be reported as earnings per share or a decrease in the amount of the net loss per share. Anti-dilution therefore has an incremental effect on earnings per share data. An anti-dilutive security is a security which would result in an increase in the amount reported as earnings per share or a decrease in the amount reported as net loss per share. [*.30, .40*]

.059 When a net income is reported, an anti-dilutive option or warrant under the treasury stock method reduces the number of common shares considered outstanding during a period. Such options or warrants, if permitted to enter the computation, would increase earnings per share by reducing the denominator used. Anti-dilutive convertible debt would increase the denominator. However, its interest adjustment would increase earnings applicable to common stock, the numerator used in the computation, by a greater amount per additional share than earnings per share computed without assuming conversion. Any numertor increase per additional denominator share which is greater than earnings per share computed without assuming conversion would have an incremental effect on earnings per share and would be anti-dilutive. Convertible preferred stock is anti-dilutive when its dividend per common share obtainable upon conversion exceeds earnings per share computed without assuming conversion.

.060 When a net loss is reported, exercise or conversion is not assumed.[15] Any computation is anti-dilutive which increases the number of shares considered outstanding during a period for which a net loss is reported. Exercise of options and warrants is not assumed since this would

[15] See Part I, paragraph .016, footnote 5.

increase the number of shares considered outstanding. Likewise, conversion would increase the number of shares considered outstanding. In addition, the if converted adjustments for convertible debt would decrease the amount of the loss. Not deducting dividends on convertible preferred stock would also decrease the amount of the loss applicable to common stock.

6. Dual Presentation

.061 The dual presentation has two groups of earnings per share data; one is primary earnings per share data and the other is fully diluted earnings per share data. Both must be presented with equal prominence on the face of the income statement. [*.16*]

.062 The dual presentation of primary and fully diluted earnings per share data should not be confused with the two earnings per share amounts which must be presented when a corporation reports extraordinary items on its income statement. Even when the dual presentation is not required, a corporation reporting extraordinary items must report (1) earnings per share for income before extraordinary items and (2) earnings per share for net income. When the dual presentation is required, a corporation reporting extraordinary items must report both amounts for primary earnings per share and both amounts for fully diluted earnings per share. [*.13*]

.063 A corporation with no extraordinary items on its income statement would report only earnings per share for net income. But this must be reported for both primary and fully diluted earnings per share by a corporation when the dual presentation is required.

7. Primary Earnings per Share

.064 Primary earnings per share is the amount of earnings attributable to each share of common stock outstanding and common stock assumed to be outstanding to reflect the dilutive effect of common stock equivalents. Primary earnings per share data include an earnings per share amount for income before extraordinary items and an earnings per share amount for net income. These data may also include an earnings per share amount for extraordinary items. [*.13, .15*]

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.065 Primary earnings per share is used in section 2011 and in these Interpretations as a convenient means of designating the presentation of these data which must appear on the face of an income statement of a corporation when the dual presentation is required. Thus, "primary" is a communication tool used merely to identify this group of earnings per share data to be presented and is not suggested as a caption to be used on the income statement. The term "primary" is not intended in any way to attribute greater significance to this group of data than is attributed to the fully diluted data.

8. Fully Diluted Earnings per Share

.066 Fully diluted earnings per share is the amount of earnings attributable to each share of common stock outstanding and common stock assumed outstanding to reflect the dilutive effect of common stock equivalents and other potentially dilutive securities. Fully diluted earnings per share data include an earnings per share amount for income before extraordinary items and an earnings per share amount for net income. These data may include an earnings per share amount for extraordinary items. [*.13, .15*]

.067 Fully diluted earnings per share is used in section 2011 and in these Interpretations as a convenient means of designating the presentation of these data which must appear on the face of an income statement of a corporation when the dual presentation is required. Thus, "fully diluted" is a communication tool used merely to identify this group of earnings per share data to be presented and is not suggested as a caption to be used on the income statement.

APPLICABILITY OF SECTION 2011

9. Corporations and Financial Presentations Excepted *

.068

Q—Does section 2011 require all corporations to present earnings per share on all income statements?

A—All corporations which are not specifically excepted by section 2011 must present earnings per share on the face of any income statement or summary of such a statement for periods beginning after December 31, 1968.

* See section 2083, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises.*

.069 The only corporations excepted from the provisions of section 2011 are:

1. Mutual companies without common stock or common stock equivalents outstanding (for example, mutual savings banks, cooperatives, credit unions, etc.).
2. Companies registered under the Investment Company Act of 1940.
3. Corporations owned by political subdivisions or municipal, county, state, federal or foreign governments.
4. Not-for-profit corporations (for example, colleges, universities, medical or scientific research entities, trade and professional associations, religious organizations, etc. which are incorporated). [*.06*]

.070 Section 2011 applies to all financial presentations which purport to present results of operations in conformity with generally accepted accounting principles and to summaries of those presentations for all corporations except those listed above. However, the following financial presentations are also excepted from the provisions of section 2011:

1. Parent company statements accompanying consolidated financial statements.
2. Statements of wholly owned subsidiaries.
3. Special purpose statements.
[*.05, .06*]

.071 Special purpose statements (as described in AU section 621, volume 1, AICPA PROFESSIONAL STANDARDS) by definition are not prepared in accordance with generally accepted accounting principles. Special purpose statements are not, however, merely those prepared for specific purposes if they purport to present results of operations in conformity with generally accepted accounting principles. For example, SEC Form S-9 for registration of certain high-grade, nonconvertible, fixed-interest debt securities requires disclosure of ratios of earnings to fixed charges for each year in the summary (or statement) of earnings. Although the SEC does not require that earnings per share data be reported in Form S-9, this form is not a "special purpose

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statement." Earnings per share must therefore be reported under section 2011.

10. Closely Held Corporations *

.072

Q—Does section 2011 apply to closely held corporations?

A—Yes, closely held corporations which are not wholly owned subsidiaries of other corporations must report earnings per share on their income statements in accordance with section 2011. A corporation whose stock is all owned by a single individual is not a wholly owned subsidiary [*.05, .06*]

11. Dilution Less Than 3%

.073

Q—Must a corporation with few dilutive securities outstanding make the dual presentation? May such a corporation ignore the dilutive securities and report earnings per share based on common shares outstanding?

A—The required reporting of earnings per share data depends on the materiality of the amount of dilution produced by securities which enable their holders to obtain common stock in the future. Aggregate dilution from all such securities which is less than 3% of earnings per common share outstanding need not be reported for either primary or fully diluted earnings per share, since such dilution is not considered to be material. Thus, if both the primary and fully diluted amounts are more than 97% of earnings per common share outstanding, earnings per share may be based on only common shares outstanding. [*.14 fn. 4*]

.074 The 3% provision applies to fully diluted earnings per share compared to earnings per common share outstanding, not compared to primary earnings per share. Anti-dilutive securities are not dilutive by definition and should be excluded in computing aggregate dilution. The 3% provision also applies to the reporting of any other earnings per share information, such as supplementary

* See section 2083, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises.*

data. Aggregate dilution of less than 3% generally should be reported when it is anticipated that earnings per share data for a period when the provision applies might subsequently be included in a comparative income statement in which the following period reflects dilution of 3% or more. Otherwise, dilution in the following period would appear greater than it in fact was. [*.15, .17*]

.075 The Board intended the 3% provision to provide relief from complex computations to corporations which would have insignificant dilution if all obligations to issue common stock in the future were fulfilled currently. This would be the case, for example, for a corporation which has no obligations to issue common stock except for a small amount of stock under options granted to its executives. [*.14 fn. 4*]

12. 3% Test

.076

Q—Is there a simple test which can be applied to determine if dilution would be at least 3%?

A—Yes. As a "rule of thumb," make both the primary and fully diluted computations whenever the number of additional common shares which must be assumed to be issued exceeds 3% [16] of the number of outstanding common shares. If the dilution produced by either computation is at least 3%, the dual presentation is required. [*.15*]

.077 Dilutive options and warrants are included in earnings per share computations under the treasury stock method, which produces incremental shares (as explained in Interpretation 51). The number of incremental shares the treasury stock method will produce can be approximated by applying a simple formula. Since stock options are the only obligations of many closely held corporations to issue common stock, the formula is useful when the test described above is to be applied and only options or warrants are considered. [*.36*]

[16] Actually, the number of additional shares must be at least 3/97 (or 3.09 + %) of the number of outstanding common shares. If earnings applicable to common stock includes an "if converted" adjustment, a greater number of additional shares would be required to produce dilution of at least 3%. Thus, although the number of additional shares is not the only determinant of dilution, common shares assumed outstanding must increase more than 3% to produce dilution of at least 3%.

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.078 The following formula[17] will approximate the number of incremental shares which will result from applying the treasury stock method for options or warrants:

$$I = \frac{M - E}{M}(N)$$

Where:

- I is the number of incremental shares which would be produced by the treasury stock method.
- M is the market price (or fair value) per share of common stock.
- E is the exercise price of the option or warrant per common share obtainable upon exercise.
- N is the total number of shares obtainable on exercise.

Subject to the constraint[18] that $M > E$

.079 An example of the application of the formula follows. Assume that a corporation has granted options to its officers to purchase 10,000 shares of common stock at $6 per share and the common stock has a market price (or fair value) of $10 per share.

.080 Applying the formula for the information given, the amounts to be substituted for the letters are:

$I = \text{unknown}$

$M = \$10$

$E = \$6$

$N = 10{,}000$

Therefore:

$$I = \frac{\$10 - \$6}{\$10}(10{,}000)$$

$$I = .4(10{,}000)$$

$$I = 4{,}000$$

---

[17] The formula should not be used when section 2011.38 applies, i. e., when the number of common shares obtainable on the exercise of all options and warrants and their equivalents exceeds 20% of the number of common shares outstanding.

[18] The formula would not be used unless the market price is greater than the exercise price since the result could be anti-dilutive.

If the 4,000 incremental shares exceeds 3% of the number of outstanding common shares, actual dilution would be computed to determine if dilution is at least 3%.

13. Subchapter S Corporations

.081

Q—Does section 2011 apply to the financial statements of corporations electing under Subchapter S of Chapter 1 of the *Internal Revenue Code?*

A—Yes, such corporations must report earnings per share on the face of their income statements. Net income is computed without regard to taxes on that income which will be paid by stockholders rather than by the corporation. Undistributed earnings of the corporation taxed to the stockholders increase the stockholders' tax bases in the shares they own, but the number of shares outstanding does not increase unless the corporation issues additional shares. The amount per share of income tax the corporation would have paid in the absence of the Subchapter S election would be useful information to disclose. [*.05, .06*]

14. Unaudited Financial Statements

.082

Q—Does section 2011 apply to unaudited financial statements?

A—Yes. If a CPA is associated with an unaudited income statement which does not report earnings per share, the CPA should phrase his disclaimer of opinion on the statement in accordance with the provisions of either AU sections 516.05-.06 or 517.06 (Volume 1, AICPA PROFESSIONAL STANDARDS) as is appropriate under the circumstances of the engagement. [*.05, .06*]

EARNINGS PER SHARE PRESENTATION

15. Reporting Loss per Share

.083

Q—Must net loss per share be reported?

A—Yes, net loss per share must be reported under the same requirements that earnings per share must be reported. Net loss per share, however, is based on outstanding

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common shares. Assuming exercise of options and warrants or conversion of convertible securities would be anti-dilutive since an increase in the number of shares assumed to be outstanding would reduce the amount of the loss per share.[19] The amount of the loss is increased by any dividends declared (or cumulative even though not declared) for the period on preferred stocks. [*.12, 2011A.05*]

16. EPS for Extraordinary Items

.084

Q—Must earnings per share be presented for extraordinary items?

A—No, although this presentation may generally be desirable. Section 2011.13 states that earnings per share data should be reported consistent with the income statement presentation required by section 2012.11. Thus, it would appear that earnings per share should be presented for (1) income before extraordinary items, (2) extraordinary items less applicable income tax, and (3) net income as required by section 2012.11 when an extraordinary item is reported on the income statement. This presentation is used in the example in section 2011C.03, Exhibit B. [*.13*] [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.]

.085 However, section 2011.13 requires that earnings per share data be presented for only (1) income before extraordinary items and (2) net income. Although the two requirements appear to conflict, earnings per share need not be presented for extraordinary items. A reader of the financial statements can determine earnings per share for extraordinary items by subtraction if it is not reported.

.086 Naturally, the earnings per share data will be more complete if an amount is reported for extraordinary items when such items are reported on the income statement. This presentation, although not required, may therefore be generally desirable. In some cases, reporting all three earnings per share amounts would be particularly helpful to the reader, such as in the situation described in section 2011.30, footnote 10 (where the effect on either income before extraordinary items or on net income is antidilutive but is dilutive on the other). [*.30, fn. 10*]

[19] See paragraph .016, footnote 5.

17. Simple Capital Structure

.087

Q—What is a simple capital structure for purposes of computing earnings per share?

A—A corporation has a simple capital structure for purposes of computing earnings per share if during the period it had no securities outstanding (or agreements to issue securities) that in the aggregate dilute earnings per outstanding common share. [*.14*]

18. Complex Capital Structure

.088

Q—What is a complex capital structure for purposes of computing earnings per share?

A—A corporation has a complex capital structure for purposes of computing earnings per share if it has issued, in addition to common stock, securities which have a dilutive effect on earnings per outstanding common share. Among the securities which may have a dilutive effect are convertible preferred stock, convertible debt, options, warrants, participating securities, different classes of common stock, and agreements to issue such securities or shares of common stock in the future. [*.15, .27, .41*]

.089 As explained in Interpretation 11, if the aggregate dilution for the period produced by all such securities which are dilutive does not reduce earnings per outstanding common share by at least 3%, a corporation may be considered as having a simple capital structure for purposes of computing earnings per share. It may be desirable, however, to report the actual dilution in such a case, particularly if the period being reported upon might later be included in a comparative income statement which includes one or more periods with dilution of 3% or more. [*.14, .14 fn. 4, .17*]

19. EPS for Simple and Complex Capital Structures

.090

Q—How does the reporting of earnings per share data differ for corporations with simple capital structures and corporations with complex capital structures?

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A—A corporation with a simple capital structure is required to have a single presentation of "earnings per common share" on the face of its income statement. A corporation with a complex capital structure is required to have a dual presentation of both primary and fully diluted earnings per share on the face of its income statement. [*.14*, *.15*]

.091 Exceptions which apply to corporations with simple capital structures are explained in Interpretation 20. An exception which applies to corporations with complex capital structures is explained in Interpretation 18.

20. Dual Presentation for Corporation with Simple Capital Structure

.092

Q—Is a corporation with a simple capital structure ever required to have the dual presentation?

A—Yes, the dual presentation is required if common stock was issued during the period on exercise, conversion, etc. and primary earnings per share would have increased or decreased if the issuance had taken place at the beginning of the period. [*.41*]

.093 A corporation has a simple capital structure when it has no dilutive securities outstanding. If outstanding anti-dilutive securities are exercised or converted, however, such a corporation would be required to have the dual presentation if primary earnings per share would have been affected as described above. Thus the dual presentation may be required for a corporation with a simple capital structure to report the incremental effect of an anti-dilutive exercise or conversion. [*.14*, *.41*]

.094 Also, the dual presentation is required for all periods presented in a comparative income statement if it is required for any period. The dual presentation may therefore be required for one or more periods in a comparative income statement when the corporation had a simple capital structure. [*.17*]

21. Primary v. Fully Diluted EPS

.095

Q—How do fully diluted earnings per share differ from primary earnings per share?

A—Primary earnings per share computations include only common stock and dilutive common stock equivalents. Fully diluted earnings per share computations include common stock and dilutive common stock equivalents together with other potentially dilutive securities. Fully diluted earnings per share also include those exercises or conversions for which common stock was issued during the period whether their effect is dilutive or anti-dilutive. [*.24, .41*]

.096 Fully diluted earnings per share show the maximum potential dilution of all dilutive contractual obligations to issue common stock and their effect on current earnings per share on a prospective basis. The difference between primary and fully diluted earnings per share shows (1) the maximum extent of potential dilution of current earnings which would occur from the conversions of securities that are not common stock equivalents or the contingent issuance of common stock not included in the computation of primary earnings per share and (2) the effect of all issuances of common stock on exercises or conversions during the year as if the issuance had occurred at the beginning of the year. [*.16, .40, .41*]

22. Captions for Earnings per Share Presentations

.097

Q—What captions should be used for reporting earnings per share amounts in the dual presentation?

A—Precise designations are not prescribed by section 2011 except that the term "earnings per common share" should not be used unless a corporation has a simple capital structure or the term is appropriately qualified. The qualification is determined by whether the corporation has only common stock equivalents or also has other potentially dilutive securities. [*.16*]

.098 Listed below are five captions which might be used to designate earnings per share amounts. Following the captions is a table indicating the captions a corporation might use when it has various combinations of securities outstanding. The first two columns of the table indicate the combinations of securities a corporation might have. The numbers in the other three columns refer to the numbers listed beside the captions which might be used to

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designate the earnings per share amounts. For example, a corporation having both dilutive common stock equivalents and other potentially dilutive securities outstanding could designate the primary amounts "Earnings per common and common equivalent share" and could designate the fully diluted amounts "Earnings per common share—assuming full dilution."

SUGGESTED EARNINGS PER SHARE CAPTIONS

1. Earnings per common share.
2. Earnings per common share—assuming no dilution.
3. Earnings per common share—assuming full dilution.
4. Earnings per common and common equivalent share. (If both dilutive and anti-dilutive common stock equivalents are present, the caption may be: Earnings per common and dilutive common equivalent share.)
5. Earnings per common share—assuming issuance of all dilutive contingent shares.

TABLE INDICATING USE OF EPS CAPTIONS

			Dual Presentation	
Common Stock Equivalents Present	*Other Potentially Dilutive Securities Present*	*Caption for Single Presentation*	*Primary Caption*	*Fully Diluted Caption*
No [a]	No [a]	1		
No [a]	Dilutive		2	3
No [a]	Anti-dilutive	1 [b]		
Dilutive	No		4	3 [c]
Dilutive	Dilutive		4	3
Dilutive	Anti-dilutive		4	5 [b, c]
Anti-dilutive	No [a]	1 [b]		
Anti-dilutive	Dilutive		2 [b]	5 [b]
Anti-dilutive	Anti-dilutive	1 [b]		

Notes:

[a] *Or dilution is less than 3% if such securities are present.*

[b] *In a note, disclose the existence of the anti-dilutive securities.*

[c] *Primary and fully diluted amounts will be the same.*

23. Captions in Comparative Statements

.099

Q—What presentation is required in a comparative income statement when a corporation has a simple capital structure in one period and a complex capital structure in another period?

A—The dual presentation is required for all periods presented if it is required for any period presented. Since the corporation had a complex capital structure in one period presented, the dual presentation is required for that period and for all other periods presented in the comparative income statement. [*.17*]

.100 In a comparative income statement the captions used should be appropriate for the most dilutive presentation. For example, if there were no common stock equivalents in one period, anti-dilutive common stock equivalents in one period, and dilutive common stock equivalents in another period in a comparative income statement, the primary amounts could have a designation such as "earnings per common and dilutive common equivalent share." Explanatory disclosure in a note may also be appropriate.

COMPUTING EARNINGS PER SHARE

24. Earnings Applicable to Common Stock

.101

Q—How is "earnings applicable to common stock" determined for earnings per share computations?

A—For a corporation with a simple capital structure, earnings applicable to common stock is net income reduced by dividends declared or paid for the period to preferred stock. Cumulative preferred dividends for the current period not paid or declared also are deducted from net income in determining earnings applicable to common stock. However, preferred dividends which are cumulative only if earned are deducted only to the extent they are earned. Interest on debt need not be adjusted in determining earnings applicable to common stock since it was deducted in arriving at net income. [*2011A.05*]

.102 For example, assume that a corporation has a net income of $6,000 and has 1,000 shares of common stock outstanding. Also outstanding are 1,000 shares of nonconvertible noncumulative preferred stock and $10,000 of 6% nonconvertible bonds. The corporation has a simple capital structure. If no dividends were paid on preferred stock, earnings applicable to common stock would be $6,000. Earnings per common share would be $6 per share ($6,000 net income divided by 1,000 common shares). The declaration of a dividend of $1 per share on preferred stock would

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result in earnings applicable to common stock of $5,000 ($6,000 net income less $1,000 for preferred dividends) and earnings per common share of $5 per share. The same result would be obtained if the dividend were cumulative and had not been declared. The same result would also be obtained whether or not the corporation paid (or declared) a dividend on common stock. [*.14, 2011A.05*]

.103 For a corporation with a complex capital structure, net income is reduced by dividends on nonconvertible preferred stock as described above. When the if converted method is applied for outstanding convertible securities, however, dividends for convertible preferred stock are not deducted from net income but other adjustments may be necessary. Under the if converted method, convertible dividends are not deducted when conversion is assumed, and interest (less applicable income tax) is added back to net income when convertible debt is assumed to be converted. [*2011A.06*]

.104 For example, assume that a corporation has a net income of $6,000 and has 1,000 shares of common stock outstanding. Also outstanding are 1,000 shares of common stock equivalent convertible preferred stock (convertible one common share for each preferred share) and $10,000 of 6% convertible bonds (convertible three common shares for each $100 bond) which are not common stock equivalents. The corporation has a complex capital structure. Assume also that the corporation paid a $1 per share dividend on both common and preferred stock and the income tax rate is 22%. For primary earnings per share, earnings applicable to common stock is $6,000 and earnings per common and common equivalent share is $3 per share ($6,000 divided by 2,000 shares, composed of 1,000 common shares and 1,000 common equivalent shares from the assumed conversion of the convertible preferred stock). For fully diluted earnings per share, earnings applicable to common stock is $6,468 ($6,000 net income plus $600 interest less $132 additional tax payable if the interest had not reduced net income). Earnings per common share assuming full dilution is $2.81 per share [$6,468 divided by 2,300 shares; composed of 1,000 common shares, 1,000 common equivalent shares, and 300 shares from the assumed conversion of the convertible bonds). [*.15, 2011A.06*]

25. Weighted Average of Shares Outstanding

.105

Q—What is the effect on earnings per share computations of issuing common stock or other securities which may be converted or exercised to obtain common stock or of reacquiring common stock or such securities during a period?

A—Such issuances or reacquisitions of common stock or other securities during a period require that a weighted average of shares be computed for the denominator to be used in the earnings per share computations. A weighted average gives due consideration to all shares outstanding and assumed to have been outstanding during a period. Shares issued or retired during a period are weighted by the fraction of the period they were outstanding. The weighted number of shares is added to the number of shares outstanding for the entire period to obtain the weighted average number of shares outstanding during the period. [*2011A.02*]

.106 For example, assume that a corporation had 100,000 common shares outstanding on January 1 and issued 6,000 additional common shares on March 1. The weighted average would be 102,000 shares for the quarter ending March 31 or 104,000 shares for the six months ending June 30 or 105,000 shares for the year ending December 31.

COMPUTATIONAL NOTES:

100,000 + 1/3 (6,000) = *102,000*
100,000 + 4/6 (6,000) = *104,000*
100,000 + 10/12 (6,000) = *105,000*

The same answers would result if the 6,000 shares issued on March 1 were merely assumed to have been issued to reflect the dilutive effect of common stock equivalents issued on March 1. It should be noted that the number of shares in the weighted average for the quarter and for the year are different.

.107 Reacquired shares are included in the weighted average only for the time they were outstanding. For example, assume that a corporation had 100,000 shares outstanding on January 1 and reacquired 6,000 shares on March 1. The weighted average would be 98,000 shares for the quarter ending March 31 or 96,000 shares for the six

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months ending June 30 or 95,000 shares for the year ending December 31.

COMPUTATIONAL NOTES:

$$100{,}000 - 6{,}000 = 94{,}000$$
$$94{,}000 + 2/3\ (6{,}000) = 98{,}000$$
$$94{,}000 + 2/6\ (6{,}000) = 96{,}000$$
$$94{,}000 + 2/12\ (6{,}000) = 95{,}000$$

The same answers would result if the 100,000 shares had included common stock equivalents and the corporation had reacquired 100 dilutive common stock equivalent convertible bonds (convertible 60 common shares for one bond) on March 1.

.108 More complex methods for computing a weighted average could be used if the number of shares involved changes frequently, such as computing an average weighted by days. (See Exhibit 4, paragraph .360.)

.109 The weighted average discussed in section 2011 and in these Interpretations is technically an arithmetical mean average of shares outstanding and assumed to be outstanding for earnings per share computations. The most precise average would be the sum of the shares determined on a daily basis divided by the number of days in the period. Less precise averaging methods may be used, however, as illustrated above, if they produce reasonable results. But methods which introduce artificial weighting are not acceptable for computing a weighted average of shares for earnings per share computations. For example, the "Rule of 78" method, which weights shares for the first month of the year by 12 and weights shares for the last month of the year by 1, is not an acceptable method.

.110 Retroactive recognition is given for all periods presented to any stock dividend, stock split or reverse split, including those occurring after the end of the period for which the computation is being made but before the statements are issued.

CONVERTIBLE SECURITIES

26. Classification and Assumed Conversion

.111

Q—Which convertible securities are assumed to be converted for primary earnings per share computations

and which are assumed to be converted for fully diluted earnings per share computations?

A—Convertible securities which are classified as common stock equivalents are assumed to be converted for both primary and fully diluted earnings per share computations. Convertible securities which are not common stock equivalents are classified as other potentially dilutive securities and are assumed to be converted only for fully diluted earnings per share computations. [*.15, .31*]

.112 Conversion is assumed for either computation only when the result is dilutive unless (1) the security is included in an aggregate computation which has a net dilutive effect or (2) for fully diluted earnings per share, common stock was issued during the period on an anti-dilutive conversion, that is, a conversion which would have had the effect of increasing earnings per share if it had occurred at the beginning of the period. When conversion is assumed, the if converted method is applied.[20] When conversion is not assumed because the result would be anti-dilutive, interest or dividends on the securities reduce the amount of earnings or increase the amount of loss otherwise applicable to common stock. [*.30, .38, .40, .41, 2011A.05, 2011A.06*]

.113 Most convertible securities are classified on the basis of their yield at time of issuance. (The exceptions are discussed in the following paragraphs of this Interpretation.) Under the yield test, convertible securities which yield less than 66⅔% of the bank prime interest rate at time of issuance are common stock equivalents; those yielding at least 66⅔% of the prime rate are other potentially dilutive securities. [*.33*]

.114 If a convertible security has a change scheduled in its interest or dividend rate within five years after issuance, its yield at issuance is considered to be the lowest scheduled rate within the five years. (See Interpretation 28 for the treatment of convertible securities which are not convertible until a future date.) A convertible security which would not otherwise be a common stock equivalent at time of issuance is classified as a common stock equiva-

[20] See paragraph .023 of this Interpretation and section 2011A.06 for a description of the if converted method.

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lent if it is issued with the same terms as those of an outstanding convertible security which is a common stock equivalent. [*.28*]

.115 Convertible securities issued prior to June 1, 1969 are classified by the issuer under one of two alternative elections specified in section 2011.46. (The election made applies to all securities issued before that date, not just to convertible securities.) Under election "a," all convertible securities issued prior to June 1, 1969 are classified as either common stock equivalents or other potentially dilutive securities under the provisions of section 2011. Under election "b," all convertible securities issued prior to June 1, 1969 which were classified as residual securities under APB Opinion No. 9 are classified as common stock equivalents; those which were classified as nonresidual securities are classified as other potentially dilutive securities. [*.46*]

.116 Convertible securities which require or permit the payment of cash upon conversion are considered the equivalents of warrants and are classified as common stock equivalents. (See Interpretation 71 for the treatment of such securities.) A few convertible participating securities are common stock equivalents for which the two-class method may be applied. (See Interpretation 87 for the treatment of such securities.) The if converted method is applied when any convertible security is assumed to be converted except for unusual cases when the two-class method is applied. [*.35, .37, 2011A.06, 2011A.14*]

27. Time of Issuance

.117

Q—What is the "time of issuance" of a convertible security?

A—"Time of issuance" is *generally* the date when agreement as to terms has been reached and announced even though subject to further actions, such as directors' or stockholders' approval. In this context, time of issuance is often referred to in financial jargon as the "handshake" date. Thus, time of issuance will usually precede the actual date of issuance of a security by some period which might be as long as several months or as short as a few hours. [*.29*]

.118 "Agreement as to terms" means that all of the terms have been set, not merely that the parties have reached an agreement in principle but the number of securities to be issued or the issue price is still to be determined at a later date. Agreement as to terms is reached when the parties are obligated to complete the transaction if it is ratified by the directors and/or stockholders, that is, neither party may legally terminate the agreement except for failure to receive approval from the directors or stockholders. The fact that the agreement is subject to a "favorable" ruling from the Treasury Department or a regulatory agency does not affect time of issuance so long as all of the terms of the agreement have been set.

.119 The classification of a convertible security is determined at time of issuance and does not change when the security is actually issued except as discussed in Interpretation 29.

.120 When time of issuance occurs before a year end but the agreement has not been approved by either the directors or stockholders before the financial statements are issued, the securities are not considered outstanding in the financial statements being issued or in earnings per share computations. (The securities are similar to a contingent issuance whose conditions are not currently being met.) [*2011A.17*]

28. Classification and Computation Not Always the Same

.121

Q—Are convertible securities included in earnings per share computations at time of issuance?

A—Convertible securities are classified at time of issuance. Generally they are assumed to be converted for earnings per share computations from this date also. Although a convertible security is classified at time of issuance, in some cases it is not assumed to be converted for earnings per share computations until a later date. [*.28, 2011A.06*]

.122 If the conversion privilege is not effective during the period being reported upon, the length of time before the privilege becomes effective determines when the security is eligible for assumed conversion in earnings per share computations. Conversion is not assumed for either primary or fully diluted computations if the conversion privi-

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lege is not effective within ten years from the end of the period being reported upon. Conversion is assumed only for fully diluted computations if the conversion privilege is effective after five years but within ten years from the end of the period being reported upon. Conversion is assumed as if the security were immediately convertible if the conversion privilege is effective within five years from the end of the period being reported upon. [*2011A.12, 2011A.13*]

.123 For example, assume that a corporation issued a debt security at the end of its 1969 reporting year that may be converted into common stock after twelve years (at the end of 1981). The security's yield at time of issuance requires that it be classified as a common stock equivalent. Conversion would not be assumed for 1969 or 1970 earnings per share computations (interest would reduce net income in 1970, however). Conversion would be assumed whenever the effect is dilutive for fully diluted computations beginning in 1971 and for both primary and fully diluted computations beginning in 1976. Thus, the security is classified at time of issuance but conversion is not assumed for earnings per share computations until later. [*.28*]

.124 Time of issuance and classification of a convertible security may precede the obligation to issue and actual issuance by as much as several months, but a convertible security is not considered outstanding in the interim until there is a valid obligation to issue the security. For example, assume that agreement as to terms for a business combination is reached and announced on December 1, 1969. Final approval by stockholders occurs on February 16, 1970 and a convertible security is to be issued March 2, 1970. Classification of the security is determined at December 1, 1969. The security would be omitted from 1969 earnings per share computations if the financial statements are issued before February 16, 1970, but the impending issuance would be disclosed.

.125 If the business combination is accounted for as a purchase, the security would be considered outstanding from the date of the acquisition in 1970 earnings per share computations if the stockholders in fact ratify the agreement. If the business combination is accounted for as a pooling of interests, prior periods' earnings per share data would be retroactively restated in comparative income

statements issued subsequently to reflect the security as outstanding for all periods presented. (See Part I, paragraphs .042-.044.) [*2011A.04*]

29. Change of Classification of Convertible Security

.126

Q—When does the classification of a convertiblé security change?

A—A convertible security's classification is generally determined only at time of issuance and does not change thereafter. However, a change of classification (usually from other potentially dilutive security status to common stock equivalent status) may be required in two situations. These are when (1) an incorrect estimate of the security's value at time of issuance was made in the absence of a market price or (2) a common stock equivalent convertible security is issued with the same terms as an already outstanding convertible security which is not a common stock equivalent. (See Interpretation 30.) [*.28, .29*]

.127 If a convertible security does not have a market price at time of issuance, an estimate must be made of the security's fair value to apply the yield test. If the estimate of the security's value is too low, a convertible security which should be classified as a common stock equivalent might not be so classified. In such a case, the security would have to be reclassified as a common stock equivalent at actual issuance. Typically, an obviously incorrect estimate would be evidenced by materially higher market transactions for the security at actual issuance shortly after the time of issuance. [*.29, .33 fn. 11*]

.128 A change of the classification of the security would not be appropriate in such a case, however, if the higher market prices resulted from an external change over which the issuer had no control. (A general increase in the market prices of other securities might indicate an external change.) A change of the classification would also not be appropriate if convertible securities were sold for cash and the gross proceeds to the issuer were substantially equal to the total amount of the original fair value estimate for the securities. In this case, the total of the net amount received by the issuer plus brokerage commissions paid is approximately equal to the original estimate of fair value of the securities.

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30. Change of Classification Is Mandatory

.129

Q—Would convertible securities issued prior to June 1, 1969 and classified as other potentially dilutive securities under section 2011.46 become common stock equivalents if another convertible security is issued with the same terms after May 31, 1969 and is classified as a common stock equivalent? [*.46*]

A—Yes, a change in classification is required by the second sentence of section 2011.28 for any outstanding convertible security which is not a common stock equivalent but which has the same terms as those of another convertible security being issued which is classified as a common stock equivalent at time of issuance. Thus, an outstanding convertible security which is not a common stock equivalent would be reclassified as a common stock equivalent if another convertible security is issued with the same terms and is classified as a common stock equivalent at time of issuance. [*.28*]

.130 Although this reclassification is an exception to the general rule that securities do not change status subsequent to time of issuance, reclassification is mandatory. All of a corporation's convertible securities issued with the same terms therefore are classified the same for earnings per share computations.

.131 For example, assume that convertible securities were issued with the same terms on May 2, June 2, and July 2, 1969. Only the July 2 issue is a common stock equivalent if classification is based on yield at time of issuance because of an increase in the bank prime interest rate. Under section 2011.28, however, both the May 2 and June 2 issues become common stock equivalents also.

31. Definition of "Same Terms"

.132

Q—What are the "same terms" (as used in the second sentence of section 2011.28) for the subsequent issuance of a convertible security?

A—The "same terms" are identical terms, not merely similar terms. Thus, any change in dividend or interest rates, conversion rates, call prices or dates, preferences in liquidation, etc. is a change in terms. Market price or issue price is not considered a "term." (See Interpretation 32.) [*.28*]

32. Issue Price Is Not a "Term"

.133

Q—Do different issue prices for different issuances of convertible securities constitute a change in "terms" if all other terms for the securities are the same?

A—No, different issue prices for convertible securities with the same terms otherwise is not a change in terms. Thus, two convertible securities issued at different prices but with the same stated dividend or interest rates, conversion rates, call prices and dates, preferences in liquidation, etc. have the same terms. [*.28*]

33. Sale of Treasury Securities Is a New Issue

.134

Q—Are convertible securities sold by an issuer from securities held as treasury securities to be classified as a new issue or as part of the original issue under the provisions of the second sentence of section 2011.28?

A—When convertible securities are acquired by the issuing corporation and subsequently reissued, they constitute a new issue with the same terms as the existing outstanding convertible security. The "new" issue's status (as a common stock equivalent or not) should be determined under both the common stock equivalent test and the provisions of the second sentence of section 2011.28. If deemed a common stock equivalent, the "new" issue could also affect the status of outstanding securities with the same terms as described in the second sentence of section 2011.28. For example, if the outstanding securities are not common stock equivalents and the reissued securities are common stock equivalents under the yield test (because of a change in market prices or the prime rate), the outstanding securities also become common stock equivalents. [*.28*]

34. Determining a Convertible Security's Cash Yield

.135

Q—Upon what return is a convertible security's cash yield based?

A—Cash yield for most convertible securities is based upon the stated amount of interest or dividends the security is scheduled to pay each year.[21] However, if the dividends

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[21] See Interpretation 26 for the amount to be used when a convertible security has a change of interest or dividends scheduled.

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on convertible preferred stock are not cumulative, yield might have to be based on some lesser amount, particularly if the stated amount appears impossible to pay. Low earnings or contractual provisions on outstanding debt, for example, might prohibit payment of the stated amount. The same would apply for preferred dividends which are cumulative only if earned. [*.33*]

35. Computing a Convertible's Cash Yield

.136

Q—How is a convertible security's cash yield at time of issuance computed?

A—Yield is a security's return expressed as a percentage of its value. For example, a $1,000 bond which is paying $45 annual interest to the holder and selling at 90 (i. e., $900) yields 5% $\left(\text{computed } \frac{\$45}{\$900} \times 100\right)$ if the time factor to maturity is ignored. Although yield is generally computed to maturity, the yield test described in section 2011 for convertible securities uses only the stated annual return expressed as a percentage of the security's market price (ignoring commissions and transfer taxes) at time of issuance. If the security does not have a market price at time of issuance, the test is based on the security's fair value. [*.33*]

36. Cash Yield of Convertible Security in a "Package"

.137

Q—How is the cash yield determined for a convertible security issued in a "package," i. e., a convertible security is one of two or more securities issued as a unit?

A—When two or more securities are issued as a unit, the unit price at time of issuance should be allocated to each security based on the relative fair values of the securities at time of issuance. For example, assume that a "package" consisting of one share of common stock, one share of convertible preferred stock, and one nonconvertible $100 bond with a detachable warrant is sold as a unit for a total price of $200. At time of issuance, fair values were $42 per share of common stock, $63 per share of convertible preferred stock, $99.75 per bond and $5.25 per warrant. The $200 unit amount would be allocated to each security as follows:

	Fair Value at Issuance	Percentage of Total	Allocated Amount of $200
Common stock	$ 42.00	20.0%	$ 40.00
Preferred stock	63.00	30.0	60.00
Bond	99.75	47.5	95.00
Warrant	5.25	2.5	5.00
Totals	$210.00	100.0%	$200.00

If the convertible preferred stock is scheduled to pay a dividend of $3.15 per share each year, it would yield 5.25%

$$\left(\text{computed } \frac{\$3.15}{\$60.00} \times 100\right)$$

[*.33, fn. 11**]

37. Property Included in Cash Yield

.138

Q—May the fair value of property to be paid as dividends or interest be included in computing cash yield since section 2011 specifically states only "cash"?

A—Yes, the fair value of property to be paid in lieu of cash may be included in computing the cash yield of a convertible security. The property so treated may include nonconvertible senior securities of the same company. But it may not include the same issue for which common stock equivalency is being determined. And it may not include securities of the issuer or its parent or subsidiary which are currently or potentially dilutive and enter into the computation of either primary or fully diluted earnings per share. [*.33*]

.139 For example, any common stock or common stock equivalent of the issuer and securities such as those described in sections 2011A.14, 2011A.15, and 2011A.20-.24 would not be considered property for this purpose. Also, "extra" dividends to be paid on convertible stock on a nonrecurring basis would not be considered in computing cash yield in conformity with the "lowest scheduled rate" provision of section 2011.33.

38. Prime Rate Used in Yield Test

.140

Q—What bank prime interest rate should be used to determine the status of a convertible security as a com-

* Also see section 5516.

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mon stock equivalent or not in applying the yield test when more than one rate is in effect in a country?

A—The prime interest rate in effect at the bank where the issuer borrows is used when more than one bank prime interest rate (or its equivalent in foreign[22] countries) is in effect in the U. S. If the issuer borrows from more than one bank and the different banks have different prime rates in effect, an average of the rates is used. If the issuer does not borrow from a bank where the prime interest rate is offered and more than one bank prime interest rate is in effect, an average of the rates would be used unless the issuer can show that the predominant rate is more appropriate than an average rate. [*.34*]

39. Prior Period Prime Rates

.141

Q—What source should be considered authoritative in determining the bank prime interest rate which was in effect in the U. S. during prior periods when applying election "a" of section 2011.46? [*.46*]

A—The *Federal Reserve Bulletin* may be considered an authoritative source for determining the bank prime interest rate at any time. When a "split" prime rate is in effect, the provisions of Interpretation 38 are applied. For readers' convenience, the dates of changes in the prime rate and the rates in effect from 1954 through 1970 have been extracted and appear in paragraph .357. [*.34*]

40. Original Issue Premium or Discount on Convertible Securities

.142

Q—What happens to original issue premium or discount when convertible securities are assumed to be converted and common stock is assumed to be issued for earnings per share computations?

A—Any original issue premium or discount amortized during the period (to compute the effective interest deducted from net income for a debt security) is eliminated from net income in arriving at earnings applicable to common stock. The unamortized original issue premium or

[22] See *The Banker,* February 1969, p. 117 *ff.,* for a discussion of rates in foreign countries which are the equivalents of the U. S. bank prime interest rate.

discount balance at the date of assumed conversion (the ending balance plus the amount amortized during the period) is then ignored for earnings per share computations. The if converted method only assumes conversion of the securities; it does not assume retirement. The converted securities are assumed to be held by the issuer as treasury securities during the period being reported upon and balance sheet accounts related to those securities are not affected by the assumed conversion. Note that these assumptions are made only for earnings per share computations; the issuer's balance sheet and net income for the period are not affected in any way by the assumptions made for earnings per share computations. [*.39, 2011A.06*]

41. No Anti-Dilution from Convertible Preferred Stock

.143

Q—When is convertible preferred stock antidilutive and therefore not assumed to be converted for earnings per share computations?

A—Convertible preferred stock is anti-dilutive and conversion is not assumed [23] whenever the amount of the dividend paid or declared for the current period (or accumulated if not paid) per common share obtainable upon conversion exceeds the earnings per share amount computed without assuming conversion. [*.30, .40, 2011A.05*]

.144 For example, assume that a corporation had a net income of $1,500 and had 1,000 shares of common stock outstanding. Also outstanding were 1,000 shares of preferred stock convertible on a one-for-one basis and classified as a common stock equivalent. A $1 per share dividend was paid to the convertible shareholders. Assumption of conversion would be anti-dilutive in this case since earnings per outstanding common share is $.50 per share. (Earnings per common and common equivalent share would be $.75 per share if conversion were assumed.) Conversion would not be assumed, but rather the preferred dividend would be deducted to compute earnings applicable to common stock. Earnings per share would be computed on the basis of actual common stock outstanding. The same result would be obtained if the dividend were cumulative and not paid.

[23] See Interpretation 44 for an exception when actual conversion occurs.

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42. No Anti-Dilution from Convertible Debt

.145

Q—When is convertible debt anti-dilutive and therefore not assumed to be converted for earnings per share computations?

A—Convertible debt is anti-dilutive and conversion is not assumed[24] whenever its interest (net of tax) per common share obtainable on conversion exceeds the earnings per share computed without assuming conversion. [*.30, .40, 2011A.05*]

.146 For example, assume that a corporation had a net income of $500 and had 1,000 shares of common stock outstanding. Also outstanding were 1,000 convertible bonds with a par value of $100 each paying interest at 3% per annum and convertible into one share of common stock each. Assume the bonds are classified as common stock equivalents and that the effective income tax rate is 50%. The earnings per common share outstanding (ignoring conversion of the bonds) is $.50 per share. Assuming conversion, $3,000 interest would be added back less $1,500 of additional income tax, resulting in a net increase of $1,500 and earnings applicable to common stock of $2,000. The $1.00 earnings per share for the 2,000 common and common equivalent shares would be anti-dilutive and conversion would therefore not be assumed.

43. Conversion Assumed for Primary Only

.147

Q—When a common stock equivalent convertible security is assumed to be converted for primary earnings per share computations, must it also be assumed to be converted for fully diluted earnings per share computations?

A—Generally, a common stock equivalent convertible security is assumed to be converted for both computations. However, if fully diluted earnings per share would be increased by the assumed conversion, conversion would be assumed only for the primary earnings per share computation. Such a situation could occur if two convertible securities were outstanding and the dividend on one classified as a common stock equivalent exceeds fully diluted earnings per share but not primary earnings per share. [*.15, .31, .40*]

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[24] See Interpretation 44 for an exception when actual conversion occurs.

.148 For example, assume that a corporation had a net income of $9,500 and had 2,000 shares of common stock outstanding. Also outstanding were 1,000 shares of Class A convertible preferred stock which was a common stock equivalent and 1,500 shares of Class B convertible preferred stock which was not a common stock equivalent. The Class A paid a dividend of $2.50 per share and the Class B paid a dividend of $1 per share. Both are convertible into common on a one-for-one basis.

.149 Primary earnings per share is $2.67 per share assuming conversion of the Class A convertible preferred ($9,500 — $1,500 = $8,000 earnings applicable to common divided by 3,000 shares). Fully diluted earnings per share would be $2.11 per share if conversion were assumed for both the Class A and Class B convertible preferred ($9,500 ÷ 4,500 shares). However, fully diluted earnings per share is $2.00 per share if conversion is assumed for only the Class B ($9,500 — $2,500 = $7,000 earnings applicable to common divided by 3,500 shares). The difference between $2.11 and $2.00 is caused by the incremental effect of assuming conversion of the Class A. Since the Class A dividend per common share obtainable upon conversion exceeds fully diluted earnings per share computed without assuming conversion, conversion would be anti-dilutive. (See Interpretation 41.) Therefore, primary earnings per share is reported at $2.67 per share and fully diluted earnings per share is reported at $2.00 per share since this is the maximum dilutive amount.

.150 This example illustrates the fact that earnings per share amounts may be affected by changes either in the numerator or in the denominator used in the computation. Naturally, in some cases, both change.

44. If Converted Method at Actual Conversion

.151

Q—Is the if converted method applied differently for primary and fully diluted earnings per share computations when actual conversion occurs?

A—When a common stock equivalent convertible security is converted during a period, the if converted method

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is applied from the beginning of the period [25] to the date of conversion for both primary and fully diluted earnings per share computations if the result is dilutive. [*.41*]

.152 If the result is anti-dilutive, however, conversion is not assumed for the primary computation. But when an actual conversion occurs during a period, conversion is assumed at the beginning [25] of the period for the fully diluted computation and the if converted method is applied, regardless of whether the result is dilutive or anti-dilutive. [*.30, .41*]

.153 Upon actual conversion, common stock issued is included in the weighted average of shares outstanding in both the primary and fully diluted computations from the date of conversion. The securities tendered by the holder for conversion are thereafter considered to be retired. [*2011A.02*]

45. Securities Convertible into Other Convertible Securities

.154

Q—How is a convertible security which is convertible into another convertible security included in earnings per share computations?

A—Such convertible securities enter earnings per share computations according to their provisions and their characteristics. [*.43*]

.155 A convertible security issued by a subsidiary which is convertible only into a parent company's convertible security is a senior security from the standpoint of the subsidiary, i. e., the yield test does not apply. For consolidated earnings per share computations, however, the subsidiary's security would be assumed to be converted into the parent's security. The parent's security would then be assumed to be converted under the if converted method (if the net result is dilutive). If the parent's convertible security is not a common stock equivalent, conversion of the parent's security would be assumed only for fully diluted computations. If it is a common stock equivalent, conversion of the parent's security would be assumed for both primary and fully diluted computations. (See Interpretation 93.)

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[25] For convertible securities issued and converted during the period, conversion is assumed only from time of issuance rather than from the beginning of the period.

.156 Convertible securities which are convertible at the option of the holder into either another convertible security or a nonconvertible security are assumed to be converted into the security which would be more advantageous for the holder (but not if the result is anti-dilutive). If conversion is assumed into the other convertible security, that security is then assumed to be converted into common stock for earnings per share computations (but not if the net result is anti-dilutive). If conversion is assumed into the nonconvertible security, dividends which would have been applicable to the nonconvertible security, as if it had been outstanding, are deducted in determining earnings applicable to common stock. If converted adjustments may also be applicable. The classification (determined under the yield test) as a common stock equivalent or other potentially dilutive security of convertible securities which are convertible at the option of the holder as discussed in this paragraph determines whether conversion is assumed for both primary and fully diluted computations or only for fully diluted computations. [*2011A.11, 2011A.13*]

.157 In some cases, the security which would be more advantageous for assumed conversion cannot be determined. This might be the case, for example, if the nonconvertible security pays a high dividend and the second convertible security has good prospects for an increase in its market price. If the more advantageous security to the holders cannot be determined, the computation should give effect to the greater earnings per share dilution.

OPTIONS AND WARRANTS AND THEIR EQUIVALENTS

46. Classification of Options and Warrants

.158

Q—How are options, warrants and their equivalents classified for earnings per share computations?

A—Options, warrants and their equivalents are always common stock equivalents unless *all* of the following conditions are met: (1) they were issued prior to June 1, 1969 *and* (2) the issuer makes election "b" under section 2011.46 *and* (3) they were not classified as residual securities under APB Opinion No. 9. Options, warrants and other equivalents classified under this exception are not common stock equivalents but are other potentially dilutive securities and are included only in fully diluted earnings per share com-

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putations.[26] All other options, warrants and their equivalents are included in both primary and fully diluted earnings per share computations. [*.35, .42, .46*]

47. No Anti-Dilution from Options and Warrants

.159

Q—When are options and warrants anti-dilutive under the treasury stock method?

A—Generally, options and warrants are anti-dilutive whenever their exercise price exceeds the market price of the common stock obtainable on exercise. This is because application of the treasury stock method in such a case would reduce the number of common shares included in the computation which would increase the earnings per share amount. [*.36, .36 fn. 14*]

.160 The prohibition against anti-dilution in applying the treasury stock method recognizes the economic fact that an option or warrant would not be exercised if the exercise price were above the market price because the stock could be purchased in the market for less than it could be purchased by exercising the option or warrant. However, if for some reason options or warrants are exercised when the market price is below the exercise price, the market price at the exercise date is applied in the fully diluted computation for the exercised options or warrants for the period they were outstanding. (See Interpretation 62.) However, anti-dilution is not reflected in the primary computation prior to exercise. [*.30, .40, .42*]

.161 In special cases for which other methods are applied (see sections 2011.37 and 2011.38), the factors which cause dilution or anti-dilution are, of course, different. These special cases are discussed in Interpretations 50 and 65-71. [*.37, .38*]

48. Equivalents of Options and Warrants

.162

Q—What kinds of securities are considered the equivalents of options and warrants and therefore always classified as common stock equivalents?

A—Stock purchase contracts, stock subscriptions not fully paid, deferred compensation plans providing for the

[26] These options and warrants would be common stock equivalents except for the fact that they were issued before section 2011 was released. Section 2011 provides that they be classified as common stock equivalents only if the issuer elects to so classify them.

issuance of common stock, and convertible debt and convertible preferred stock allowing or requiring the payment of cash at conversion (regardless of the yield of such convertible securities at time of issuance) are considered the equivalents of options or warrants. The treasury stock method should be applied for all of these securities unless their terms or the provisions of sections 2011.37 and 2011.38 require that another method be applied for the computation of earnings per share. [*.27, .35, .36, .37, .38*]

49. Grouping Options and Warrants

.163

Q—May anti-dilutive options and warrants be grouped with dilutive options and warrants in applying the treasury stock method?

A—No, except in the special situations discussed below. [*.30, .40*]

.164 Section 2011.35, footnote 13, allows reasonable grouping of like securities, i. e., options and warrants with the same exercise prices per common share to be issued. For example, it would be appropriate to group an option to purchase one share of common stock for $20 with a warrant to purchase two shares of common stock for $40. Assuming a market price of $15 per share for common stock, these options and warrants would not be grouped with a warrant to purchase one share of common stock for $10. [*.35 fn. 13*]

.165 If an aggregate computation is required, however, anti-dilutive and dilutive securities must be included in the same computation. Section 2011.38 provides for an aggregate computation, for example. An anti-dilutive option which must be exercised before a dilutive option may be exercised must also be included in an aggregate computation. [*.38*]

.166 For example, assume an option is exercisable at $30 to purchase one share of common stock and a second option is exercisable at $10 to purchase one share of common stock *after* the first option is exercised. The two options would be grouped and considered as a "two-step" option to buy two shares of common stock for $40. Their aggregate effect would be dilutive whenever the market price of common stock exceeds $20 per share. An aggre-

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gate computation would not be made for a dilutive option which must be exercised before an anti-dilutive option may be exercised, because the anti-dilutive option would not be exercised in such a situation.

50. Methods Used for Options and Warrants

.167

Q—Since different methods are described for the treatment of options and warrants in section 2011, in what order should the different methods be applied?

A—In determining the effect of options and warrants and their equivalents in earnings per share computations, apply section paragraphs in the following order (to the extent that each is pertinent):

Section 2011.37
Section 2011.38
Section 2011.36 [.36]

.168 Section 2011.37 applies to options and warrants or their equivalents (1) which either allow or require the tendering of debt at exercise or (2) whose proceeds from exercise must be applied to retire debt or other securities under the terms of those securities. Section 2011.37 also applies to convertible securities which either allow or permit the payment of cash at conversion. Such convertibles are considered the equivalents of warrants. [*.35, .37*]

.169 Section 2011.38 applies only when the number of common shares obtainable upon exercise of all outstanding options and warrants and their equivalents exceed 20% of the number of common shares outstanding at the end of the period. [*.38*]

.170 Section 2011.36 (the treasury stock method) applies to all other options and warrants and their equivalents. [*.36*]

51. Treasury Stock Method Reflects Dilution of Options and Warrants

.171

Q—How does the treasury stock method reflect the dilutive effect of options and warrants?

A—The treasury stock method increases the number of shares assumed to be outstanding when the exercise price of an option or warrant is below the market price of common stock obtainable on exercise. The dilutive effect of the

treasury stock method is demonstrated in the following example. [*.36 fn. 14*]

.172 Assume that a corporation earned $125,000 during a period when it had 60,000 shares of common stock outstanding. The common stock sold at an average market price of $20 per share during the period. Also outstanding were 10,000 warrants which could be exercised to purchase one share of common stock for $15 for each warrant exercised. Earnings per common share *outstanding* would be $2.08 per share ($125,000 ÷ 60,000 shares).

.173 Applying the treasury stock method, the 10,000 warrants would be assumed to have been exercised by their holders at the beginning of the period. Upon exercise, 10,000 shares of common stock would be assumed to have been issued by the corporation to the holders. The $150,000 proceeds (10,000 warrants at an exercise price of $15 per share) would be assumed to have been used by the corporation to purchase 7,500 shares ($150,000 ÷ $20 per share average market price) of common stock in the market on the exercise date. Common stock would therefore increase 2,500 shares.[27] (10,000 shares issued less 7,500 shares purchased results in 2,500 *incremental* shares.) A total of 62,500 shares would be considered as outstanding for the entire period. The amount to be reported as primary earnings per share would be $2.00 per share ($125,000 ÷ 62,500 shares), or dilution of $.08 per share.

.174 Fully diluted earnings per share would also be $2.00 per share if the ending market price of the common stock were $20 per share or less. But an ending market price above $20 per share would cause more dilution to be reflected in fully diluted earnings per share. For example, an ending market price of $25 per share would produce 4,000 incremental common shares[28] which would result in fully diluted earnings per share of $1.95 per share. Dilution would be $.13 per share from earnings per outstanding share and $.05 per share from primary earnings per share. [*.42*]

[27] The incremental number of shares may be more simply computed

$$\frac{\$20 - \$15}{\$20} \times 10{,}000 = 2{,}500$$ using the formula given in Interpretation 12

[28] For fully diluted incremental shares, the computation would be

$$\frac{\$25 - \$15}{\$25} \times 10{,}000 = 4{,}000.$$

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52. Market Prices Used for Treasury Stock Method

.175

Q—What market prices of common stock are used in applying the treasury stock method for options and warrants?

A—The average market price of common stock during each three-month quarter included in the period being reported upon is used to determine the number of incremental shares included in primary earnings per share computations. When a period of less than three months is being reported upon, the average market price during that period is used. [*.36, 2011C.03*]

.176 The average market price during each three-month quarter included in the period being reported upon is also used to determine the number of incremental shares included in fully diluted earnings per share computations *unless* (1) the ending market price for the quarter is higher than the average market price or (2) options or warrants were exercised during the quarter. [*.42, 2011C.03*]

.177 A higher ending market price for the quarter is used in fully diluted computations rather than the average market price. For the fully diluted year-to-date computation, the number of incremental shares produced by applying the ending market price is compared to the number of shares determined by computing a year-to-date weighted average of incremental shares included in the quarterly fully diluted computations. The number of incremental shares used in the fully diluted year-to-date computation is the greater of the number of incremental shares determined from the ending market price or from the weighted average of quarters. (See Interpretation 60 and paragraph .359 for examples.)

.178 When options or warrants are exercised, the market price on the exercise date is applied for the exercised options or warrants from the beginning of the year to the exercise date for fully diluted computations. Thus, the incremental share computations for quarters prior to the exercise date use the market price at the exercise date rather than the ending or average market price. (See Interpretations 61 and 62 for examples.)

.179 In accordance with the anti-dilution provisions of section 2011 exercise of options or warrants is not as-

sumed for any quarter when the exercise price is higher than the market price determined for the computation (as described above) except when options or warrants have in fact been exercised. However, anti-dilutive options or warrants would be included in an aggregate computation resulting in a net dilutive effect. [*.30, .38, .40, .42*]

.180 Thus, options and warrants may be included in the computations in some quarters but not in other quarters. Also, options and warrants may be included in fully diluted earnings per share computations in a quarter when the ending market price is above the exercise price but not included in primary earnings per share computations for the quarter because the average market price is below the exercise price. [*.30, .42*]

53. How Many Market Prices?

.181

Q—How many market prices should be used to determine the average market price of common stock when applying the treasury stock method?

A—As many market prices as are needed to compute a meaningful average would be used. [*.36*]

.182 Theoretically, every market transaction for a company's common stock (both the number of shares and the price per share) could be included in determining the average market price. For example, consider four transactions of: 100 shares at $10 per share, 60 shares at $11 per share, 30 shares at $12 per share, and 10 shares at $13 per share. The average of the four prices would be $11.50 (a simple average) but the average price for the 200 shares would be $10.75 per share (a weighted average).

.183 As a practical matter, however, a simple average of monthly prices is adequate so long as prices do not fluctuate significantly. If prices fluctuate greatly, weekly or daily prices probably would be used. Only if volume of common shares traded and prices at which trades occurred both fluctuated significantly would it be necessary to compute a weighted average to obtain a meaningful average market price.

54. What Market Price to Use?

.184

Q—Should the market price used in computing the average described in Interpretation 53 be the high, low, close or an average of high and low prices?

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A—Generally, closing market prices would be adequate for use in computing the average market price. When prices fluctuate widely, however, an average of the high and low prices for the period the price represents (whether a month, week, or day) would usually produce a more representative price to be used. [*.36*]

.185 Perhaps more important than the price selected is that the particular price selected be used consistently unless it is no longer representative because of changed conditions. For example, a company using the closing price during several years of relatively stable market prices could change to an average of high and low prices if prices started fluctuating greatly and the closing market price would no longer produce a representative average market price. Likewise, a company using an average of high and low prices during several years of relatively stable volume could use an average weighted by the number of shares included in market transactions during the period if both prices and volume started fluctuating greatly and the simple average of high and low prices would no longer produce a representative average market price. Shorter periods would be more appropriate than longer periods in this case also, as noted in Interpretation 53.

.186 Changing the price, period or method used in computing the average market price would only be done when it becomes obvious that a representative average market price would not be obtained if the change were not made. In the absence of changed conditions a change would not be made.

55. Over-the-Counter and Listed Stocks Not Traded

.187

Q—What price should be used when applying the treasury stock method for an over-the-counter stock or a listed stock not traded?

A—If available, market prices at which trades occur would be used in applying the treasury stock method. For stocks traded over-the-counter, the actual trade prices may not be known. Bid and asked quotations generally are available, however, for both over-the-counter stocks and listed stocks not traded. [*.36*]

.188 The price which will be representative of the market price may have to be computed from the information

available. An average of the bid and asked quotations might produce a representative price. In some cases, an average of quotations from several dealers could be used. Generally the method selected would be used consistently in the absence of actual market prices.

.189 It should be noted that although bid quotations produce a conservative estimate of a stock's market value, asked quotations are more conservative for earnings per share computations. This is because a higher market price produces more incremental shares under the treasury stock method than does a lower price. Therefore, to obtain a conservative answer, the asked quotation would be used in applying the treasury stock method for listed common stocks not traded and for common stocks traded over the counter.

56. Fair Value Used If No Market Price

.190

Q—How should the average market price be determined, to apply the treasury stock method for options and warrants, if a company's common stock is not traded (for example, for a closely held company with only options outstanding)?

A—When a company's common stock is not traded and market prices are therefore not available, the fair value per share of its common stock is used to apply the treasury stock method for options and warrants. [*.33 fn. 11*]

.191 Estimating the fair value of a share of common stock which is seldom, if ever, traded is often difficult. Various methods of valuation may be appropriate under different circumstances. While book value or liquidation value per share may provide some indication of fair value, these amounts usually would not be used without adjustment. Estimations based on replacement value or capitalized earnings value, however, might be used in determining fair value.

.192 In some cases documents may be used as a basis for estimating the fair value of a company's common stock. Personal financial statements of stockholders prepared in accordance with *Audits of Personal Financial Statements* (An AICPA Industry Audit Guide published by the American Institute of CPAs in 1968) would present the estimated

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value of their stock ownership in the company. Buy and sell agreements contain provisions for determining the value of a stockholder's interest in a company in the event of death or retirement or withdrawal from participation in the company's activities. Estate tax valuations established for recently deceased stockholders may provide a basis for estimating the current value of a company's stock. Merger or sales negotiations entered into by the company and valuations or appraisals obtained by a stockholder or the company for credit purposes may provide established values appropriate for use in estimating the fair value of a company's common stock. A fair value estimate of the stock might also be projected currently from the relationship at the time of issuance of the warrant or option to earnings (on a per share basis) or to the book value of the common stock.

.193 External sources may also be used to obtain a fair value estimate for a company's stock. Traded securities of other companies in the same industry, their price-earnings ratios, dividend yields, and the relationship of their market prices to book values per share may provide guidance for estimating the value of a stock which is not traded. In addition to the methods suggested above, articles in professional publications may suggest other valuation methods and provide more specific guidance for applying selected techniques (for example, see *The Journal of Accountancy,* August 1969, pages 35-47, and March 1966, pages 47-55). Revenue Ruling 59-60 also provides guidance for valuing stocks with no quoted market prices. In some instances, companies have engaged investment bankers to estimate the value of the common stock when management believed a fair value could not be obtained any other way.

.194 When a fair value estimate is used in the absence of market prices for a company's common stock, this fact and the method used to estimate the fair value would be disclosed as required by section 2011.20. The disclosure would usually be contained in a note to the earnings per share amounts presented (such as the example in section 2011C.04). [*.20*]

57. Options and Warrants Outstanding Part of a Period

.195

Q—How should dilutive options or warrants which are outstanding for only part of a period be treated for earnings per share computations?

A—Dilutive options or warrants which are issued during a period or which expire or are cancelled during a period are reflected in both primary and fully diluted earnings per share computations for the time they were outstanding during the period being reported upon. The common equivalent shares to be considered enter earnings per share computations as a weighted average as described in section 2011A.02. [*.36, .41, 2011A.02*]

.196 For example, assume that a corporation whose financial reporting year ends on December 31 issued 100,000 warrants for one share each on October 8, 1969 with an exercise price of $10. Assume also an average market price for common stock during the intervening twelve-week period of $12 per share. Applying the treasury stock method for primary earnings per share computations for the fourth quarter, the 16,667 incremental shares

$$\left(\text{computed } \frac{\$12 - \$10}{\$12} \times 100{,}000 = 16{,}667\right)$$

would be weighted 12/13, since they were outstanding for only twelve of the thirteen weeks during the quarter, and would represent 15,385 common shares (16,667 × 12/13) in the fourth quarter of 1969. In the annual earnings per share computation for 1969, these warrants would represent 3,846 common shares (15,385 ÷ 4).

.197 If the market price at December 31, 1969 for common stock exceeded the $12 average market price, the higher market price would be used in computing fully diluted earnings per share to reflect maximum potential dilution as specified in section 2011.42. For a market price of common stock on December 31 of $12.50 per share, the shares to be added for the fourth quarter fully diluted earnings per share would be computed as follows:

$$\frac{\$12.50 - \$10}{\$12.50} \times 100{,}000 = 20{,}000$$

$$12/13 \times 20{,}000 = \textit{18,462} \text{ shares.}$$

The shares to be added for 1969 annual fully diluted earnings per share in this case would be 4,615.

.198 If the warrants described in the above example expired or were cancelled on March 25, 1970 and we assume

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an average market price for common stock during the twelve weeks then ended of $12, the same results as above would be obtained for primary earnings per share computations for the first quarter of 1970. That is, assumed exercise of the 100,000 warrants would produce 16,667 incremental shares weighted 12/13 and would represent 15,385 common shares in the first quarter of 1970. In the annual earnings per share computations for 1970, these warrants would represent 3,846 common shares.

.199 If the market price of common stock on the *last day the warrants were outstanding* (March 25, 1970) exceeded the $12 average market price for the twelve week period, the higher market price would be used in computing fully diluted earnings per share to reflect maximum dilution. For a market price of $12.50 on March 25, 1970 in this example, 18,462 shares would be added for the first quarter computations and 4,615 shares would be added for the 1970 annual computations in computing fully diluted earnings per share. [*.42*]

.200 Generally, options or warrants which expire or are cancelled will not affect earnings per share computations. The above examples are included only for those rare cases when they do. Most dilutive options and warrants will be exercised prior to expiration or cancellation. Anti-dilutive options and warrants do not enter earnings per share computations,[29] since they would not be exercised when common stock could be purchased for less in the market than through exercise. [*.30, .40*]

.201 When dilutive options or warrants expire or are cancelled during a period, it may also be desirable to furnish supplementary earnings per share data as described in section 2011.22, but previously reported earnings per share data would not be retroactively adjusted for expirations or cancellations of warrants or options. [*.22*]

58. What Is a Period?

.202

Q—What is a "period" as the term is used in section 2011?

A—A "period" is the time for which net income is reported and earnings per share are computed.

---

[29] Except in the unusual situations described in section 2011.38 and in Part I, paragraph .016, fn. 6.

.203 However, when the treasury stock method or any method[30] requiring the computation of an average market price is used and the reporting period is longer than three months, a separate computation is made for each three-month period. [*2011C.03*]

.204 If a period of less than a quarter is being reported upon, the average market price of common stock during the period encompassed by the income statement is used in applying the treasury stock methods. Other methods[30] requiring the use of average market prices also use the prices in effect during this shorter period.

59. Share Averaging

.205

Q—When the reporting period is longer than three months and the treasury stock method is applied, how is the weighted average of shares computed for the reporting period?

A—A weighted average of shares is computed based on the average market prices during each three months included in the reporting period. Thus, if the period being reported upon is six months, nine months, or one year, a weighted average[31] of shares is computed for each quarter. The weighted averages for all quarters are then added together, and the resulting total is divided by the number of quarters to determine the weighted average for the period. [*2011C.03*]

.206 Assume, for example, that a corporation had 25,000 shares of common stock outstanding during a year and also had granted options which resulted in the following incremental shares computed using the treasury stock method: 500 in the first quarter, none in the second quarter because they would have been anti-dilutive, 1,400 in the third quarter, and 1,000 in the fourth quarter. The weighted average of shares for the year could be computed either

$$25{,}500 + 25{,}000 + 26{,}400 + 26{,}000 = 102{,}900$$

$$102{,}900 \div 4 = \mathit{25{,}725}$$

or

$$\frac{500}{4} + \frac{1{,}400}{4} + \frac{1{,}000}{4} = 725$$

$$725 + 25{,}000 = \mathit{25{,}725}$$

[30] For example, see Interpretations 67, 70, 77 and 79.

[31] See Interpretation 25 and paragraph .359 for examples of computing a weighted average.

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60. Applying Ending and Average Market Prices

.207

Q—How do the computations of primary and fully diluted earnings per share differ when the treasury stock method is applied for options and warrants and the ending market price of common stock is different from the average market price?

A—When the ending market price of common stock is higher than the average market price for the period, the ending market price is used for the fully diluted computation to reflect maximum potential dilution. The use of different market prices for primary and fully diluted earnings per share computations naturally results in different numbers of shares for the two computations. The use of a higher ending market price for fully diluted computations may also result in the assumption of exercise for fully diluted earnings per share but not for primary earnings per share. Year-to-date computations for fully diluted earnings per share may also be more complex when market prices of common stock increase and then decrease during the year, since the share computation is then made two ways and the greater number of shares is used in computing year-to-date fully diluted earnings per share. The above situations are illustrated in the following example. [*.42*]

.208 Assume stock options are outstanding to obtain 5,000 shares of common stock at an exercise price of $10 per share. Assume also the following average and ending market prices of common stock during the calendar year:

	Average Market Price	*Ending Market Price*
First quarter	$11.11	$12.00
Second quarter	9.75	11.00
Third quarter	13.89	14.00
Fourth quarter	12.50	13.00

.209 For primary earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the dilutive effect of the options:

	Primary Incremental Shares	
	Quarterly EPS	*Year-to-Date EPS*
First quarter	500(1)	500
Second quarter	—0—	250(2)
Third quarter	1,400(3)	633(4)
Fourth quarter	1,000(5)	725(6)

COMPUTATIONAL NOTES:

(1) $\frac{\$11.11 - \$10}{\$11.11} \times 5{,}000 = 500$

(2) 500 + 0 = 500. 500 ÷ 2 = 250

(3) $\frac{\$13.89 - \$10}{\$13.89} \times 5{,}000 = 1{,}400$

(4) 500 + 0 + 1,400 = 1,900. 1,900 ÷ 3 = 633

(5) $\frac{\$12.50 - \$10}{\$12.50} \times 5{,}000 = 1{,}000$

(6) 500 + 0 + 1,400 + 1,000 = 2,900. 2,900 ÷ 4 = 725

.210 For fully diluted earnings per share, the treasury stock method would produce the following number of incremental shares to reflect the maximum dilutive effect of the options:

	Fully Diluted Incremental Shares	
	Quarterly EPS (1)	*Year-to-Date EPS*
First quarter	833	833
Second quarter	455(2)	644(3)
Third quarter	1,429	1,429(4)
Fourth quarter	1,154	1,154(5)

COMPUTATIONAL NOTES:

(1) Based on ending market price for each quarter.

(2) Note that the average market price for this quarter was anti-dilutive, so the computation is made only for fully diluted earnings per share.

(3) 833 + 455 = 1,288. 1,288 ÷ 2 = 644
Use 644 weighted average since 644 is greater than 455 incremental shares based on ending market price.

(4) 833 + 455 + 1,429 = 2,717. 2,717 ÷ 3 = 906.
Use 1,429 incremental shares based on the ending market price since 1,429 is greater than 906.

(5) 833 + 455 + 1,429 + 1,154 = 3,871. 3,871 ÷ 4 = 968.
Use 1,154 incremental shares based on the ending market price since 1,154 is greater than 968.

.211 Note that the two computations made for year-to-date fully diluted incremental shares may in some cases cause different market prices to be applied for the quarterly and year-to-date fully diluted computations. For example, assume that in the above illustration the average market price in the fourth quarter was $13 and the ending market price was $12.50. The $13 average market price would produce 1,154 incremental shares in the fourth quarter for both primary and fully diluted computations. In the annual fully diluted computation, however, the $12.50 ending market price would produce 1,000 incremental shares while the average number of shares for the four quarters would be only 968 (see computational note 5 above under fully diluted).

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Therefore the average market price would be used for the fourth quarter fully diluted computation and the ending market price would be used for the annual fully diluted computation.

.212 A more comprehensive example of these points appears in paragraph .359.

61. *Treasury Stock Method at Exercise*

.213

Q—How is the treasury stock method applied for options and warrants which are exercised?

A—Common stock issued upon the exercise of options or warrants is included in the weighted average of outstanding shares from the exercise date. The treasury stock method is applied for exercised options or warrants from the beginning of the period to the exercise date. For primary earnings per share, the computation for the period prior to exercise is based on the average market price of common stock during the period the exercised options or warrants were outstanding (if the result is dilutive). Incremental shares are weighted for the period the options or warrants were outstanding and shares issued are weighted for the period the shares were outstanding. For fully diluted earnings per share, however, the computation for the period prior to exercise is based on the market price of common stock when the options or warrants were exercised regardless of whether the result is dilutive or anti-dilutive. Incremental shares are weighted for the period the options or warrants were outstanding and shares issued are weighted for the period the shares are outstanding. These situations are illustrated in the following example. [*.42, 2011A.02*]

.214 Assume stock options are outstanding to obtain 5,000 shares of common stock at an exercise price of $10 per share. Assume also the following average and ending market prices of common stock during the calendar year:

	Average Market Price	*Ending Market Price*
First quarter	$11.11	$12.00
Second quarter	9.75	11.00
Third quarter	13.89	14.00
Fourth quarter	12.50	13.00

Also assume that 1,000 options were exercised May 1 when the market price of common stock was $10.50 per share and

another 1,000 options were exercised September 1 when the market price of common stock was $15 per share. The average market price from April 1 to May 1 was $11.25 and from July 1 to September 1 was $13.

.215 For primary earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the dilutive effect of the options:

	Primary Incremental Shares	
	Quarterly EPS	*Year-to-Date EPS*
First quarter	500	500
Second quarter	37(1)	269(2)
Third quarter	994(3)	510(4)
Fourth quarter	600	533(5)

COMPUTATIONAL NOTES:

(1) ⅓ of 111 incremental shares for 1,000 options exercised May 1 (using $11.25 average market price for the period the options were outstanding). Remaining options are anti-dilutive.

(2) 500 + 37 = 537. 537 ÷ 2 = 269

(3) 840 incremental shares for 3,000 options outstanding all of the quarter (exercise assumed at $13.89 average market price for the quarter) plus ⅔ of the 231 incremental shares for 1,000 options outstanding for two months of the quarter (exercise assumed at $13 average market price for the period the options were outstanding). 840 + 154 = 994

(4) 500 + 37 + 994 = 1,531. 1,531 ÷ 3 = 510

(5) 500 + 37 + 994 + 600 = 2,131. 2,131 ÷ 4 = 533

In addition, outstanding shares would increase as follows to reflect options *exercised* May 1 and September 1:

	Increase in Outstanding Shares	
	Quarterly EPS	*Year-to-Date EPS*
First quarter	—0—	—0—
Second quarter	667(1)	333(2)
Third quarter	1,333(3)	667(4)
Fourth quarter	2,000(5)	1,000(6)

COMPUTATIONAL NOTES:

(1) ⅔ of 1,000 shares issued May 1 and outstanding for two months.

(2) 0 + 667 = 667. 667 ÷ 2 = 333

(3) 1,000 shares issued May 1 plus ⅓ of 1,000 shares issued September 1.

(4) 667 + 1,333 = 2,000. 2,000 ÷ 3 = 667

(5) 1,000 shares issued May 1 plus 1,000 shares issued September 1.

(6) 0 + 667 + 1,333 + 2,000 = 4,000. 4,000 ÷ 4 = 1,000

.216 For fully diluted earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the maximum dilutive effect of the options:

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	Fully Diluted Incremental Shares	
	Quarterly EPS	Year-to-Date EPS
First quarter	833	833
Second quarter	380(1)	548(2)
Third quarter	1,079(3)	1,174(4)
Fourth quarter	692(5)	930(6)

COMPUTATIONAL NOTES:

(1) 364 incremental shares for 4,000 options outstanding all of the quarter (using $11 ending market price) plus ⅓ of 48 incremental shares for 1,000 options exercised May 1 (using $10.50 market price at exercise date).

(2) (667 + 48) + 380 = 1,095. 1,095 ÷ 2 = 548. For the first quarter, 667 incremental shares for 4,000 options (using $12 ending market price) plus 48 incremental shares for 1,000 options exercised May 1 (using $10.50 market price at exercise date). See note 1 for second quarter. The incremental shares for the two quarters are then weighted.

(3) 857 incremental shares for 3,000 options outstanding all of the quarter plus ⅔ (333) = 222 incremental shares for 1,000 options exercised September 1 and outstanding two months.

(4) 857 incremental shares for 3,000 options outstanding for all of the three quarters based on $14 higher ending market price applied for all of the three quarters plus 4/9 (48) = 21 for the May 1 exercise plus 8/9 (333) = 296 for the September 1 exercise.

(5) Based on $13 market price and 3,000 options.

(6) 500 + 273 + 857 + 692 = 2,322. 2,322 ÷ 4 = 581 incremental shares for 3,000 options outstanding for four quarters using market prices of $12, $11, $14 and $13 for the respective quarters for computing the weighted average of incremental shares. Since 692 incremental shares determined by applying the ending market price is greater than 581 weighted incremental shares, 692 is used. The 692 is increased by 4/12 (48) = 16 shares for the May 1 exercise plus 8/12 (333) = 222 for the September 1 exercise. 692 + 16 + 222 = 930.

In addition, outstanding shares would increase by the same number of shares as illustrated for the primary earnings per share computation for the options *exercised* on May 1 and September 1, i. e., 667 shares in the second quarter, 1,333 in the third quarter, 2,000 in the fourth quarter, 333 for the first six months, 667 for the first nine months, and 1,000 for the year.

62. Anti-Dilutive Exercise

.217

Q—Is the treasury stock method applied for options and warrants which are exercised when the market price is below the exercise price?

A—Options or warrants usually would not be exercised in such a situation. The common stock obtainable upon exercise could be purchased in the market for less than the exercise price. However, in those rare cases where such an exercise does occur, the treasury stock method is applied from the beginning of the year to the exercise date for fully diluted computations using the market price at the exercise date. The result will be anti-dilutive. [*.42*]

.218 For primary computations, the average market price from the beginning of the quarter to the exercise date is used, but only if the result is dilutive. Thus, when the average market price is less than the exercise price while the exercised options or warrants were outstanding, the exercised options or warrants are omitted from primary computations. [*.30, .36*]

.219 Common stock issued upon exercise is included in the weighted average of outstanding shares from the exercise date for both primary and fully diluted computations. Shares produced by the treasury stock method are included in the weighted average of outstanding shares for the time the exercised options or warrants were outstanding. [*2011A.02*]

.220 For example, assume stock options are outstanding to obtain 5,000 shares of common stock at an exercise price of $10 per share. Assume also the following average and ending market prices of common stock during the calendar year.

	Average Market Price	*Ending Market Price*
First quarter	$11.11	$12.00
Second quarter	9.75	11.00
Third quarter	13.89	14.00
Fourth quarter	12.50	13.00

On June 1, 1,000 options were exercised when the market price of common stock was $9.50 per share. The average market price from April 1 to June 1 was $9.65 per share.

.221 For primary earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the dilutive effect of the options:

	Primary Incremental Shares	
	Quarterly EPS	*Year-to-Date EPS*
First quarter	500	500
Second quarter	—0—(1)	250
Third quarter	1,120(2)	540(3)
Fourth quarter	800	605(4)

COMPUTATIONAL NOTES:

(1) Average market price for both outstanding options and exercised options are anti-dilutive.

(2) 1,120 incremental shares for 4,000 options outstanding all of the quarter.

(3) 500 + 0 + 1,120 = 1,620. 1,620 ÷ 3 = 540

(4) 500 + 0 + 1,120 + 800 = 2,420. 2,420 ÷ 4 = 605

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In addition, outstanding shares would increase as follows to reflect options *exercised* June 1:

	Increase in Outstanding Shares	
	Quarterly EPS	Year-to-Date EPS
First quarter	—0—	—0—
Second quarter	333(1)	167(2)
Third quarter	1,000(3)	444(4)
Fourth quarter	1,000(5)	583(6)

COMPUTATIONAL NOTES:

(1) ⅓ of 1,000 shares issued June 1 and outstanding for one month.
(2) 0 + 333 = 333. 333 ÷ 2 = *167*
(3) 1,000 shares issued June 1.
(4) 0 + 333 + 1,000 = 1,333. 1,333 ÷ 3 = *444*
(5) 1,000 shares issued June 1.
(6) 0 + 333 + 1,000 + 1,000 = 2,333. 2,333 ÷ 4 = *583*

.222 For fully diluted earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the maximum dilutive effect of the options:

	Fully Diluted Incremental Shares	
	Quarterly EPS	Year-to-Date EPS
First quarter	833	833
Second quarter	329(1)	472(2)
Third quarter	1,143(3)	1,114(4)
Fourth quarter	923(5)	901(6)

COMPUTATIONAL NOTES:

(1) 364 incremental shares for 4,000 options outstanding all of the quarter less ⅔ (1,000—1,053) = — 35 to reflect the anti-dilutive effect of the exercise of 1,000 options outstanding 2 months during the quarter. 364 — 35 = 329
(2) (667 − 53) + (364 − 35) = 943. 943 ÷ 2 = *472*. See note 1. For the first quarter, 667 incremental shares for 4,000 options are reduced by 53 anti-dilutive shares for 1,000 options exercised June 1. The net incremental shares for the two quarters are then weighted.
(3) 1,143 incremental shares for 4,000 options outstanding all of the quarter.
(4) 1,143 incremental shares for 4,000 options outstanding for all of the three quarters based on $14 higher ending market price applied for all of the three quarters *less* 5/9 (53) = − 29 for the June 1 anti-dilutive exercise.
(5) Based on $13 market price and 4,000 options.
(6) 667 + 364 + 1,143 + 923 = 3,097. 3,097 ÷ 4 = 774 incremental shares for 4,000 options outstanding for four quarters using market prices of $12, $11, $14 and $13 for the respective quarters for computing the weighted average of incremental shares. Since 923 incremental shares determined by applying the ending market price is greater than 774 weighted incremental shares, 923 is used. The 923 is decreased by 5/12 (— 53) = — 22 for the June 1 anti-dilutive exercise. 923 — 22 = *901*.

In addition, outstanding shares would increase by the same number of shares as illustrated for the primary earnings per share computation for the options *exercised* on June 1, i. e., 333 shares in the second quarter, 1,000 shares in the third and fourth quarters, 167 shares for the first six

months, 444 shares for the first nine months, and 583 shares for the year.

63. "Substantially All" of Three Months

.223

Q—How long is "substantially all" of a three-month period and why should exercise of options and warrants not be assumed in applying the treasury stock method "until" the market price has exceeded the exercise price for such a period?

A—"Substantially all" is not defined in section 2011. Following the recommendation [32] to not assume exercise before the three-month test is met (1) eliminates the need to make the computation until the market price has exceeded the exercise price for a significant period and (2) reduces "flip-flop" of options and warrants in and out of the computation because of the common stock's market price fluctuations above and below the exercise price. [*.36*]

.224 Presumably, eleven weeks would be substantially all of a thirteen-week quarter. Therefore, the computation would be made for any quarter after the market price has once been above the exercise price for any eleven weeks during a quarter.

.225 Note that this is a one-time test. Exercise need not be assumed for the computations *until* the test has been met, not *unless* the test is met in a particular quarter. Thus, once the test is met, the average market price would be computed thereafter unless the market prices are clearly anti-dilutive.

.226 The test applies for both primary and fully diluted computations. But after the test has once been met, an ending market price which is above the exercise price is used for the fully diluted computation even though the average market price is below the exercise price. [*.42*]

.227 This recommendation also applies to earnings per share computations for income statements prepared for periods which are less than a quarter. When applied to shorter periods, however, virtually all market prices in the

[32] The Board recommended that exercise of options and warrants not be assumed for earnings per share data *until* the market price has been above the exercise price for *substantially all* of the three months ending with the month for which the computation is being made.

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shorter period should be above the exercise price or exercise need not be assumed. For a one-month statement, for example, the market prices during that month and for most of the two preceding months should be above the exercise price. [*.36*]

64. Total of Quarters May Not Equal Annual EPS

.228

Q—Are previously reported earnings per share data ever retroactively adjusted or restated for changes in the incremental number of shares computed using the treasury stock method?

A—No, retroactive adjustment or restatement of previously reported earnings per share data are not made when the incremental number of shares determined by applying the treasury stock method changes. The Board realized that the total of four quarter's earnings per share might not equal the earnings per share for the year when market prices change and the treasury stock method is applied. [*.36, .41*]

.229 Computations for each quarter or other period are independent. Earnings per share data would not either be restated retroactively nor adjusted currently to obtain quarterly (or other period) amounts to equal the amount computed for the year or year to date.

65. Unusual Warrants and Their Equivalents

.230

Q—To what kinds of securities does section 2011.37 apply?

A—Section 2011.37 must be applied for earnings per share computations for the following kinds of securities, all of which are classified as common stock equivalents:

1. Warrants which *require* the tendering of debt or other securities of the issuer or its parent or its subsidiary in full or partial payment of the exercise price.

2. Warrants which *permit* as an alternative the tendering of debt or other securities of the issuer or its parent or its subsidiary in full or partial payment of the exercise price.

3. Warrants whose proceeds from exercise must be applied toward the retirement of debt or other securities of the issuer. Such debt or other securities would have

been issued with the warrants and the requirement to apply any proceeds toward retirement would usually be written into an indenture, making the requirement a contractual obligation.

4. Convertible securities which *require* the payment of cash upon conversion (regardless of their yield at time of issuance).

5. Convertible securities which *permit* the payment of cash as an alternative upon conversion, for example, to obtain a greater number of common shares than could be obtained from straight conversion (regardless of their yield at time of issuance). [*.37*]

66. Securities Subject to Section 2011.37 Tests

.231

Q—Are all of the securities listed in the preceding Interpretation subject to the two tests described in section 2011.37?

A—The two tests described in section 2011.37 are tests to determine whether certain warrants are dilutive or anti-dilutive. The "a" test is the usual test to determine if a warrant is dilutive. The "b" test is applied when securities can be tendered in lieu of cash to exercise a warrant. The computations to be made when either or both tests are met are described in Interpretations 67-70. [*.37*]

.232 The "a" test (the market price of the related common stock must exceed the exercise price of the warrant or the convertible security considered the equivalent of a warrant) applies to warrants (1) which require the tendering of debt, (2) which permit the tendering of debt, and (3) whose proceeds must be used to retire debt.

.233 The "b" test (the security to be tendered is selling at enough discount to establish an effective exercise price below the market price of the common stock obtainable) applies only to the debt or other securities which must or may be tendered toward the exercise price of the warrant (the debt listed in 1 and 2 in Interpretation 65). The "b" test gives recognition to the possibility that a warrant holder could purchase debt in the market at a discount and exercise a warrant by tendering the debt at its face amount, thereby effecting the purchase of the common stock for less than its market price.

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.234 These tests are demonstrated in the following example. Assume that a warrant may be exercised to purchase two shares of common stock by tendering either $100 cash or a $100 face value debenture when market prices are $48 per common share, $94 per debenture, and $6 per warrant. The "a" test is not met (2 × $48 = $96 market price of common does not exceed the exercise price of $100 cash). The "b" test is met. (The $94 market price of the debenture is below the $96 market price for two shares of common. This may also be computed

$$\frac{\text{\$94 market price of debenture}}{\text{\$100 tender value of debenture}} \times \text{\$50 exercise price per}$$

share = $47 effective exercise price per share.) Note that the market price of the warrant is not considered in either test.

.235 The "a" and "b" tests apply to securities on an individual basis. However, when section 2011.38 applies (see Interpretations 72-74), the securities subject to these tests are included in the aggregate computation required by that paragraph whether their individual effect is dilutive or anti-dilutive. [*.35, .38*]

67. Market Prices Used in Section 2011.37 Tests

.236

Q—What market prices are used for the two tests described in section 2011.37?

A—The market prices used for these two tests and for the computations when the tests are met correspond to the market prices used for the treasury stock method (see Interpretations 52-56). Therefore, the computations are made for each quarter and the shares for the quarters are averaged for annual primary computations. [*.37*]

.237 The market price of common stock for both tests is the average market price during each three-month quarter included in the period being reported upon. The ending market price of common stock is used, however, for fully diluted earnings per share if the ending price is *higher* than the average price. [*.42, 2011C.03*]

.238 For the "b" test, the average market price of the debt or other security during each three-month quarter included in the period being reported upon is used. The

ending market price of the debt or other security is used, however, for fully diluted earnings per share if the ending price is *lower* than the average price. [*.37*]

.239 Usually, only one test will be met. In some cases, however, both tests will be met. Also, different tests may be met for primary and fully diluted computations. The computations to be made in these situations are explained in Interpretations 68 and 69. When neither test is met, these securities are not included in earnings per share computations unless section 2011.38 applies. [*.35, .38*]

68. Computations for Warrants Requiring the Tendering of Debt

.240

Q—What computations are made under the "a" and "b" tests specified in section 2011.37 for warrants which require that debt or other securities be tendered upon exercise?

A—If either the "a" or "b" test described in Interpretations 66 and 67 is met when debt or other securities *must* be tendered toward the exercise price, exercise of the warrants is assumed. The debt or other security is tendered at the amount it must be tendered (usually face amount). Interest, net of tax, on the debt is added back to net income in determining earnings applicable to common stock. Common stock is assumed to be issued on the exercise date. The treasury stock method is applied for any cash proceeds when cash is also to be tendered with the debt. The fact that both tests may sometimes be met does not affect the computations. [*.37*]

69. Computations for Warrants Allowing the Tendering of Debt

.241

Q—What computations are made under the "a" and "b" tests specified in section 2011.37 for warrants which permit the tendering of debt or other securities upon exercise?

A—The computations depend upon the test met. If both tests are met, the computations depend upon the alternatives available since some warrants and their equivalents provide two or more exercise or conversion alternatives to the holder. For example, a warrant may be exercisable by paying $60 cash to obtain one share of common stock

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or by tendering $100 face value debt to obtain two shares of common stock. In such a case, debt *may* be tendered but is not required to be tendered. [.37]

.242 When only the "a" test is met (because the debt or other security is selling for more than the amount for which it may be tendered), the treasury stock method is applied since the debt or other security would not be tendered toward exercise of the warrant or its equivalent.

.243 When only the "b" test is met (the debt or other security which may be tendered is selling at enough discount to create an effective exercise price below the market price of the common stock), the procedures described in Interpretation 68 (for when debt or other securities *must* be tendered) are applied.

.244 If *both* the "a" and "b" tests described above are met when debt or other securities *may* be tendered toward the exercise price or if two or more exercise or conversion alternatives meet one test (whether or not both tests are met), the computation should be based upon the alternative which meets the test and is more (or most) advantageous to the holder of the warrant or its equivalent. [*2011A.13*]

.245 The "a" and "b" tests are applied for each quarter using the market prices specified in Interpretation 67. When either test is met, the computations are made for that quarter. Different tests may apply for different quarters in the period. The shares determined for each quarter are averaged for year-to-date primary computations. In fully diluted year-to-date computations, the greater of the average number of shares included in the fully diluted quarterly computations or the number of shares determined by applying ending market prices is used. [*2011C.03*]

70. Computations for Warrants Whose Proceeds Are Applied To Retire Debt

.246

Q—How are warrants whose proceeds must be used to retire debt or other securities included in earnings per share computations?

A—When debt or other securities of the issuer require that the proceeds from the exercise of warrants or their

equivalents be applied toward retirement of those securities, exercise of the warrants is assumed at the beginning of the period (or time of issuance, if later). The proceeds from exercise are assumed to have been used to purchase the securities to be retired at the date of assumed exercise. [*.37*]

.247 These computations are made on a quarterly basis. The shares determined for each quarter are averaged for annual earnings per share computations. The purchase price to be used is the average market price during each three-month quarter for the securities assumed to have been purchased. To reflect maximum potential dilution, the purchase price for the computation of fully diluted earnings per share is the market price of the securities to be retired at the end of the period if this price is *higher* than the average market price. [*.42, 2011C.03*]

.248 Exercise of the warrants is not assumed for either primary or fully diluted earnings per share unless the market price of the related common stock exceeds the exercise price of the warrants.[33] When exercise is assumed and the proceeds from exercise are used to purchase securities to be retired, interest (net of tax) on any debt retired must be added back to net income in determining earnings applicable to common stock. Any excess amount from the assumed exercise of the warrants above the amount needed for the purchase of securities is used to purchase common stock under the treasury stock method. [*.30, .37, .40*]

71. Treasury Stock Method for Convertibles

.249

Q—How are convertible securities which require or permit the payment of cash at conversion included in earnings per share computations?

A—Convertible securities which require or permit the payment of cash at conversion are considered the equivalents of warrants and are therefore always [34] common stock equivalents. [*.37*]

.250 Convertible securities requiring the payment of cash are assumed to be converted at the beginning of the

[33] Exercise may be assumed, however, if section 2011.38 applies. See Interpretations 72-74.

[34] Unless issued before June 1, 1969 and classified under election "b" of section 2011.46.

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period (or time of issuance, if later) and the if converted method is applied. Proceeds from conversion are used to purchase common stock under the treasury stock method. Thus, the incremental number of shares assumed to be outstanding is the difference between the number of shares issued upon assumed conversion and the number of shares assumed purchased under the treasury stock method. If the net result of the aggregate computation of applying both the if converted method and the treasury stock method is dilutive, these computations are included in both primary and fully diluted earnings per share. The computations are not included, however, if the net result is anti-dilutive.[35] [*.30, .40*]

• **.251** Some convertible securities permit the payment of cash at conversion to obtain a more favorable conversion rate. The procedures described in the preceding paragraph are applied for such securities except that no proceeds are assumed to be received upon conversion whenever the amount of cash to be paid exceeds the market value of the additional shares obtainable. The treasury stock method therefore cannot be applied when this condition exists and only the if converted method is applied (if the result is dilutive).[35] [*.37, 2011A.13*]

.252 When several conversion alternatives exist (for example, permitting the payment of different amounts of cash for different conversion rates), the computation should give effect to the alternative which is most advantageous to the holder of the convertible security. [*2011A.13*]

72. Anti-Dilutive Options and Warrants Included

.253

Q—When section 2011.38 applies (the number of common shares obtainable upon exercise of all options and warrants exceeds 20% of the number of common shares outstanding at the end of the period), are anti-dilutive options and warrants assumed to be exercised as well as dilutive options and warrants?

A—Yes, when section 2011.38 applies, all options and warrants and their equivalents are assumed to be exercised (or converted) whether they are dilutive or anti-

[35] Conversion may be assumed even if the result is anti-dilutive when section 2011.38 applies. See Interpretations 72-74 and sections 2011.35 and 2011.38.

dilutive. Under this exception to the general rule that computations should not give effect to anti-dilution, all of the computations specified in sections 2011.36, 2011.37 and 2011.38 are made and aggregated. If the net result is dilutive, all are included. If the net result is anti-dilutive, all are excluded. [*.35, .36, .37, .38*]

73. No Order for Exercise

.254

Q—When section 2011.38 applies and several issues of options and warrants with different exercise prices are outstanding, which options and warrants should be assumed to be exercised to obtain common stock under the treasury stock method, i. e., may anti-dilutive options and warrants be used in applying the treasury stock method or is the treasury stock method applicable only for dilutive options and warrants?

A—All options and warrants are assumed to be exercised when section 2011.38 applies without regard to whether the proceeds will be applied to purchase common stock under the treasury stock method or will be applied to the retirement of debt. Specific options or warrants are not to be allocated for the treasury stock method, but rather all options and warrants are assumed to be exercised and the number of common shares assumed to be repurchased under the treasury stock method may not exceed 20% of the number of common shares outstanding at the end of the period. [*.38*]

74. Explanation of 20% Provision

.255

Q—How is the 20% provision described in section 2011.38 applied?

A—20% is used in two ways in section 2011.38. First, a 20% *test* is applied[36] to outstanding common shares. If the 20% test is met, an aggregate computation is required and all options and warrants and their equivalents are assumed to be exercised. Then a 20% *limitation* is applied to the number of common shares purchased under the treasury stock method. [*.38*]

[36] A corporation which has made election "b" of section 2011.46 would apply this test for both primary and fully diluted earnings per share computations, since the number of shares obtainable from options and warrants may differ for the two computations as described in Interpretation 81.

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.256 Even though the 20% test is met, the number of shares purchased under the treasury stock method may be below the 20% limitation if the market price is high relative to the exercise price. For example, if 1,000,000 common shares and warrants to obtain 500,000 shares were outstanding, the 20% test would be met and the 20% limitation for the treasury stock method would be 200,000 shares. At an exercise price of $10 and a market price of $50, however, only 100,000 shares could be purchased under the treasury stock method.

.257 Note that the 20% limitation applies only to shares assumed *purchased* under the treasury stock method. It does not apply to the number of incremental shares which results from the computation. In the above example, 400,000 incremental shares resulted from the assumed issuance of 500,000 shares upon exercise and the assumed purchase of 100,000 shares under the treasury stock method.

.258 In addition, some warrants and their equivalents for which the treasury stock method may not be applicable result in the assumed issuance of common stock. They are therefore included in applying the 20% test and are included in the aggregate computation if the test is met. For example, warrants whose proceeds must be used to retire debt are included in applying the 20% test and in the aggregate computation if the test is met. Only the proceeds in excess of the amount required for debt retirement would be eligible for the treasury stock method, however. Warrants assumed to be exercised by tendering debt or other securities would also be included in applying the 20% test and in the aggregate computation if the test is met. But only if both cash and debt or other securities were assumed tendered would there be any proceeds eligible for the treasury stock method. Convertible securities which require or permit the payment of cash at conversion are considered the equivalent of warrants. Such convertible securities would be included in applying the 20% test and in the aggregate computation if the test is met. [*.35, .37, .38*]

.259 Most convertible securities, however, (those which do *not* require or permit the payment of cash at conversion) are *not* included in applying the 20% test. Nor are other securities which are not options or warrants or

their equivalents included in the 20% test. For example, the usual participating securities, two-class common stocks and common stock issuable when specified conditions are met are not included in the 20% test. [*.27, .33*]

.260 Securities which are not included in the 20% test are not included in the aggregate computation [37] described in section 2011.38. Thus, even if the net result of the aggregate computation is anti-dilutive and therefore not included in the earnings per share computation, other securities not included in the aggregate computation would be included in the earnings per share computations if they are dilutive. [*.15, .38*]

75. Original Issue Premium or Discount

.261

Q—What treatment is accorded to any original issue premium or discount when debt is assumed acquired under the provisions of sections 2011.37 and 2011.38?

A—Original issue premium or discount is treated as specified in Interpretation 40, i. e., applicable premium or discount amortized during the period is eliminated from net income. Unamortized premium or discount is not included in earnings applicable to common stock and does not affect earnings per share. [*2011A.06*]

76. Redemption Premium or Discount

.262

Q—What treatment is accorded to any redemption premium or discount when debt is assumed acquired under the provisions of sections 2011.37 and 2011.38?

A—Redemption premium or discount, i. e., the difference between the purchase price and the "book" carrying amount of debt, is ignored for earnings per share computations. [*2011A.06*]

.263 Redemption premium or discount could occur only when the proceeds from the assumed exercise of options and warrants are applied to purchase debt at the market price under the provisions of either section 2011.37 or 2011.38. Redemption premium or discount is not included

[37] However, convertible debt assumed to be retired with proceeds from exercise in excess of the amount required for applying the treasury stock method would be included in the aggregate computation and its interest would be eliminated as described in section 2011A.06.

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in earnings applicable to common stock and does not affect earnings per share.

.264 Common shares are, of course, assumed to be issued for all options and warrants assumed to be exercised. [*.36, .42*]

77. Debt Purchased Under Section 2011.38

.265

Q—What debt may the issuer assume is purchased when the provisions of section 2011.38 apply?

A—The issuer may select any debt which is eligible to be retired for assumed purchase when the provisions of section 2011.38 apply. This includes convertible debt (both common stock equivalents and other potentially dilutive securities) except that convertible debt may not be assumed purchased if the purchase would be anti-dilutive (that is, result in less dilution). Debt is eligible to be retired when it either may be "called" or is trading and could be purchased in the market. [*.30, .38, .40*]

.266 The same debt is assumed purchased for both primary and fully diluted earnings per share computations. Different amounts of debt may be assumed purchased, however, since different market prices may have to be used for the primary and fully diluted computations for the treasury stock method. The average market price of the debt during each quarter for which the computations are made is used for both the primary and fully diluted computations under section 2011.38. [*.38*]

78. Compensating Balances Excluded

.267

Q—When section 2011.38 applies and a loan is assumed to be paid, what treatment is accorded to any compensating balance maintained for the loan?

A—A compensating balance maintained for a loan assumed to be paid is excluded from consideration in applying section 2011.38. Although a compensating balance increases the effective interest rate on a loan to the borrower, only the actual interest paid or accrued (less applicable income tax) is adjusted against net income for earnings per share computations. [*.38*]

79. Investments Under Section 2011.38

.268

Q—What securities are eligible for assumed purchase as investments when the provisions of section 2011.38 apply?

A—Only U. S. government securities and commercial paper are eligible for assumed purchase as investments when the provisions of section 2011.38 apply. Tax-exempt securities of state and local governments are not eligible. The same securities are assumed purchased as investments for both primary and fully diluted earnings per share computations. Different amounts may have to be assumed invested for primary and fully diluted computations, however. [*.38*]

.269 U. S. government securities, in the context of section 2011.38, are securities issued by the federal government, not merely securities guaranteed by the federal government. Typically the securities to be considered would be short-term securities, such as Treasury bills.

80. Debt Eligible Only While Outstanding

.270

Q—When section 2011.38 applies and debt assumed purchased was actually outstanding only part of the period, may the assumed purchase apply for the entire period?

A—No, debt issued or retired during the period may be assumed purchased at its average market price under section 2011.38 only for the time the debt was actually outstanding. Since all computations under this paragraph are made on a quarterly basis, the issue or retirement typically affects only one quarter. An investment in U. S. government securities or commercial paper must be assumed for the time when debt was not outstanding and therefore could not be purchased. Any difference in interest (net of tax) between the debt and the investment naturally is reflected in earnings applicable to common stock. [*.38*]

81. Computations May Differ for Primary and Fully Diluted when Section 2011.38 Applies

.271

Q—Will section 2011.38 always apply for both primary and fully diluted computations if it applies to either?

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A—No, in some cases section 2011.38 may apply for fully diluted computations but not for primary computations. This could occur when an issuer has made election "b" under section 2011.46 and the common shares obtainable upon exercise of options and warrants issued before June 1, 1969 exceed 20% of the common shares outstanding. Section 2011.38 applies in such a case for fully diluted but not for primary computations because the options and warrants issued before June 1, 1969 are included only in fully diluted computations. [*.38, .46*]

.272 Even if the common shares obtainable upon exercise of options and warrants issued before June 1, 1969 do not exceed 20% of the outstanding common shares when election "b" is in effect, the subsequent issuance of additional options or warrants could cause section 2011.38 to apply for fully diluted but not for primary computations. In such a case, section 2011.38 would be applied only for fully diluted computations because options and warrants issued before June 1, 1969 would not be included in primary computations. [*.38, .46*]

.273 The computation of primary and fully diluted earnings per share would also differ if section 2011.38 applied for both computations, but the net result in primary is anti-dilutive and is dilutive in fully diluted. This could occur when the ending market price is above the exercise price but the average market price is below the exercise price. In such a case, the computations would be included only for determining fully diluted earnings per share. [*.30, .36, .38, .42*]

82. Deferred Compensation Stock Option

.274

Q—What treatment for earnings per share computations should be accorded to an employee deferred compensation plan with the compensation to be paid in stock?

A—Stock to be issued to an employee under a deferred compensation plan is considered a stock option. The time of issuance is the agreement date (or "date of grant"). The fact that the employee may not receive (or be able to sell) the stock until more than five or ten years from the statement date does not affect the computation. Accordingly, all shares to be issued are considered outstanding and

the treasury stock method is applied to determine the incremental number of shares to be included in the earnings per share computations. The exercise amount of the option is the sum of the amount the employee must pay, the unamortized deferred compensation, and any tax benefit credited to capital surplus.[38] The exercise amount is divided by the market price [39] per share of the common stock to determine the number of shares assumed to be purchased. [*.29, .35, .36, 2011A.12, 2011A.13*]

.275 For primary earnings per share computations, the average unamortized deferred compensation for the period and the average market price of the issuer's common stock are used. For fully diluted earnings per share computations, the unamortized deferred compensation at the end of the period and, if higher than the average market price, the ending market price of the issuer's common stock are used.

.276 For example, assume that on January 2, 1973 [40] a corporation grants options to its president for the purchase of 6,000 shares of its common stock at $2 per share, with options for 1,000 shares exercisable each July 1 and January 1 for three years as partial compensation for services during the preceding six months. The shares issued cannot be sold within three years of the issue date. At time of the grant of the options (January 2, 1973 [41]), the 6,000 shares have a market price of $10 per share. Also assume

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[38] The tax benefit credited to capital surplus is the "windfall" tax credit resulting from an increase in the market price of the stock between the date the plan is entered into and the date the compensation charge is deductible for tax purposes. Since the compensation is charged on the financial statements against the period benefited, the tax related to the charge results in a timing difference for interperiod tax allocation. If the market price of the stock increases, the additional reduction in taxes (i. e., a "windfall" gain) should be credited to capital surplus and considered part of the proceeds from the stock compensation plan which would be used to purchase stock under the treasury stock method.

[39] The unadjusted quoted market price of a share of stock of the same class that trades freely in an established market should be used. If a quoted market price is not available, the best estimate of what the market price would be (not reduced for any restrictions imposed) should be used.

[40] Grants or awards made prior to January 1, 1973 are subject to section 4061 rather than section 4062. Accordingly, fair value per share rather than market price is used if a restriction on the sale of the stock makes it worth less than the market price of freely trading stock.

[41] If the corporation has made election "b" under section 2011.46 as to grants or awards made prior to June 1, 1969, only the fully diluted computations would apply, since "time of issuance" of these options is the date of grant.

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that the market price per share increases steadily during the three years at the rate of $1 per quarter and the tax rate is 50%. The total compensation to be charged to expense over the three-year period is $48,000 ($10 market price reduced by the $2 option price results in $8 per share compensation multiplied by 6,000 shares).

.277 At March 31, 1973, the unamortized deferred compensation is $44,000 ($48,000 — $4,000) and the windfall tax benefit is $3,000 ($1.00 × 6,000 = $6,000 increase in market multiplied by .50 tax rate). The total exercise price is $12,000 (6,000 × $2). For primary computations, averages of $46,000 unamortized deferred compensation and $1,500 windfall tax benefit plus the $12,000 total exercise price produce $59,500 "proceeds" for the total exercise amount. Dividing by the average market price of $10.50 ($10 + $11 = $21 divided by 2) results in 5,667 shares assumed repurchased under the treasury stock method. Therefore, 333 incremental shares (6,000 — 5,667) are assumed to be outstanding for the first quarter in the primary computation. For fully diluted computations, 636 incremental shares are computed:

$44,000 + $3,000 + $12,000 = $59,000
$59,000 ÷ $11 = 5,364
6,000 — 5,364 = *636*

.278 At June 30, 1973, the second quarter primary computation would include 913 incremental shares and fully diluted would include 1,167 incremental shares computed:

$42,000 + $4,500 + $12,000 = $58,500
$58,500 ÷ $11.50 = 5,087
6,000 — 5,087 = *913*
$40,000 + $6,000 + $12,000 = $58,000
$58,000 ÷ $12 = 4,833
6,000 — 4,833 = *1,167*

.279 On July 1, 1973, 1,000 shares would be issued to the president and are outstanding shares thereafter.[42]

[42] The amount of the tax benefit for each share issued will be the lesser of the difference between the $2 exercise price and (1) the market price of the unrestricted stock when the restricted stock is issued or (2) the market price when restrictions lift. Changes in the windfall tax gain after the stock is issued are ignored in this computation since the compensation paid in stock is considered finalized upon issuance in this example.

At September 30, 1973, the treasury stock method would produce 660 incremental shares for the third quarter primary and 885 incremental shares for fully diluted computed:

$$\$38{,}000 + \$6{,}250 + \$10{,}000 = \$54{,}250$$
$$\$54{,}250 \div \$12.50 = 4{,}340$$
$$5{,}000 - 4{,}340 = \mathit{660}$$

$$\$36{,}000 + \$7{,}500 + \$10{,}000 = \$53{,}500$$
$$\$53{,}500 \div \$13 = 4{,}115$$
$$5{,}000 - 4{,}115 = \mathit{885}$$

.280 At December 31, 1973, the treasury stock method would produce 1,093 incremental shares for the fourth quarter primary and 1,286 incremental shares for fully diluted computed:

$$\$34{,}000 + \$8{,}750 + \$10{,}000 = \$52{,}750$$
$$\$52{,}750 \div \$13.50 = 3{,}907$$
$$5{,}000 - 3{,}907 = \mathit{1{,}093}$$

$$\$32{,}000 + \$10{,}000 + \$10{,}000 = \$52{,}000$$
$$\$52{,}000 \div \$14 = 3{,}714$$
$$5{,}000 - 3{,}714 = \mathit{1{,}286}$$

.281 The deferred compensation payable in stock would produce the following shares of common stock to be included in the corporation's 1973 annual earnings per share computations:

	Primary Computations	*Fully Diluted Computations*
Incremental shares from application of the treasury stock method:		
First quarter	333	1,167(1)
Second quarter	913	1,167
Third quarter	660	1,286(2)
Fourth quarter	1,093	1,286
Totals	2,999	4,906
Shares for weighted average (divide totals by 4)	750	1,227
Shares issued (1,000 ÷ 2)	500	500
Total shares	1,250	1,727

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COMPUTATIONAL NOTES:

(1) 636 incremental shares computed for first quarter fully diluted not used in annual computation. 1,167 incremental shares based on $12 market price at July 1 "exercise date" when the stock was issued.

(2) 885 incremental shares computed for third quarter fully diluted not used in annual computation. 1,286 incremental shares based on $14 ending market price for the fourth quarter.

.282 If the market price of the stock should subsequently fall below the market price at the date of grant, the application of the treasury stock method would be antidilutive. In such a case, the treasury stock method would not be applied and any unissued shares would not be considered outstanding for earnings per share computations. [*.30, .40*]

.283 The procedures described above are also used for deferred compensation plans to be paid in stock which do not require the employee to make a payment to obtain the stock. In such plans, the option price is zero. The period for measuring compensation under such plans is generally the period over which the restrictions lift. Although the plans are different, the procedures described in this Interpretation are applied with the zero option price offset by an increase in the unamortized deferred compensation. Also, these procedures would be applied for earnings per share computations whether or not the plan has been recorded by the company prior to the issuance of the stock. [*.35, .36, .39*]

.284 Whether or not these procedures apply to "phantom" or "shadow" stock deferred compensation plans depends upon the nature of the plan. These plans may require the employer corporation to (1) either issue stock or pay cash for the stock's value to the employee at a future date or (2) pay the employee in cash at a future date for any increase in the stock's value. Most "phantom" stock plans are based on the employer corporation's stock but some of these plans are based on the stock of an unrelated corporation selected by the employee. Additionally, these plans may either be "funded" or "unfunded." Funding may be accomplished by periodically setting aside any cash to be paid out under the plan or by purchasing stock (which may subsequently be issued or sold to fulfill the plan) or, in the

case of plans based on the employer corporation's stock, by reserving unissued or treasury shares.

.285 Phantom stock deferred compensation plans based on the employer corporation's stock (or the stock of a parent or subsidiary corporation) are included in earnings per share computations under the procedures described above in this Interpretation. However, plans requiring the employer to pay cash rather than stock to the employee are an exception if stock will not be sold to provide the cash. Such plans affect earnings per share only through any compensation charged against net income, since the stock value determines the compensation amount and stock is not issued.

.286 Phantom stock plans based on the stock of an unrelated corporation likewise affect earnings per share only through any compensation charged against net income, since the employer corporation's stock is in no way involved in the plan.

[As amended, for all stock option, purchase, award, and bonus rights granted after December 31, 1972 by APB Opinion No. 25.] (See section 4062.)

83. Stock Subscriptions Are Warrants

.287

Q—How are stock subscriptions included in earnings per share computations?

A—Fully paid stock subscriptions are considered outstanding stock whether or not the shares have actually been issued. Partially paid stock subscriptions are considered the equivalents of warrants and are therefore always[43]

[43] Unless subscribed before June 1, 1969 and election "b" under section 2011.46 is made.

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common stock equivalents. The unpaid balance is assumed to be proceeds used to purchase stock under the treasury stock method. [*.35*]

.288 The number of shares included in earnings per share computations for partially paid stock subscriptions is the difference between the number of shares subscribed and the number of shares assumed to be purchased under the treasury stock method.

.289 The procedures described above are used for subscriptions to purchase convertible securities as well as for subscriptions to purchase common stock. Any incremental convertible securities resulting are then assumed to be converted into common stock if the result is dilutive (see Interpretation 84).

84. Options or Warrants to Purchase Convertible Securities

.290

Q—What treatment is accorded options or warrants to purchase convertible securities?

A—Options or warrants to purchase convertible securities are assumed to be exercised to purchase the *convertible* security whenever the market price of both the convertible security and the common stock obtainable upon conversion are above the exercise price of the warrant. However, exercise is not assumed unless conversion of the *outstanding* convertible securities is also assumed. The treasury stock method is applied to determine the incremental number of convertible securities which are assumed to be issued and immediately converted into common stock. The if converted adjustments which would be applicable to the incremental convertible securities are ignored since the adjustments would be self-cancelling, i. e., any interest or dividends imputed to the incremental convertible securities would be cancelled in applying the if converted method. [*.30, .40, .36, 2011A.06*]

.291 For example, assume that a corporation issued 10,000 warrants exercisable to obtain its $100 par value 5% convertible debt. Each warrant may be exercised at $90 to obtain one convertible bond. Each bond is convertible into two shares of common stock. The market prices of the securities are $46 per common share and $95 per convertible

bond. The warrants are dilutive (2 × $46 = $92 which is greater than the $90 exercise price).

.292 Assumption of exercise would produce $900,000 proceeds, which would be used to purchase 9,474 convertible bonds, resulting in 526 incremental bonds. Conversion would be assumed and 1,052 shares of common (2 × 526 = 1,052) would be assumed issued to replace the 526 convertible bonds. [*.36*]

.293 If the market price of common were $45 per share or less, exercise would not be assumed (for example, at $42 per share, 2 × $42 = $84 which is less than $90).

.294 The classification of the convertible security as a common stock equivalent or other potentially dilutive security determines whether the incremental number of common shares enters primary and fully diluted or enters only fully diluted earnings per share computations. [*.33*]

TWO-CLASS COMMON STOCK AND PARTICIPATING SECURITIES

85. EPS Treatment of Two-Class and Participating Securities

.295

Q—How are two-class common stocks and participating securities treated for earnings per share computations?

A—Two-class common is a term applied when a corporation has issued more than one class of common stock (for example, Class A and Class B). A participating security is a security eligible to participate in dividends with common stock; often a fixed amount is guaranteed to the participating security, then common is paid a dividend at the same rate, and the security participates with common on a reduced ratio thereafter. Classes of common stock other than "ordinary" common stock and the participating securities may be convertible into "ordinary" common stock or may be nonconvertible and may or may not be senior to common stock.

.296 For example, some stocks may be designated as common stock (e. g., Class B Common), but their terms and conditions are equivalent to preferred stock (by limiting their voting rights or the amount of dividends they may receive and by giving them preferences in liquidation). If

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dividends are guaranteed in some way but limited in participation to a maximum amount for a particular class of common stock, that common stock is considered the equivalent of a senior security to the extent it is to share in earnings.

.297 If dividend participation for a particular class of common stock is not limited but the participation is at a rate different from the "ordinary" common stock (for example, participating equally to some amount per share and partially participating thereafter), the two-class method is used. The two-class method is also used for participating preferred stock which is not limited as to participation in dividends with common stock. The two-class method is modified, however, when it is applied for a convertible security. (See Interpretation 87.) To be applied for a convertible security, the two-class method must result in greater dilution than would result from application of the if converted method. [*2011A.09, 2011A.10*]

.298 A determination of the status of a two-class common stock or other participating security as a common stock equivalent or as an other potentially dilutive security is based on an analysis of all the characteristics of the security, including the ability to share in the earnings potential of the issuing corporation on substantially the same basis as the common stock. Dividend participation *per se* does not make such a security a common stock equivalent. [*2011A.15*]

.299 The two-class method of computation for nonconvertible securities is discussed in Interpretation 86. The two-class method of computation for convertible securities is discussed in Interpretation 87.

86. Two-Class Method for Nonconvertible Securities

.300

Q—How is the two-class method applied for nonconvertible securities?

A—The two-class method for nonconvertible securities is an earnings allocation formula which determines earnings per share for each class of common stock and participating security according to dividends paid and participation rights in undistributed earnings. [*2011A.10*]

.301 Under the two-class method, net income is first reduced by the amount of dividends actually paid for the period to each class of stock and by the contractual amount of any dividends (or interest on participating income bonds) which must be paid (for example, unpaid cumulative dividends or dividends declared during the period and paid during the following period). The remaining unencumbered undistributed earnings is secondly allocated to common stock and participating securities to the extent each security may share in earnings. The total earnings allocated to each security is determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

.302 This amount is divided by the number of outstanding shares of the security to which the earnings are allocated to determine the earnings per share for the security. For this computation, outstanding common stock (the "ordinary" class of common stock) includes the usual common stock equivalent securities assumed to be converted or exercised for primary computations and includes these securities and all other potentially dilutive securities assumed to be converted or exercised for fully diluted computations. Although reporting earnings per share for each class of security may be desirable, earnings per share must be reported for the "ordinary" class of common stock.

.303 The application of the two-class method for a nonconvertible security is illustrated in the following example. Assume that a corporation had 5,000 shares of $100 par value nonconvertible preferred stock and 10,000 shares of $50 par value common stock outstanding during 1969 and had a net income of $65,000. The preferred stock is entitled to a noncumulative annual dividend of $5 per share before any dividend is paid on common. After common has been paid a dividend of $2 per share, the preferred stock then participates in any additional dividends on a 40:60 *per share* ratio with common. That is, after preferred and common have been paid dividends of $5 and $2 per share respectively, preferred participates in any additional dividends at a rate of two-thirds of the additional amount paid to common on a per share basis. Also assume that for 1969 preferred shareholders have been paid $27,000 (or $5.40 per

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share) and common shareholders have been paid $26,000 (or $2.60 per share). Earnings per share for 1969 would be computed as follows under the two-class method for non-convertible securities:

Net income		$65,000
Less dividends paid:		
Preferred	$27,000	
Common	26,000	53,000
Undistributed 1969 earnings		$12,000

Allocation of undistributed earnings:

To preferred:

$$\frac{.4(5{,}000)}{.4(5{,}000) + .6(10{,}000)} \times \$12{,}000 = \$3{,}000$$

$$\$3{,}000 \div 5{,}000 \text{ shares} = \$.60 \text{ per share.}$$

To common:

$$\frac{.6(10{,}000)}{.4(5{,}000 + .6(10{,}000)} \times \$12{,}000 = \$9{,}000$$

$$\$9{,}000 \div 10{,}000 \text{ shares} = \$.90 \text{ per share.}$$

Earnings per share amounts:

	Preferred Stock	*Common Stock*
Distributed earnings	$5.40	$2.60
Undistributed earnings	.60	.90
Totals	$6.00	$3.50

87. Two-Class Method for Convertible Securities

.304

Q—How is the two-class method applied for convertible securities?

A—Most convertible two-class common stocks and other convertible participating securities are assumed to be converted and the if converted method is applied for earnings per share computations. The two-class method is rarely appropriate for such convertible securities and may be applied only when it results in greater dilution than

would result from the if converted method. [*2011A.06, 2011A.09*]

.305 When the two-class method is used for a convertible two-class common or other convertible participating security, net income is first allocated under the procedure described in Interpretation 86 for dividends for the current period which were paid or declared or are cumulative if not paid or declared. Conversion of the convertible two-class common and participating securities is then assumed, but adjustments to net income usually made for the if converted method are *not* made. Unencumbered undistributed earnings is divided by the total of all common shares outstanding and assumed outstanding from conversions and exercise. The resulting amount per share is added to the amount of the dividends per share allocated to each class of security to determine the earnings per share for each class of security. Although reporting earnings per share for each class of security may be desirable, earnings per share must be reported for the "ordinary" class of common stock. [*2011A.10*]

.306 The application of the two-class method for a convertible security is illustrated in the following example. Assume that a corporation had 10,000 shares of Class A common stock (the "ordinary" common) and 5,000 shares of Class B common stock outstanding during 1969 and had a net income of $65,000. Each share of Class B is convertible into two shares of Class A. The Class B is entitled to a noncumulative annual dividend of $5 per share. After Class A has been paid a dividend of $2 per share, Class B then participates in any additional dividends on a 40:60 *per share* ratio with Class A. For 1969 the Class A shareholders have been paid $26,000 (or $2.60 per share) and the Class B shareholders have been paid $27,000 (or $5.40 per share). Earnings per share for 1969 would be computed as follows:

Under the if converted method:

$$\frac{\$65{,}000}{20{,}000 \text{ shares*}} = \$3.25 \text{ per share}$$

* Conversion of Class B is assumed.

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Under the two-class method for convertible securities:

Net income		$65,000
Less dividends paid:		
Class A common	$26,000	
Class B common	27,000	53,000
Undistributed 1969 earnings		$12,000

Allocation of undistributed earnings:

$$\frac{\$12{,}000}{20{,}000 \text{ shares}} = \$.60 \text{ per Class A share.}$$

$$2(.60) = \$1.20 \text{ per Class B share.}$$

Earnings per share amounts:

	Class A	*Class B*
Distributed earnings	$2.60	$5.40
Undistributed earnings	.60	1.20
Totals	$3.20	$6.60

.307 The two-class method may be used in this case since it results in greater dilution than the if converted method.

SECURITIES ISSUABLE UPON SATISFACTION OF SPECIFIED CONDITIONS

88. Contingent Shares

.308

Q—How is common stock contingently issuable or subject to recall classified and treated in earnings per share computations?

A—Common stock contingently issuable or subject to contingent recall is always[44] classified as a common stock equivalent unless it will be issued upon the mere passage of time and is therefore considered to be outstanding for both

[44] Unless their time of issuance (see Interpretation 89) is prior to June 1, 1969 *and* the issuer makes election "b" of section 2011.46 *and* they were not considered residual securities under APB Opinion No. 9. Contingent shares meeting these three conditions are other potentially dilutive securities.

primary and fully diluted computations. Whether (1) the stock will be issued in the future upon the satisfaction of specified conditions, (2) the stock has been placed in escrow and part must be returned if specified conditions are not met, or (3) the stock has been issued but the holder must return part if specified conditions are not met does not affect the classification of contingent shares. [*.27, 2011A.16*]

.309 When certain conditions are not met, however, contingent shares are omitted from primary or from primary and fully diluted earnings per share computations. Typical examples of the conditions to be met for contingent shares are (1) the passage of time along with other conditions, (2) the maintenance of some level of earnings, (3) the attainment of some level of earnings, and (4) changes in market prices which modify the number of shares to be issued.

.310 Contingent shares are included in both primary and fully diluted computations when the conditions for their issuance are currently being met. If additional shares would be contingently issuable if a higher earnings level were being attained currently, the additional shares are included only in fully diluted computations (giving effect to the higher earnings level) but only if dilution results. Contingent shares based on (1) the attainment of increased earnings levels above the present earnings level or (2) the maintenance of increased earnings above the present level of earnings over a period of years are included only in fully diluted computations (giving effect to the higher earnings level) but only if dilution results. [*2011A.17*]

.311 When contingent shares have been included in an earnings per share computation, they continue to be included in the computations in following periods until the expiration of the term of the agreement providing for the contingent issuance of additional shares. However, contingent shares are excluded from the computations whenever their effect would be anti-dilutive. [*.30, .40*]

.312 Prior period primary and fully diluted earnings per share should be retroactively restated whenever the number of shares issued or contingently issuable changes from the number of shares originally included in the com-

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putation. However, prior period earnings per share data are not retroactively restated for shares actually issued when the condition was the attainment of specified increased earnings levels and the shares were not previously considered outstanding. [*2011A.17-.19*]

89. Time of Issuance for Contingent Issuances

.313

Q—What is the time of issuance of a contingently issuable security?

A—The time of issuance of a contingently issuable security is the date when agreement to terms has been reached and announced even though subject to further actions, such as directors' or stockholders' approval. But, contingently issuable common stock is considered outstanding for earnings per share computations only when the terms become binding. (See Interpretations 27 and 28.) [*.29*]

90. Market Price Conditions

.314

Q—How do market price conditions affect the number of contingent shares included in earnings per share computations?

A—The number of contingently issuable shares may depend on market prices for an issuer's common stock. Generally, these market price conditions for contingent shares may be classified as (1) maximum future market price guarantees, (2) market prices for base number of shares to be determined, and (3) minimum future market price guarantees. Additionally, some agreements based on market prices for an issuer's common stock specify that no less than some minimum number of shares and/or no more than some maximum number of shares will be issued regardless of market prices. [*2011A.18, 2011A.19*]

.315 Conditions which guarantee a maximum future price provide ''upside'' assurance. That is, the issuer guarantees that the market price per share will increase to some stated amount within some time period. To the extent that the market price does not increase as guaranteed, the issuer agrees to issue additional shares or pay cash to make up the difference. Such a guarantee may extend to shares already issued as well as shares to be issued.

.316 Conditions for market prices to determine the base number of shares to be issued may relate to periodic prices (such as the end of each year), an average of prices over some period, or some final price (such as at the end of five years). The conditions may also specify maximum or minimum market price guarantees.

.317 Conditions which guarantee a minimum future price provide "downside" protection. That is, the issuer guarantees that the market price per share will not decrease below some stated amount within some time period. To the extent that the market price goes below that amount, the issuer agrees to issue additional shares or pay cash to make up the difference. Such a guarantee may extend to shares already issued as well as to shares to be issued.

.318 When the number of contingently issuable shares depends on the future market price of an issuer's common stock, earnings per share computations reflect the number of shares which would be issuable based on the market price at the close of the period being reported upon. If a minimum and/or maximum number of shares is also specified, the number of shares determined from the market price at the close of the period would, if necessary, be adjusted to not less than the minimum nor more than the maximum number of shares so specified.

.319 When additional shares are to be issued for an "upside" or a "downside" guarantee and the market price at the close of the period is less than the guaranteed price, earnings per share computations should give effect to the additional shares which would be issued.

.320 The number of contingently issuable shares may differ for primary and fully diluted computations based upon earnings levels. But market price conditions do not cause different numbers of contingently issuable shares to be included in primary and fully diluted computations. Specifically, more shares are not included in fully diluted than in primary computations because of market price guarantees. A market price guarantee has the same effect on both computations. [*2011A.17, 2011A.18, 2011A.19*]

.321 Prior period earnings per share would be retroactively restated if the number of shares issued or contin-

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gently issuable subsequently changes because of market price changes.

91. Earnings Conditions

.322

Q—How does an earnings condition affect the number of contingent shares included in earnings per share computations?

A—Earnings conditions for the contingent issuance of common stock vary. Some earnings conditions determine the *total* number of shares to be issued, for example, one share for each $100 earned (1) each year for five years or (2) based on a formula, such as ten times the average annual earnings for five years. [*2011A.17, 2011A.19*]

.323 Other earnings conditions determine the *additional* number of shares to be issued. Typically, additional shares are to be issued based on either (1) the *maintenance* of (a) the present level of earnings or (b) a higher level of earnings or (2) the *attainment* of (a) a higher level of earnings or (b) successively higher levels of earnings.

.324 Earnings conditions may specify a minimum and/or a maximum number of shares to be issued regardless of earnings. Shares may be issued each year or only at the end of several years. Earnings conditions may apply to each year individually or may apply to all years on some cumulative or average basis. Various combinations of the earnings conditions described above may be contained in an agreement.

.325 Some maximum number of shares may be issued initially (or placed in escrow) with the stipulation that unearned shares are to be returned to the issuer. Such plans specifying that shares are returnable are treated the same as contingently issuable shares for earnings per share computations. [*2011A.16*]

.326 Because of the diversity of earnings conditions, stating general guidelines which will apply to all agreements is difficult. The number of shares included in earnings per share computations for an earnings agreement should conform to the provisions of sections 2011A.17 and 2011A.19 and to the guidelines given below.

.327 If shares would at some time be issuable based on the present level of earnings, the shares issuable based on that level of earnings projected to the end of the agreement are considered outstanding for both primary and fully diluted computations. If shares previously considered outstanding become unissuable (for example, because of a decline in earnings), previously reported earnings per share data would be retroactively restated when the term of the condition expires and it is determined that the shares will not be issued. [*2011A.17, 2011A.19*]

.328 If additional shares would at some time be issuable if a level of earnings higher than the present level were attained, the additional shares issuable based on the higher level (or levels) projected to the end of the agreement are considered outstanding only for the fully diluted computation, giving effect to the higher earnings level. If different levels of earnings are specified, the level which results in the greatest dilution is used. If additional shares previously considered outstanding become unissuable (for example, because the higher earnings level is not maintained), previously reported earnings per share data would be retroactively restated when it is determined that the shares will not be issued. If in giving effect to the higher earnings level dilution does not result, the additional shares are not included in the computation. When such additional shares were not included in prior earnings per share computations but are subsequently issued (for example, because the higher earnings level was actually attained), previously reported earnings per share data are *not* retroactively restated.

.329 When an earnings condition specifies a minimum and/or a maximum number of shares to be issued, no less than the minimum nor no more than the maximum number specified would be included in the earnings per share computations. If shares are issued each year and a total minimum and/or maximum number is specified, the minimum and/or maximum would be reduced by the number of shares issued.

92. Convertible Securities Contingently Issuable

.330

Q—How are contingently issuable convertible securities treated for earnings per share computations?

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A—Contingently issuable convertible securities are included in earnings per share computations under the guidelines described for convertible securities and the guidelines described for contingently issuable common stock. That is, additional convertible securities are assumed to be issued in conformity with the conditions specified for their issuance. (See Interpretations 88-91 for an explanation of how conditions affect the number of securities considered outstanding.) [*.33, 2011A.06, 2011A.16-.19*]

.331 Time of issuance of the contingently issuable convertible securities is the date when agreement as to terms has been reached and announced. The classification of the contingently issuable convertible security as a common stock equivalent or other potentially dilutive security is determined at time of issuance based on its yield at that time[45] and does not change when the security is actually issued. A change in the bank prime interest rate or the market price of the security between the time of issuance and actual issuance of a contingently issuable convertible security has no effect on its classification.[46] [*.29*]

.332 Those contingently issuable convertible securities classified as common stock equivalents are included in both primary and fully diluted computations. However, such common stock equivalents based on the attainment or maintenance of earnings above the present level are included only in fully diluted computations. Contingently issuable convertible securities classified as other potentially dilutive securities are included only in fully diluted computations. [*.33, 2011A.17*]

.333 When contingently issuable convertible securities are to be included in earnings per share computations, conversion of the additional securities is assumed. However, conversion is not assumed for the additional securities unless conversion is also assumed for their counterpart outstanding convertible securities. Interest or dividends are not imputed for the additional contingently issuable convertible securities since any imputed amount would be

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[45] Unless it has the same terms as the terms of an outstanding convertible security which is a common stock equivalent. A convertible security contingently issuable at May 31, 1969 would be classified under either election "a" or election "b" of section 2011.46.

[46] Except in the situations described in Interpretations 29 and 30.

reversed by the if converted adjustments for assumed conversion. [*2011A.06*]

PARENT AND CONSOLIDATED FINANCIAL STATEMENTS

93. Securities Issued by Subsidiaries

.334

Q—How do convertible securities and options and warrants issued by a subsidiary affect parent and/or consolidated earnings per share?

A—The effect of options and warrants and convertible securities issued by a subsidiary upon consolidated earnings per share (or parent company earnings per share when parent company statements are prepared as the primary financial statements using the equity method) depends upon whether the securities issued by the subsidiary to the public enable their holders to obtain common stock of the subsidiary company or common stock of the parent company. [*2011A.20*]

.335 Securities issued by a subsidiary which enable their holders to obtain the subsidiary's common stock are included in computing the subsidiary's earnings per share data. These earnings per share data are then included in the parent or consolidated earnings per share computations based on the consolidated group's holdings of the subsidiary's securities. [*2011A.21-.22*]

.336 Options and warrants issued by a subsidiary which enable their holders to purchase parent company common stock are common stock equivalents[47] for parent or consolidated earnings per share computations. Securities of a subsidiary convertible into parent company common stock are classified as common stock equivalents or other potentially dilutive securities for parent or consolidated earnings per share computations under the yield test.[48] [*2011A.23-.24*]

.337 The following example illustrates the earnings per share computations for a subsidiary's securities which enable their holders to obtain the subsidiary's common stock. Assume that a parent corporation had a net income

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[47] Unless issued prior to June 1, 1969 and the parent company makes election "b" specified by section 2011.46.

[48] See Interpretation 45 for a description of the treatment of a subsidiary security convertible into a parent company's convertible security.

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of $10,000 from operations (excluding any dividends paid by the subsidiary), had 10,000 shares of common stock outstanding and had not issued any other securities. The parent corporation owned 900 of the common shares of a domestic subsidiary corporation and also owned 40 warrants and 100 shares of convertible preferred stock issued by the subsidiary. The subsidiary corporation had a net income of $3,600 and had outstanding 1,000 shares of common stock, 200 warrants exercisable to purchase 200 shares of its common at $10 per share (assume $20 average and ending market price for common), and 200 shares of preferred stock convertible into two of its common shares for each preferred share. The convertible preferred paid a dividend of $1.50 per share and is not a common stock equivalent. Assume that no intercompany eliminations or adjustments are necessary except for dividends. (Income taxes have been ignored in the following computations for simplicity.) [*2011A.21-.22*]

Earnings per share for the subsidiary

Primary earnings per share $3.00

Computed:

$$\frac{\$3{,}600^{a} - \$300^{b}}{1{,}000^{c} + 100^{d}}$$

[a] Subsidiary's net income.

[b] Dividends paid by subsidiary on convertible preferred stock.

[c] Shares of subsidiary's common stock outstanding.

[d] Incremental shares of subsidiary's common stock assumed outstanding applying the treasury stock method for warrants (computed $\frac{\$20-\$10}{\$20} \times 200$).

Fully diluted earnings per share $2.40

Computed:

$$\frac{\$3{,}600^{e}}{1{,}000 + 100 + 400^{f}}$$

[e] Subsidiary's earnings applicable to common stock applying the if converted method for convertible preferred stock.

[f] Shares of subsidiary's common stock assumed outstanding from conversion of convertible preferred stock.

Parent or consolidated earnings per share

Primary earnings per share $1.29

Computed:

$$\frac{\$10{,}000^{a} + \$150^{b} + \$2{,}700^{c} + \$60^{d}}{10{,}000^{e}}$$

[a] Parent's net income.

[b] Dividends received by parent on subsidiary's convertible preferred stock.

[c] Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed: $\frac{900}{1{,}000}$ (1,000 shares × $3 per share).

[d] Parent's proportionate interest in subsidiary's earnings attributable to warrants, computed: $\frac{40}{200}$ (100 incremental shares × $3 per share).

[e] Shares of parent's common stock outstanding.

Fully diluted earnings per share $1.27

Computed:

$$\frac{\$10{,}000 + \$2{,}160^{f} + \$48^{g} + \$480^{h}}{10{,}000}$$

[f] Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed: $\frac{900}{1{,}000}$ (1,000 shares × $2.40 per share).

[g] Parent's proportionate interest in subsidiary's earnings attributable to warrants, computed: $\frac{40}{200}$ (100 incremental shares × $2.40 per share).

[h] Parent's proportionate interest in subsidiary's earnings attributable to convertible preferred stock, computed: $\frac{100}{200}$ (400 shares from conversion × $2.40 per share).

[*2011A.21*]

.338 The above computations apply only to earnings per share data. Parent or consolidated net income is determined in the usual manner as follows:

Parent net income from operations......				$10,000
Subsidiary net income			$3,600	
Less minority interest:				
	Preferred	$150 [i]		
	Common	330 [j]	480	3,120
Parent or consolidated net income				$13,120

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Computed:

[i] 50% (200 preferred shares × $1.50 dividend per share).

[j] 10% ($3,600 net income—$300 preferred dividends).

Note that parent or consolidated net income is not the basis for parent or consolidated earnings per share computations.

.339 These computations would be different if the subsidiary's securities could be exercised or converted only to obtain the parent company's common stock. For example, assume the same facts as were given in the preceding illustration except (1) the warrants and convertible securities are all owned by outsiders, (2) the subsidiary's warrants are exercisable only to obtain parent company common stock, and (3) the subsidiary's preferred stock is convertible only into parent company common stock.

Earnings per share for the subsidiary

Primary earnings per share $3.30

Computed:

$$\frac{\$3{,}600 - \$300}{1{,}000}$$

Fully diluted earnings per share $3.30

Computed:

$$\frac{\$3{,}600 - \$300}{1{,}000}$$

Parent or consolidated earnings per share

Primary earnings per share $1.28

Computed:

$$\frac{\$10{,}000^{a} + \$2{,}970^{b}}{10{,}000^{c} + 100^{d}}$$

[a] Parent's net income.

[b] Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed: $\frac{900}{1{,}000}$ (1,000 shares × $3.30 per share).

[c] Shares of parent's common stock outstanding.

[d] Incremental shares of parent's common stock assumed outstanding applying the treasury stock method for warrants issued by subsidiary exercisable to obtain parent's common stock (computed $\frac{\$20-\$10}{\$20} \times 200$).

Fully diluted earnings per share $1.26

Computed:

$$\frac{\$10{,}000 + \$2{,}970 + \$300^{e}}{10{,}000 + 100 + 400^{f}}$$

[e] Dividends paid by subsidiary on convertible preferred stock which would not have been received by outsiders if the subsidiary's preferred stock had been converted into parent's common stock at the beginning of the period.

[f] Shares of parent's common stock assumed outstanding from conversion of subsidiary's preferred stock convertible into parent's common stock.

[*2011A.23-.24*]

.340 Parent or consolidated net income would be determined as follows:

Parent net income from operations			$10,000
Subsidiary net income		$3,600	
Less: Dividends on preferred stock	$300		
Minority common interest (10%)	330	630	2,970
Parent or consolidated net income			$12,970

Note that parent or consolidated net income is not the basis for parent or consolidated earnings per share computations. [*.39*]

EFFECTS OF SCHEDULED CHANGES

94. Changing Exercise Prices and Conversion Rates

.341

Q—How do changes which may occur in exercise prices or conversion rates affect earnings per share computations?

A—Except as discussed in the next paragraph, if an exercise price or conversion rate is in effect during a period, that exercise price or conversion rate is used for primary computations. When no exercise price or conversion rate is in effect during a period, the earliest effective exercise price or conversion rate during the following five years

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is used for primary computations. The most advantageous exercise price or conversion rate available to the holder within ten years is always used for fully diluted computations. Previously reported earnings per share data are not restated for subsequent changes in the conversion rate or exercise price. [*2011A.12, 2011A.13*]

.342 If a convertible security having an increasing conversion rate is issued in exchange for another class of security of the issuing company and is at some time convertible back into as many of the same or a similar security as was exchanged, the conversion rate used in the computation does not result in a reduction of the number of common shares (or common stock equivalents) existing before the exchange.

.343 For example, assume that a corporation issued 100,000 shares of convertible preferred to officers and principal stockholders in exchange for 300,000 shares of common stock and each preferred share is convertible back into one common share the first year, two common shares the second year, three common shares the third year, and four common shares the fourth year and thereafter. The convertible preferred would be included as 300,000 common equivalent shares for primary earnings per share computations and 400,000 common equivalent shares for fully diluted earnings per share computations for the first three years and 400,000 common equivalent shares thereafter for both computations.

ELECTION TO CLASSIFY OUTSTANDING SECURITIES

95. Factors in Section 2011.46 Election

.344

Q—What factors would be considered in classifying securities issued prior to June 1, 1969 under the elections provided in section 2011.46?

A—The following factors might be considered for elections "a" and "b" provided in section 2011.46:

1. The section 2011 recommends restatement of prior periods' earnings per share data if election "b" is made

and such data are included in financial statements issued after May 31, 1969, e. g., included in a comparative income statement. Restatement is not required under election "b." Although retroactive restatement is recommended, restatement may not greatly change previously reported earnings per share data. Such data therefore could be included in a comparative income statement without restatement and without a significant loss of comparability.

If election "a" is made, however, all prior periods' earnings per share data must be retroactively recomputed and restated under the provisions of section 2011 when prior periods' data are subsequently presented.

2. Section 2011 includes all options and warrants as common stock equivalents and establishes a test at issuance for convertible securities to determine their classification as common stock equivalents or not. APB Opinion No. 9 excluded the effect of options and warrants from the first EPS amount (unless they were classified as residual securities) and allowed a convertible security to move from senior security to residual status and vice versa based on the value of its conversion rights and common stock characteristics. [*.46*]

.345 Therefore, election "b" would generally exclude options and warrants issued before May 31, 1969 from primary earnings per share computations. Election "a," on the other hand, would cause convertible securities classified as residual under APB Opinion No. 9 at May 31, 1969 which would not be common stock equivalents at issuance under section 2011 to be reclassified as other potentially dilutive securities. If a corporation had options and warrants and convertible securities as described above, the effects of both types of securities would probably be considered in determining the election to be made.

96. Effect of New Issue of Common Stock Equivalents

.346

Q—When securities are classified under election "b" of section 2011.46, can the classifications of those securities change in the future?

A—Generally, the classification of a security does not change after either election is made. However, convertible securities issued before June 1, 1969 would change from

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other potentially dilutive security status to common stock equivalent status if another convertible security is issued with the same terms which is a common stock equivalent as specified by the second sentence of section 2011.28. (See Interpretation 30.) [*.28, .46*]

97. No Change for Options and Warrants

.347

Q—Would outstanding options or warrants issued prior to June 1, 1969 classified as non-residual securities under election "b" of section 2011.46 become common stock equivalents under the second sentence of section 2011.28 if another option or warrant were issued with the same terms after May 31, 1969?

A—No, such a change of classification applies only to convertible securities. Although this creates a difference of treatment between convertible securities and options and warrants, the Board was explicit in naming only convertible securities. [*.28*]

.348 Because warrants are often traded, identification of a warrant being exercised as having been issued "before" or "after" may be impossible. When an exercised warrant cannot definitely be identified as having been issued after May 31, 1969, exercise is assumed on a FIFO basis. That is, the first warrants issued are assumed to be the first exercised when specific identification is impossible. The same treatment applies for options, except options usually are not transferable and the specific option being exercised can usually be identified.

98. Prior Period Restatement Recommended

.349

Q—Must earnings per share reported under the provisions of APB Opinion No. 9 be restated under the provisions of section 2011?

A—When election "b" of section 2011.46 is made, section 2011 recommends that earnings per share amounts previously reported under APB Opinion No. 9 be restated so the previously outstanding securities conform to the classifications determined under election "b" when such amounts are reported in comparative income statements and election "b" applies to at least one period in the statement. To the extent that the Opinions differ, following this recom-

mendation will have the effect of retroactively restating previously reported earnings per share amounts. [*.45*]

.350 If election "a" of section 2011.46 is made, section 2011 must be applied for all periods presented. [*.46*]

.351 If election "b" of section 2011.46 is made, some companies might prefer not to restate previously reported earnings per share amounts and such restatement is not required by section 2011. There may be cases, however, where the corporation or its auditor may believe that disclosure of the restated earnings per share data is particularly appropriate.

99. Is Prior Period Restatement Permitted?

.352

Q—May prior period earnings per share amounts be retroactively restated other than when restatement is required, for example, for changes in the number of shares computed under the treasury stock method or when a convertible security being issued is determined to be a common stock equivalent and causes outstanding convertible securities with the same terms which were not common stock equivalents at issuance to also become common stock equivalents?

A—No, previously reported earnings per share amounts generally are retroactively restated only when restatement is required (see Part I, paragraphs .039-.041). Earnings per share data are not restated because of changes in the number of shares computed under the treasury stock method. Nor should primary earnings per share data be restated when a convertible security's classification changes because of the subsequent issuance of another convertible security with the same terms. [*.28, .36*]

DISCLOSURE

100. Required Disclosure

.353

Q—What information related to earnings per share is required to be disclosed in addition to earnings per share data?

A—Section 2011 requires disclosure of the following information:

1. Restatement for a prior period adjustment.

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2. Dividend preferences.
3. Liquidation preferences.
4. Participation rights.
5. Call prices and dates.
6. Conversion rates and dates.
7. Exercise prices and dates.
8. Sinking fund requirements.
9. Unusual voting rights.
10. Bases upon which primary and fully diluted earnings per share were calculated. (The computations would not, however, appear upon the face of the income statement.)
11. Issues which are common stock equivalents.
12. Issues which are potentially dilutive securities.
13. Assumptions and adjustments made for earnings per share data.
14. Shares issued upon conversion, exercise, and conditions met for contingent issuances.
15. Recapitalization occurring during the period or before the statements are issued.
16. Stock dividends, stock splits or reverse splits occurring after the close of the period before the statements are issued.
17. Claims of senior securities entering earnings per share computations.
18. Dividends declared by the constituents in a pooling.
19. Basis of presentation of dividends in a pooling on other than a historical basis.
20. Per share and aggregate amount of cumulative preferred dividends in arrears.

[*.18, .19, .20, .21, .23, 2011A.03, 2011A.05, 2011A.05 fn. 2, 2011A.25*]

101. Supplementary Data

.354

Q—When must supplementary earnings per share data be furnished?

A—Supplementary earnings per share data must be furnished for the latest period when common stock is issued on conversion during the period or after the close of the

period before the report is issued if primary earnings per share would have increased or decreased at least 3% if the issuance had occurred at the beginning of the period. It may also be desirable to furnish supplementary earnings per share data for each period presented giving the cumulative retroactive effect of all such issuances, but primary earnings per share as reported in those periods should not be retroactively adjusted. [*.22, .14 fn.* 4]

.355 Supplementary earnings per share data generally would also be furnished whenever common stock or common stock equivalents have been sold for cash and the proceeds have been or are to be used to retire preferred stock or debt. The supplementary data would be furnished even though the sale occurred shortly after the close of the period but before completion of the financial report. [*.23*]

.356 When the issuance of a convertible security classified as a common stock equivalent causes outstanding convertible securities with the same terms classified as other potentially dilutive securities to be reclassified as common stock equivalents, supplementary earnings per share data may be useful to explain the change in classification. The supplementary data would show what previously reported primary earnings per share would have been if the convertible securities had been classified as common stock equivalents since issuance and thus reconstruct the primary earnings trend. Previously reported primary earnings per share would not be retroactively restated for prior periods in a comparative income statement because of such a change in classification. [*.22, .28*]

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EXHIBIT 1

U. S. BANK PRIME INTEREST RATES
(Source: Federal Reserve Bulletin)

Effective Date		Prime Rate (%)	66 2/3% of Prime Rate (%)
1954	January 1	3.25	2.17
	March 17	3.00	2.00
1955	August 4	3.25	2.17
	October 14	3.50	2.33
1956	April 13	3.75	2.50
	August 21	4.00	2.67
1957	August 6	4.50	3.00
1958	January 22	4.00	2.67
	April 21	3.50	2.33
	September 11	4.00	2.67
1959	May 18	4.50	3.00
	September 1	5.00	3.33
1960	August 23	4.50	3.00
1965	December 6	5.00	3.33
1966	March 10	5.50	3.67
	June 29	5.75	3.83
	August 16	6.00	4.00
1967	January 26-27	5.75(1)	3.83
	March 27	5.50	3.67
	November 20	6.00	4.00
1968	April 19	6.50	4.33
	September 25	6.25(2)	4.17
	November 13	6.25	4.17
	December 2	6.50	4.33
	December 18	6.75	4.50
1969	January 7	7.00	4.67
	March 17	7.50	5.00
	June 9	8.50	5.67
1970	February 25	8.50(3)	5.67
	March 25-26	8.00(4)	5.33

Notes:

(1) 5.75% predominant rate with 5.50% in effect at some banks.

(2) 6.25% predominant rate with 6% in effect at some banks.

(3) 8.50% predominant rate. Starting on February 25, 1970, however, and on several days thereafter, several small banks reduced their prime rates to 8%. At least one bank announced a 7½% prime rate. (See Interpretation 38.)

(4) Many major banks reduced their prime rates to 8% on March 25 and others followed on March 26. The 8% rate was the predominant rate in effect the date this table was prepared (May 6, 1970).

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EXHIBIT 2

EXAMPLES OF COMPUTING AVERAGE MARKET PRICES

An average market price may be computed various ways in applying the treasury stock method for options and warrants. (See Interpretations 53 and 54.) In first applying the treasury stock method, the computation depends upon the stability of the market price of the common stock.

In the following example, an average market price has been computed eight different ways for one quarter. First, the computation is based upon weekly prices. The weekly prices are then averaged to determine a monthly average, which is then averaged to determine a quarterly average. (Although not illustrated, a quarterly average could also be computed by adding weekly prices and dividing by 13, thereby eliminating the computation of a monthly average.) In the second example, the computation is based upon monthly prices.

The "High-Low" computation is based upon an average of the high and low prices for the week or month. In the weighted averages, the market prices are weighted by the number of shares involved in the transactions.

Assume the following market transactions for a corporation's common stock during a three-month period:

	Week	High	Low	Close	Shares Traded
Month 1	1	21	19	20	300
	2	24	20	23	700
	3	24	22	22	500
	4	23	21	21	500
Month 2	5	26	22	23	1,000
	6	27	23	26	1,200
	7	29	27	28	1,500
	8	31	29	31	2,000
Month 3	9	28	26	26	2,500
	10	26	22	23	1,500
	11	24	22	22	1,000
	12	22	20	21	800
	13	20	20	20	500

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Computing quarterly average from monthly averages based on weekly prices:

	Simple Averages		*Weighted Averages*		
Week	*High-Low*	*Close*	*Shares*	*High-Low*	*Close*
1...........	20	20	300	6,000	6,000
2...........	22	23	700	15,400	16,100
3...........	23	22	500	11,500	11,000
4...........	22	21	500	11,000	10,500
Month 1 totals	87	86	2,000	43,900	43,600
Divide by	4	4		2,000	2,000
Month 1 averages	21.75	21.50		21.95	21.80
5...........	24	23	1,000	24,000	23,000
6...........	25	26	1,200	30,000	31,200
7...........	28	28	1,500	42,000	42,000
8...........	30	31	2,000	60,000	62,000
Month 2 totals	107	108	5,700	156,000	158,200
Divide by	4	4		5,700	5,700
Month 2 averages	26.75	27.00		27.37	27.75
9...........	27	26	2,500	67,500	65,000
10...........	24	23	1,500	36,000	34,500
11...........	23	22	1,000	23,000	22,000
12...........	21	21	800	16,800	16,800
13...........	20	20	500	10,000	10,000
Month 3 totals	115	112	6,300	153,300	148,300
Divide by	5	5		6,300	6,300
Month 3 averages	23.00	22.40		24.33	23.54
Three month total	71.50	70.90		73.65	73.09
Divide by	3	3		3	3
Three month average	23.83	23.63		24.55	24.36

Computing quarterly averages from monthly prices:

	Simple Averages		*Weighted Averages*		
	High-Low	*Close*	*Shares*	*High-Low*	*Close*
Month 1	21.50	21.00	2,000	43,000	42,000
Month 2	26.50	31.00	5,700	151,050	176,700
Month 3	24.00	20.00	6,300	151,200	126,000
Quarterly total	72.00	72.00	14,000	345,250	344,700
Divided by	3	3		14,000	14,000
Quarterly average ..	24.00	24.00		24.66	24.62

Assuming an exercise price of $20 for options or warrants to purchase 10,000 shares, the above average market prices would produce the following incremental shares:

	Simple Averages		*Weighted Averages*	
	High-Low	*Close*	*High-Low*	*Close*
Weekly prices	1,607	1,536	1,853	1,790
Monthly prices	1,667	1,667	1,890	1,877

Note: Computed

$$10{,}000 - \left(\frac{\$20 \times 10{,}000}{\text{average price}}\right) = \text{incremental shares}$$

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EXHIBIT 3

APPLICATION OF THE TREASURY STOCK METHOD FOR OPTIONS AND WARRANTS

.359 Assume 100,000 common shares are outstanding and 10,000 warrants are outstanding which are exercisable at $20 per share to obtain 10,000 common shares. Assume also the following market prices for common stock during a three-year period:

Market Prices Per Share of Common Stock

	Year 1		*Year 2*		*Year 3*	
Quarter	*Average*	*Ending*	*Average*	*Ending*	*Average*	*Ending*
1..........	$18*	$22	$24	$25	$20	$18
2..........	20*	21	22	21	18	22
3..........	22	19	20	19	24	21
4..........	24	23	18	17	22	25

* Assume market prices had been more than $20 for substantially all of a previous quarter.

Computation of Number of Incremental Shares by Quarters

Primary Earnings Per Share(1)

Quarter	*Year 1*	*Year 2*	*Year 3*
1..................	—0—	1,667	—0—
2..................	—0—	909	—0—
3..................	909	—0—	1,667
4..................	1,667	—0—	909

Fully Diluted Earnings Per Share

Quarter	*Year 1*	*Year 2*	*Year 3*
1..................	909(2)	2,000(2)	—0—
2..................	476(2)	909(1)	909(2)
3..................	909(1)	—0—	1,667(1)
4..................	1,667(1)	—0—	2,000(2)

(1) Based on average market price

(2) Based on ending market price

Note: Computed $\left(\frac{\text{Market Price—Exercise Price}}{\text{Market Price}}\right) \times 10{,}000 =$ Incremental Shares

Number of Incremental Shares Included in Year-to-Date Weighted Average

Primary Earnings Per Share(1)

	Year 1	Year 2	Year 3
First quarter	—0—	1,667	—0—
Six months	—0—	1,288	—0—
Nine months	303	859	556
Year	644	644	644

Fully Diluted Earnings Per Share

	Year 1	Year 2	Year 3
First quarter	909(1)	2,000(1)	—0—(1)
Six months	693(1)	1,455(1)	909(2)
Nine months	765(1)	970(1)	859(1)
Year	1,304(2)	727(1)	2,000(2)

(1) Computed by adding incremental shares of each quarter included and dividing by number of quarters included in the year-to-date.
(2) Incremental shares for all quarters included based on ending market price.

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EXHIBIT 4
DAYS BETWEEN TWO DATES

.360 The table on page 12,869 is useful in computing a weighted average of shares outstanding when the number of shares outstanding changes frequently during the year. The table includes numbered days for two years; one day must be added after February 28 during leap year. Corporations reporting on a calendar year basis should use the first 366 numbers; all other corporations should use both tables.

Since the number of days between two dates is determined by subtraction, the number used for the last day of the year is the first day of the following year. That is, a corporation reporting on a calendar year having a stock transaction on June 20 should weight the shares outstanding before the transaction by 170 (determined $171 - 1 = 170$) and the shares outstanding after the transaction by 195 (determined $366 - 171 = 195$). The 170 days before plus the 195 days after then equal 365 days. For leap year, corresponding computations would be $172 - 1 = 171$ and $367 - 172 = 195$, so $171 + 195 = 366$.

An example of how to use the table follows. Assume a corporation reports on a fiscal year ending June 30. At July 1, 1969 the corporation had 100,000 shares of common stock outstanding. On August 25, 1969 the corporation distributed a 5% stock dividend to its shareholders. On September 18, 1969 the corporation purchased 525 shares of its stock. On April 8, 1970 the corporation issued 10,000 shares of its stock for cash. On May 21, 1970 the corporation split its stock 2-for-1.

The days to be used for weighting are:

Transaction Day	Number for Transaction Day	Number for Beginning Day	Days for Weighting
September 18, 1969	261	182	79
April 8, 1970	463	261	202
End of year	547	463	84
Total days			365

The August 25, 1969 stock dividend and the May 21, 1970 stock split are reflected retroactively in the weighted average of shares outstanding as computed below:

Date	Shares		Stock Dividend[49]	Stock Split[49]	Days Outstanding	Weighted Shares
7/ 1/69	outstanding	100,000	× 1.05 = 105,000	× 2 = 210,000 ×	79	= 16,590,000
9/18/69	purchase	(525)		× 2 = (1,050)		
				208,950 ×	202	= 42,207,900
4/ 8/70	issue	10,000		× 2 = 20,000		
				228,950 ×	84	= 19,231,800
Totals					365	78,029,700

Weighted average number of shares outstanding:

$$\frac{78{,}029{,}700}{365} = 213{,}780$$

[49] Note that stock dividends and stock splits are retroactive adjustments rather than transactions to be weighted by the number of days a stock dividend or split was outstanding.

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TABLE OF DAYS BETWEEN TWO DATES

Day in Month	January	February	March	April	May	June	July	August	September	October	November	December
1	1	32	60	91	121	152	182	213	244	274	305	335
2	2	33	61	92	122	153	183	214	245	275	306	336
3	3	34	62	93	123	154	184	215	246	276	307	337
4	4	35	63	94	124	155	185	216	247	277	308	338
5	5	36	64	95	125	156	186	217	248	278	309	339
6	6	37	65	96	126	157	187	218	249	279	310	340
7	7	38	66	97	127	158	188	219	250	280	311	341
8	8	39	67	98	128	159	189	220	251	281	312	342
9	9	40	68	99	129	160	190	221	252	282	313	343
10	10	41	69	100	130	161	191	222	253	283	314	344
11	11	42	70	101	131	162	192	223	254	284	315	345
12	12	43	71	102	132	163	193	224	255	285	316	346
13	13	44	72	103	133	164	194	225	256	286	317	347
14	14	45	73	104	134	165	195	226	257	287	318	348
15	15	46	74	105	135	166	196	227	258	288	319	349
16	16	47	75	106	136	167	197	228	259	289	320	350
17	17	48	76	107	137	168	198	229	260	290	321	351
18	18	49	77	108	138	169	199	230	261	291	322	352
19	19	50	78	109	139	170	200	231	262	292	323	353
20	20	51	79	110	140	171	201	232	263	293	324	354
21	21	52	80	111	141	172	202	233	264	294	325	355
22	22	53	81	112	142	173	203	234	265	295	326	356
23	23	54	82	113	143	174	204	235	266	296	327	357
24	24	55	83	114	144	175	205	236	267	297	328	358
25	25	56	84	115	145	176	206	237	268	298	329	359
26	26	57	85	116	146	177	207	238	269	299	330	360
27	27	58	86	117	147	178	208	239	270	300	331	361
28	28	59	87	118	148	179	209	240	271	301	332	362
29	29	..	88	119	149	180	210	241	272	302	333	363
30	30	..	89	120	150	181	211	242	273	303	334	364
31	31	..	90	...	151	...	212	243	...	304	...	365

Day in Month	January	February	March	April	May	June	July	August	September	October	November	December
1	366	397	425	456	486	517	547	578	609	639	670	700
2	367	398	426	457	487	518	548	579	610	640	671	701
3	368	399	427	458	488	519	549	580	611	641	672	702
4	369	400	428	459	489	520	550	581	612	642	673	703
5	370	401	429	460	490	521	551	582	613	643	674	704
6	371	402	430	461	491	522	552	583	614	644	675	705
7	372	403	431	462	492	523	553	584	615	645	676	706
8	373	404	432	463	493	524	554	585	616	646	677	707
9	374	405	433	464	494	525	555	586	617	647	678	708
10	375	406	434	465	495	526	556	587	618	648	679	709
11	376	407	435	466	496	527	557	588	619	649	680	710
12	377	408	436	467	497	528	558	589	620	650	681	711
13	378	409	437	468	498	529	559	590	621	651	682	712
14	379	410	438	469	499	530	560	591	622	652	683	713
15	380	411	439	470	500	531	561	592	623	653	684	714
16	381	412	440	471	501	532	562	593	624	654	685	715
17	382	413	441	472	502	533	563	594	625	655	686	716
18	383	414	442	473	503	534	564	595	626	656	687	717
19	384	415	443	474	504	535	565	596	627	657	688	718
20	385	416	444	475	505	536	566	597	628	658	689	719
21	386	417	445	476	506	537	567	598	629	659	690	720
22	387	418	446	477	507	538	568	599	630	660	691	721
23	388	419	447	478	508	539	569	600	631	661	692	722
24	389	420	448	479	509	540	570	601	632	662	693	723
25	390	421	449	480	510	541	571	602	633	663	694	724
26	391	422	450	481	511	542	572	603	634	664	695	725
27	392	423	451	482	512	543	573	604	635	665	696	726
28	393	424	452	483	513	544	574	605	636	666	697	727
29	394	...	453	484	514	545	575	606	637	667	698	728
30	395	...	454	485	515	546	576	607	638	668	699	729
31	396	...	455	...	516	...	577	608	...	669	...	730

102. Two-Class Method for Warrants Issued by REITs

.361 *Question*—The capitalization of a real estate investment trust (REIT) includes shares of beneficial interest (common stock) and an equal number of warrants. This REIT is not subject to federal income tax with respect to the income it distributes to its shareholders because it distributes at least 90 percent of its annual taxable income (as defined by the *Internal Revenue Code*) and elects not to be taxed on the income distributed. How should this entity treat warrants in computing earnings per share under section 2011?

.362 *Interpretation*—The "two-class" method of computing primary earnings per share should be used by any REIT which elects under the *Internal Revenue Code* not to be subject to tax on income distributed and which pays dividends equal to 90 percent or more of its taxable income. Under this method, dividends are deducted from net income and the remaining amount (the undistributed earnings) is allocated to the total of common shares and common share equivalents with use of warrant proceeds applied as described in paragraph .36 or .38. Per share distributions to common shareholders (total dividends divided by the weighted average of common shares outstanding) are added to this per share amount to determine primary earnings per share.

.363 For example, the REIT described in the question above should compute primary earnings per share under the "two-class" method in conjunction with section 2011.38. Assume that this REIT has a net income of $1,000,000 and distributes $900,000 in dividends on 1,000,000 common shares outstanding. Warrants exercisable at $5 per share for 1,000,000 common shares are also outstanding. Assuming a market price of $23 per share for common and a 3 percent interest rate for debt and/or investments in commercial paper or U.S. government securities, primary earnings per share would be determined applying the two-class method and paragraph .38 as follows:

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Net income		$1,000,000
Less dividends		900,000
Undistributed earnings		$ 100,000
Proceeds from the exercise of warrants: 1,000,000 × $5	$5,000,000	
Purchase of treasury stock under paragraph .38-a 200,000 shares × $23	4,600,000	
Balance to retire debt under paragraph .38-b	400,000	
Interest rate on debt retired	.03	
Interest adjustment		12,000
Adjusted undistributed earnings		$ 112,000
Common shares outstanding		1,000,000
Common shares assumed issued for warrants	1,000,000	
Less treasury stock purchased	200,000	
Incremental shares for warrants		800,000
Common and common equivalent shares		1,800,000
Primary earnings per share:		
Distributed earnings ($900,000 ÷ 1,000,000)		$ .90
Undistributed earnings ($112,000 ÷ 1,800,000)		.06
Total earnings per common and common equivalent share		$ .96

.364 If the per share amount computed above had exceeded earnings per outstanding common share of $1.00 (computed: $1,000,000 ÷ 1,000,000 shares), the result would be anti-dilutive and primary earnings per share would be reported as $1.00 in accordance with paragraph .30.

.365 The two-class method should not be used by a REIT in computing fully diluted earnings per share in order to reflect maximum potential dilution. Therefore, fully diluted earnings per share computed for the above example would be $.56 (computed: $1,012,000 ÷ 1,800,000 shares) applying only paragraph .38.

.366 Although dividends declared after the close of the taxable year may be included in meeting the 90 percent

requirement for federal income tax purposes, only dividends paid or declared during the period for which the computation is being made should be considered in applying the two-class method. However, a dividend declaration (or official company policy in lieu of actual declaration) before the close of the period stated as a percentage of taxable earnings (the amount to be determined after the close of the period) will be considered as being declared during the period if the dividend is paid by the date the financial statements are issued.

[Issue Date: September, 1971.]

The next page is 12,951.

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AC Section U2012

Reporting The Results of Operations: Accounting Interpretation of Section 2012

1. Illustration of the Application of Section 2012

.001 *Question*—As stated in section 2012.19, judgment is required to segregate in the income statement the effects of events or transactions that are extraordinary items. What factors must be considered in determining whether the effects of a particular event or transaction are extraordinary items or should otherwise be set forth in the income statement, and how are these factors applied in practice?

.002 *Interpretation*—The first question which generally should be considered in determining the appropriate classification of profit or loss items which appear to be unusual, infrequently occurring or extraordinary is:

> Does the event or transaction involve the sale, abandonment or other manner of disposal of a segment of a business as defined in section 2012.13?

.003 *Discussion*—As explained in section 2012.08, results of discontinued operations of a segment of a business and any gain or loss from disposal of the segment should be reported separately in the income statement, but should not be designated as extraordinary items. The term "segment of a business" is defined in section 2012.13 as a component of an entity whose activities represent a separate major line of business or class of customer. Section 2012 further provides guidelines for the determination of a segment of a business and distinguishes between the disposal of a segment and the disposal of assets incident to the evolution of an entity's business. The following are illustrative of disposals which should be classified as disposals of a segment of a business:

(1) A sale by a diversified company of a major division which represents the company's only activities in the electronics industry. The assets and results of

operations of the division are clearly segregated for internal financial reporting purposes from the other assets and results of operations of the company.

(2) A sale by a meat packing company of a 25% interest in a professional football team which has been accounted for under the equity method. All other activities of the company are in the meat packing business.

(3) A sale by a communications company of all its radio stations which represent 30% of gross revenues. The company's remaining activities are three television stations and a publishing company. The assets and results of operations of the radio stations are clearly distinguishable physically, operationally and for financial reporting purposes.

(4) A food distributor disposes of one of its two divisions. One division sells food wholesale primarily to supermarket chains and the other division sells food through its chain of fast food restaurants, some of which are franchised and some of which are company-owned. Both divisions are in the business of distribution of food. However, the nature of selling food through fast food outlets is vastly different than that of wholesaling food to supermarket chains. Thus by having two major classes of customers, the company has two segments of its business.

.004 Certain disposals would not constitute disposals of a segment of a business because they do not meet the criteria specified in section 2012. For example, the following disposals should not be classified as disposals of a segment of a business:

(5) The sale of a major foreign subsidiary engaged in silver mining by a mining company which represents all of the company's activities in that particular country. Even though the subsidiary being sold may account for a significant percentage of gross revenue of the consolidated group and all of its revenues in the particular country, the fact that the company continues to engage in silver mining activities in other countries would indicate that there was a sale of a part of a line of business.

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(6) The sale by a petrochemical company of a 25% interest in a petrochemical plant which is accounted for as an investment in a corporate joint venture under the equity method. Since the remaining activities of the company are in the same line of business as the 25% interest which has been sold, there has not been a sale of a major line of business but rather a sale of part of a line of business.

(7) A manufacturer of children's wear discontinues all of its operations in Italy which were composed of designing and selling children's wear for the Italian market. In the context of determining a segment of a business by class of customer, the nationality of customers or slight variations in product lines in order to appeal to particular groups are not determining factors.

(8) A diversified company sells a subsidiary which manufactures furniture. The company has retained its other furniture manufacturing subsidiary. The disposal of the subsidiary, therefore, is not a disposal of a segment of the business but rather a disposal of part of a line of business. As discussed in section 2012.13, such disposals are incident to the evolution of the entity's business.

(9) The sale of all the assets (including the plant) related to the manufacture of men's woolen suits by an apparel manufacturer in order to concentrate activities in the manufacture of men's suits from synthetic products. This would represent a disposal of a product line as distinguished from the disposal of a major line of business.

.005 If it has been determined that the particular event or transaction is not a disposal of a segment of a business, then the criteria for extraordinary items classification should be considered. That is:

Does the event or transaction meet both criteria of *unusual nature* and *infrequency of occurrence?*

.006 *Discussion*—Section 2012.19-.22 discusses the criteria of unusual nature and infrequency of occurrence of events or transactions taking into account the environment

in which the entity operates. Paragraph .23 specifies certain gains or losses which should not be reported as extraordinary unless they are the direct result of a major casualty, an expropriation, or a prohibition under a newly enacted law or regulation that clearly meets both criteria for extraordinary classification. Events or transactions which would meet both criteria in the circumstances described are:

(10) A large portion of a tobacco manufacturer's crops are destroyed by a hail storm. Severe damage from hail storms in the locality where the manufacturer grows tobacco is rare.

(11) A steel fabricating company sells the only land it owns. The land was acquired ten years ago for future expansion, but shortly thereafter the company abandoned all plans for expansion and held the land for appreciation.

(12) A company sells a block of common stock of a publicly traded company. The block of shares, which represents less than 10% of the publicly-held company, is the only security investment the company has ever owned.

(13) An earthquake destroys one of the oil refineries owned by a large multi-national oil company.

.007 The following are illustrative of events or transactions which do not meet both criteria in the circumstances described and thus should not be reported as extraordinary items:

(14) A citrus grower's Florida crop is damaged by frost. Frost damage is normally experienced every three or four years. The criterion of infrequency of occurrence taking into account the environment in which the company operates would not be met since the history of losses caused by frost damage provides evidence that such damage may reasonably be expected to recur in the foreseeable future.

(15) A company which operates a chain of warehouses sells the excess land surrounding one of its warehouses. When the company buys property to establish a new warehouse, it usually buys more land than it expects to use for the warehouse with the expectation

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that the land will appreciate in value. In the past five years, there have been two instances in which the company sold such excess land. The criterion of infrequency of occurrence has not been met since past experience indicates that such sales may reasonably be expected to recur in the foreseeable future.

(16) A large diversified company sells a block of shares from its portfolio of securities which it has acquired for investment purposes. This is the first sale from its portfolio of securities. Since the company owns several securities for investment purposes, it should be concluded that sales of such securities are related to its ordinary and typical activities in the environment in which it operates and thus the criterion of unusual nature would not be met.

(17) A textile manufacturer with only one plant moves to another location. It has not relocated a plant in twenty years and has no plans to do so in the foreseeable future. Notwithstanding the infrequency of occurrence of the event as it relates to this particular company, moving from one location to another is an occurrence which is a consequence of customary and continuing business activities, some of which are finding more favorable labor markets, more modern facilities, and proximity to customers or suppliers. Therefore, the criterion of unusual nature has not been met and the moving expenses (and related gains and losses) should not be reported as an extraordinary item. Another example of an event which is a consequence of customary and typical business activities (namely financing) is an unsuccessful public registration, the cost of which should not be reported as an extraordinary item. (For additional examples, see section 2012.23.)

.008 Disposals of part of a line of business, such as examples 5-9 of this Interpretation, should not be classified as extraordinary items. As discussed in section 2012.13, such disposals are incident to the evolution of the entity's business and therefore the criterion of unusual nature would not be met.

.009 *Question*—Section 2012.27 states that events and transactions that were reported as extraordinary items in

statements of income for fiscal years ending before October 1, 1973 should not be restated except that a statement of income including operations of discontinued segments of a business that meet the paragraph .13 criteria may be reclassified in comparative statements to conform with the provisions of paragraphs .08 and .09 of section 2012. If a gain or loss on such a disposal in a prior year had been classified as an extraordinary item but was not computed in the *manner* specified in section 2012.15-.17, may the prior year income statements be reclassified and the gain or loss adjusted to comply with the provisions of section 2012?

.010 *Interpretation*—Section 2012 specifically uses the term "reclassified" in paragraph .27 and makes direct reference to paragraphs .08 and .09 which describe the manner of reporting disposals of a segment of a business as defined in paragraph .13. While such reclassification is optional under section 2012, there should not be a redetermination (restatement) of net income using the measurement principles specified in paragraphs .15-.17. Since Opinions of the Board are not intended to be retroactive unless otherwise stated, the method of computing of the gain or loss on disposals of a segment should not be retroactively applied if it results in a change in net income of a prior year.

.011 *Question*—Events or transactions which are not disposals of a segment of a business and are not extraordinary items may nevertheless be required to be reported as a separate component of income from continuing operations under the provisions of section 2012.26. If a company sells a portion of a line of business which does not meet the definition of a segment of a business as defined in section 2012.13, should the gain or loss be calculated using the measurement principles for determination of gain or loss on disposal of a segment of a business as prescribed in section 2012.15-.17 and how should the financial effects of such sale be reported?

.012 *Interpretation*—The gain or loss on a sale of a portion of a line of business which is not a segment of a business as defined in paragraph .13 should be calculated using the same measurement principles as if it were a segment of a business (section 2012.15-.17). Under the provisions of section 2012.26, the amount of such gain or loss

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should be reported as a separate component of income from continuing operations. However, the gain or loss should not be reported on the face of the income statement net of income taxes or in any manner inconsistent with the provisions of paragraphs .08 and .11 of section 2012 which may imply that it is a disposal of a segment of the business. In addition, the earnings per share effect should not be disclosed on the face of the income statement. Revenues and related costs and expenses of the portion of the line of business prior to the measurement date should not be segregated on the face of the income statement but may be disclosed in the notes to the financial statements and such disclosure is encouraged. In addition, the notes to the financial statements should disclose, if known, those items specified in section 2012.18.

.013 The foregoing examples are illustrative. It should be recognized that all attendant circumstances, which can vary from those above, need to be considered in making the judgments required by section 2012.

[Issue Date: November, 1973]

The next page is 12,971.

AC Section U2021

Reporting Changes in Financial Position: Accounting Interpretations of Section 2021

1. Number of Funds Statements Required

.001 *Question*—Section 2021.07 states that when a balance sheet and an income statement are issued, a "Statement of Changes in Financial Position" (funds statement) should be presented for each period for which an income statement is presented. If comparative income statements for the past five years and only a balance sheet for the end of the five-year period are presented, how many statements of changes in financial position must be presented?

.002 *Interpretation* — Normally, five statements of changes in financial position would be required by section 2021.07—one for each year for which an income statement is presented. However, the detail of net changes in each element of working capital is required to be presented only for the current year (see section 2021.12).

.003 It should also be noted that section 2021 is effective for fiscal periods ending after September 30, 1971. Therefore, a statement of changes in financial position is not required for any period covered by an income statement ending before that date, although their presentation for earlier years is encouraged.

.004 For example, assume the financial statements described in the question included a balance sheet dated December 31, 1972 and income statements for the calendar years ending December 31, 1972, 1971, 1970, 1969, and 1968. Statements of changes in financial position are required only for the calendar years ended December 31, 1972 and December 31, 1971.

[Issue Date: February, 1972.]

2. Funds Statement for Mutuals and Co-ops

.005 *Question*—Section 2021.07 requires all "profit-oriented business entities" to present a statement of changes in financial position when financial statements purporting to present both financial position and results of operations

are issued. Are mutual companies and co-operative organizations considered "profit-oriented business entities" for this purpose?

.006 *Interpretation*—Yes, for purposes of reporting under section 2021 mutual companies and co-operative organizations are considered to be "profit oriented." These entities should therefore include a statement of changes in financial position when issuing both a balance sheet and an income statement.

[Issue Date: February, 1972.]

3. Funds Statements for Mutual Funds and Real Estate Companies

.007 *Question*—Investment companies carrying their investments at "value" (e. g., mutual funds, many "closed-end" companies, "variable annuity accounts" of life insurance companies and common trust funds) generally include a "statement of changes in net assets" and real estate investment companies may include a "statement of funds generated and disbursed" among their financial statements. The format of these statements may differ somewhat from that described in section 2021.10 for a statement of changes in financial position, but they present the information required by the section. Does such a variation in format comply with the requirements of the section?

.008 *Interpretation*—A format that varies from that described in section 2021.10 is acceptable in the case of these statements which have been devised as the most appropriate for reporting information which is peculiar in these industries, so long as the statements contain the information required by the section. The section recognizes the need for flexibility in form (paragraph .09) so long as the required information is disclosed in the most useful portrayal of the financing and investing activities and the changes in financial position of the reporting entity (paragraph .11).

.009 It is expected that Audit Guides issued by the AICPA in the future will illustrate the type of statement of changes in financial position that may be appropriate for a particular industry. Companies should, naturally, follow the recommendations of these Guides.

[Issue Date: June, 1972.]

The next page is 13,051.

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AC Section U4062

Accounting for Stock Issued to Employees: Accounting Interpretations of Section 4062

1. Stock Plans Established by a Principal Stockholder

.001 *Question*—Accounting for compensatory and noncompensatory stock option, purchase and award plans adopted by a corporation is discussed in sections 4062 and 4061. Should a corporation account for plans or transactions ("plans"), if they have characteristics otherwise similar to compensatory plans adopted by corporations, that are established or financed by a principal stockholder (i. e., one who either owns 10% or more of the corporation's common stock or has the ability, directly or indirectly, to control or influence significantly the corporation)?

.002 *Interpretation*—It is difficult to evaluate a principal stockholder's intent when he establishes or finances a plan with characteristics otherwise similar to compensatory plans generally adopted by corporations. A principal stockholder may be satisfying his generous nature, settling a moral obligation, or attempting to increase or maintain the value of his own investment. If a principal stockholder's intention is to enhance or maintain the value of his investment by entering into such an arrangement, the corporation is implicitly benefiting from the plan by retention of, and possibly improved performance by, the employee. In this case, the benefits to a principal stockholder and to the corporation are generally impossible to separate. Similarly, it is virtually impossible to separate a principal stockholder's personal satisfaction from the benefit to the corporation. Section 1025.14, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* states that "Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment."

.003 The economic substance of this type of plan is substantially the same for the corporation and the employee, whether the plan is adopted by the corporation or a principal stockholder. Consequently, the corporation should account for this type of plan when one is established or financed by a principal stockholder unless (1) the relationship between the stockholder and the corporation's employee is one which would normally result in generosity (i. e., an immediate family relationship), (2) the stockholder has an obligation to the employee which is completely unrelated to the latter's employment (e. g., the stockholder transfers shares to the employee because of personal business relationships in the past, unrelated to the present employment situation), or (3) the corporation clearly does not benefit from the transaction (e. g., the stockholder transfers shares to a minor employee with whom he has had a close relationship over a number of years).

.004 This type of plan should be treated as a contribution to capital by the principal stockholder with the offsetting charge accounted for in the same manner as compensatory plans adopted by corporations.

.005 Compensation cost should be recognized as an expense of one or more periods in accordance with the provisions of section 4062.12-.15.

.006 The corporation should account for tax benefits, if any, from this type of plan in accordance with the provisions of section 4062.16-.18. If the corporation receives no tax benefit from this type of plan, but would have received such benefit had the plan been adopted by the corporation, the absence of such tax benefit is one of the variables in estimating the plan's cost to the corporation (see section 1091.89.).

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The next page is 13,101.

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AC Section U4063

Accounting For The Cost of Pension Plans: Accounting Interpretations of Section 4063

A DISCUSSION OF THE BACKGROUND AND REQUIREMENTS OF SECTION 4063

By Julius W. Phoenix, Jr., and William D. Bosse

PART I

1. Introduction

.001 Section 4063, issued in November 1966, is both long and comprehensive. It includes 15 separate sections, an appendix briefly describing actuarial techniques, and a glossary devoted principally to the actuarial terms used throughout section 4063. The scope of section 4063 results from the need to consider many interrelated factors affecting estimation of pension cost for accounting purposes. The complexities of estimating pension cost arise primarily from the many uncertainties inherent in the long periods separating the time of estimation from the time of payment of benefits to employees. Underlying the estimates are annuity and compound-interest computations. Mathematical probability factors are used to deal with such uncertainties as employee death or termination and changes in compensation.

.002 The major difficulties in estimating pension cost are in selecting the pertinent data relating to employees as a group, designing the actuarial computation and formulating assumptions regarding such matters as earnings of pension-fund assets. The process usually requires the technical skill, experience and judgment of an actuary. Although significant reliance may be placed on the work of an actuary, the accountant should become familiar with the actuarial concepts and methods so that he can understand the data prepared by the actuary and reach his own conclusions as to whether the provision for pension cost complies with section 4063 (see paragraphs .007-.008 for some key definitions).

.003 All complexities and difficulties notwithstanding, the basic accounting for pension plans recommended in section 4063 is relatively easy to understand.

.004 To begin negatively, provisions for pension cost should not be based on contributions to the pension fund, nor should they be limited to the amounts for which the company has a legal liability. They should not fluctuate widely as a result of pension-fund investment gains and losses or from other causes unrelated to the employee group.

.005 Turning to the positive, the provision for pension cost should be based on an actuarial cost method that gives effect, in a consistent manner, to employee group data, pension benefits, pension-fund earnings, investment gains or losses, and other assumptions regarding future events. The actuarial cost method selected should result in a systematic and rational allocation of the total cost of pensions among the employees' years of active service. If the actuarial cost method selected includes past service cost as an integral part of normal cost, the provision for pension cost should be normal cost adjusted for the effect on pension-fund earnings of differences between amounts accrued and amounts funded. If the actuarial cost method deals with past service cost separately from normal cost, the provision for pension cost should include normal cost, an amount for past service cost, and an adjustment for the effect on pension-fund earnings of differences between amounts accrued and amounts funded.

.006 As can be seen later, the most controversial issue in developing section 4063 had to do with the amount to be included for past service cost.

2. Some Key Definitions

.007 For convenience, some terms are delineated here. ''Normal cost'' is the portion of the annual pension cost that, under the actuarial cost method in use, is related to years after the date of an actuarial valuation of the plan. ''Past service cost" refers to the portion of the total pension cost that, under the actuarial cost method in use, is identified with periods prior to the adoption of the plan. Similarly, ''prior service cost'' refers to the portion of the

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total pension cost that, under the actuarial cost method in use, is identified with all periods prior to the date of an actuarial valuation of the plan. Therefore, "prior service cost" includes, as of the date of its determination, the past service cost, the normal cost for years prior to that date, and increases in pension cost arising when the plan may have been amended to change the benefits or the group of employees covered. Since "prior service cost" is based on present value on the date of determination, it reflects the effect of other factors to that date, such as assumed earnings or interest equivalents, pension benefits paid to date, and gains or losses under the experience to date. Essentially, it is determined at any time in the same way that a past service cost would be determined if the plan were then being put into effect for the first time.

.008 Section 4063 at times makes reference to a specific part of prior service cost, the most usual being "the amounts of any increases or decreases in prior service cost arising on an amendment to the plan." Since such an amount is dealt with like a past service cost, unless otherwise indicated by the context, the term "past service cost" is used in this article to refer to both past service cost arising on the adoption of the plan and the amounts of any increases or decreases in prior service cost arising on amendments of the plan.

3. Previous Pronouncements

.009 Before discussing section 4063 further, it might be well to review briefly the previous official pronouncements of the American Institute of Certified Public Accountants on the subject of pension plans.

.010 The first pronouncement was made in Accounting Research Bulletin No. 36 issued by the committee on accounting procedure in November 1948. It was entitled "Pension Plans—Accounting for Annuity Costs Based on Past Services." Although this Bulletin dealt with only one small segment of the pension accounting problem, it did focus on the most troublesome area, both conceptually and practically, that accountants have had to face in dealing with this complex accounting subject.

.011 ARB No. 36 was included without substantive change as Chapter 13a, "Pension Plans—Annuity Costs Based on Past Service," of ARB No. 43, Restatement and Revision of Accounting Research Bulletins.[1] In ARB No. 43, Chapter 13a, the committee on accounting procedure expressed its belief that "even though the calculation is based on past service, costs of annuities based on such service are incurred in contemplation of present and future services, not necessarily of the individual affected but of the organization as a whole, and therefore should be charged to the present and future periods benefited. This belief is based on the assumption that although the benefits to a company flowing from pension plans are intangible, they are nevertheless real. The element of past service is one of the important considerations in establishing pension plans, and annuity cost measured by such past service contribute to the benefits gained by the adoption of the plan. It is usually expected that such benefits will include better employee morale, the removal of superannuated employees from the payroll, and the attraction and retention of more desirable personnel, all of which should result in improved operations."

.012 The position of the committee on accounting procedure was reaffirmed by a later generation of that committee in Accounting Research Bulletin No. 47, issued in September 1956.[2] Bulletin No. 47, however, was more specific about how past service cost should be treated and also introduced the factor of vested benefits. The committee expressed its preferences that "costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees," and that "costs based on past services should be charged off over some reasonable period, provided the allocation is made on a systematic and rational basis and does not cause distortion of the operating results in any one year." The committee recognized, however, that its preferences were not universally accepted and went on to say that "as a minimum, the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to em-

[1] Editor's Note: Footnote reference eliminated.
[2] Editor's Note: Footnote reference eliminated.

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ployees to the extent that pension rights have vested in the employees, reduced, in the case of the balance sheet, by any accumulated trusteed funds or annuity contracts purchased." The committee did not explain what it meant by the term "vested" and did not make any recommendation concerning appropriate actuarial cost methods or recognition of actuarial gains and losses. This void is filled by section 4063.

4. Development of Section 4063

.013 When the accounting variations found in practice made it evident that Accounting Research Bulletin No. 47 was not an adequate guide for accounting for the cost of pension plans, the Accounting Principles Board decided that the subject needed further study and authorized an accounting research study to be made. This study was undertaken by Ernest L. Hicks, who performed an outstanding job in putting together the many accounting complexities surrounding pension plans.

.014 The study was completed and published in 1965. A subcommittee[3] of the Accounting Principles Board began its analysis of the subject when preliminary drafts of the research study became available. Early in 1966, after the initial volume of comments on the study subsided, the subcommittee presented to the full Board a discussion outline of suggestions, problem areas and possible opinion content.

.015 During its meetings through June of that year, the Board devoted much time to discussion of the subject. A regular attendant at Board and subcommittee meetings was Frederick P. Sloat, a member of the American Academy of Actuaries, whose assistance and advice were invaluable. Along the way, the subcommittee initiated a series of meetings with representatives of the actuarial societies, the bar association, utility associations and the Financial Executives Institute.

.016 It is important to emphasize the diligence with which the Board sought the views of responsible members of the business community before reaching the point of

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[3] John W. Queenan, chairman, Marshall S. Armstrong, LeRoy Layton, and Oral L. Luper.

taking any final votes on the contents of section 4063. It is equally important to emphasize the degree of interest and the spirit of co-operation with which the business community responded to the request of the subcommittee. This dispelled any doubt concerning the business community's genuine interest in what the Accounting Principles Board is doing. It does have views that should be considered by the profession and it does want to help.

.017 The exposure draft was issued in July 1966. The comments received as a result of the exposure were gratifying. Replies were received from over 300 of those on the exposure list, including many of the top executives of leading corporations around the country. All comments were read, analyzed and catalogued. After consideration of these comments and a further meeting of the Board, the exposure draft was converted into the final section 4063 in November 1966.

.018 From the authors' observations, the Board appreciates the efforts expended by companies in commenting on its proposed opinions, especially where the comments are supported by reasons and analysis.

.019 It may be helpful to an understanding of section 4063 to discuss its major objective and what is likely to be its principal accomplishment—the elimination of inappropriate fluctuations.

5. Major Objective of Section 4063

.020 Pension cost is an important cost of doing business. Except in rare cases, when a company commits itself to pay pensions to its employees upon their retirement, the cost of those pensions may be expected to continue as long as the company has employees. Furthermore, and this is important, pension cost year by year should not be greatly out of line with the size or compensation of the employee group. For example, it does not appear reasonable for a company with a stable or growing employee group to have pension cost of $50,000 one year, $100,000 the next and $10,000 the next. Although not usually so extreme, fluctuations of this sort did occur in many cases found in practice.

.021 These fluctuations were due largely to the effect given to three things: (1) actuarial gains and losses,

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(2) the funding of pension plans and (3) legal safeguards typically written into the plans. The primary accomplishment of the pension section probably will be to eliminate the fluctuations due to these factors.

.022 A brief comment about each: **First, actuarial gains and losses.** In recent years, some companies made substantial reductions in their annual provision for pension cost when investment gains were realized by the pension fund, when the estimated future earnings rate of the fund was increased or when accumulated appreciation in pension-fund investments was recognized in the actuarial valuation.

.023 These occurrences represent some examples of what are described in section 4063 as actuarial gains. To eliminate the fluctuations in pension cost caused by these gains, the Board concluded that actuarial gains— and, in like manner, actuarial losses—"should be given effect in the provision for pension cost in a consistent manner that reflects the long-range nature of pension cost." The recommended way for accomplishing this is, with certain exceptions, to "spread" or "average" these actuarial gains and losses over a period of years.

.024 **Second, funding.** Some companies based their provision for pension cost on the amount funded—that is, the amount paid to the pension fund. The amounts funded frequently varied widely from year to year because of working capital availability, tax considerations and other factors. Section 4063 make it clear that, under accrual accounting, amounts funded are not determinative of pension costs.

.025 Accrual accounting is based on the assignment of costs among years on the basis of the economic benefits derived from the incurrence of the cost. Funding arrangements may not, and often do not, follow the pattern of economic benefits. Funding is a matter of financial management and may be discretionary; it is not a matter of accounting principle, however.

.026 **Third, legal safeguards.** Somewhat related to funding is the influence of legal safeguards that limit the company's liability for the payment of pensions to the

amount in the pension fund. As a matter of business prudence, most companies include a clause in their pension plan to the effect that the company may, in its discretion, discontinue the plan or discontinue contributions. In these cases, the employees have no rights to any benefits beyond those than can be paid from the assets in the pension fund. Relying on these clauses, some companies took the position that they had no liability for pensions and therefore did not need to record pension cost beyond the amounts contributed to the pension fund. The Board concluded that clauses such as these could not, as a practical matter, be brought into play by a business that expected to continue to operate in today's economy. In short, these clauses should have little effect on the incurrence of pension cost. Except in rare instances, therefore, they should be ignored in determining the amount of pension cost to be provided.

.027 While many other matters are covered in section 4063, the conclusions about actuarial gains and losses, funding and legal safeguards will probably have the most widespread effect on accounting for the cost of pension plans.

.028 These conclusions are essential to eliminating the wide fluctuations in pension cost that were largely responsible for section 4063 being written in the first place.

6. Interest Equivalents

.029 Before proceeding to a discussion of the basic section 4063 recommendations, a peripheral issue should be clarified.

.030 In many places, section 4063 refers to "amounts equivalent to interest" or "interest equivalents." As used in section 4063 and in the actuarial profession, "interest" is a simple way of referring to the earnings, assumed or actual, of a pension fund. The need to take interest equivalents into account in computing the pension-cost provision arises when the actual pension fund differs from a theoretical fund and when the amounts funded differ from the amounts which have been recorded for accounting purposes.

.031 Under the present-worth basis used for pension-cost accounting, it is assumed that amounts equivalent to

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prior service cost and normal cost will be contributed to a fund and that the fund will produce earnings (interest) at an assumed rate. If contributions for these amounts are not made, they will not be available to produce earnings, and it becomes necessary to make an additional provision equivalent to what the earnings would have been if the contributions had been made. This assumption is extended to past service cost even though it is known at the outset that the amounts will not be funded until sometime in the future, or not at all.

.032 For this reason, section 4063 calls for the pension-cost provision to include an amount equivalent to interest on unfunded prior service cost. Such interest may be included as a separate component of the provision or it may be included in the amortization of the past service cost (subject to the 10 per cent maximum). Whenever past service cost is being amortized and the prior year pension-cost provisions have not been funded, an amount equivalent to interest on the unfunded provisions should be added to the provision for the year in addition to any amount included in the amortization. Conversely, when the amounts funded exceed the prior year pension-cost provisions, a reduction of the provision for the year is needed to reflect the interest equivalents on the excess amounts funded.

7. What Constitutes Pension Cost?

.033 The preceding discussion is about the recommendations designed to eliminate fluctuations and about the need for interest equivalents. Agreement concerning these matters was reached by the Board with relative ease. Also, there was never any disagreement that pension cost should be accounted for on the accrual basis, and that the entire cost applicable to an accounting period should be provided. There was disagreement about what constitutes the entire cost applicable to an accounting period. The different views are explained in section 4063. For purposes of this article, suffice it to say that one view was that pension cost should "take into account all estimated prospective benefit payments under a plan with respect to the *existing employee group*" whereas the principal other view was "that pension cost is related to the pension benefits to

be paid to the *continuing employee group as a whole*" (emphasis added).

.034 Under either view, annual pension cost would include normal cost. The difference between the two views essentially revolved around what to do about past service cost.

.035 The Board agreed, as had the predecessor committee on accounting procedure, that past service cost relates to periods subsequent to the adoption or amendment of a plan and should not be charged against retained earnings as something applicable to the past. Some members of the Board believed this cost should be specifically recognized in annual provisions over a period of years, although there were some differences in views concerning the period to use. Other members of the Board believed it unnecessary to make specific provisions for past service cost if all benefit payments could be met on a continuing basis by annual provisions representing normal cost plus an amount equivalent to interest on unfunded prior service cost.

.036 There was merit in both positions. Although the Board stated a preference for past service cost being amortized, it concluded that it should not at this time rule out either approach as an acceptable measure of cost. Accordingly, in the interest of attaining the substantial improvement in accounting for the cost of pension plans that would result from the other conclusions of section 4063, the Board framed section 4063 in terms of a minimum method based on the normal-cost-plus-interest concept and a maximum method based upon the amortization-of-past-service-cost concept. One result of this conclusion is that any period may be selected for the amortization of past service cost, as long as the total annual provision falls between the minimum and maximum.

.037 Many would term the minimum-maximum approach to be a flaw in section 4063, and it is fair to say that few, if any, of those working with section 4063 felt that it was a completely satisfying answer. If the minimum-maximum approach is a flaw, however, the authors believe that the flaw is more apparent than real because, as section 4063 is written, it allows a company to fit its accounting

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for the cost of its pension plan to the facts and circumstances in its particular case and to record the pension cost most realistic for it.

8. Minimum—Maximum

.038 Before discussing the mechanics of the minimum-maximum methods, three general observations should be made.

.039 First, the difference between the two methods is essentially in the extent to which past service cost is included in the pension-cost provision. Under the defined minimum, only interest on unfunded prior service cost (plus any indicated provision for vested benefits) is included. Under the defined maximum, 10 per cent of the past service cost is included. Normal cost is the same under both.

.040 In two frequently used actuarial cost methods, the ''individual level premium" and ''aggregate'' methods, past service cost is not measured separately. That is, past service cost is included in normal cost. Because there is no amount of separately computed past service cost, the defined minimum and maximum are the same under these methods.

.041 On the other hand, in other frequently used actuarial cost methods, such as the ''unit-credit'' (''accrued benefit"), ''entry age normal," and ''attained age normal" methods, past service cost is measured separately. It is only when methods such as these are used that there is a difference between the defined minimum and maximum. Furthermore, if the past service cost has been fully amortized, there is no difference between the defined minimum and maximum.

.042 The second general observation is that section 4063 contemplates that the defined minimum, the defined maximum and the provision for the year will all be computed using the actuarial cost method selected. For example, if the pension-cost provision is based on the unit credit method, the defined maximum should also be based on that method and not on the entry age normal method, which usually would give a greater maximum amount.

.043 The third general observation has to do with an apparent misconception about the defined minimum and maximum.

.044 There has been some comment to the effect that any pension-cost provision is acceptable under section 4063 so long as it falls between the minimum and the maximum each year. This may be described as a bouncing-ball effect—that is, the pension-cost provision can bounce up and down between the two limits. This view of section 4063 is a mistaken one.

.045 Section 4063 contemplates that in all cases the provision for pension cost will be based on an acceptable actuarial cost method, with all variable factors consistently applied. Furthermore, the treatment of actuarial gains and losses, the actuarial assumptions and the like, should conform with the recommendations of section 4063, and should be applied consistently from year to year.

.046 As to past service cost, if the vested-benefit provision is not required, section 4063 contemplates that the company will select interest-only or some amortization plan not exceeding 10 per cent and apply whatever it selects consistently. If this is done, pension-cost provisions will not bounce around from year to year, unless caused by such factors as size, composition or compensation of the employee group. If the vested-benefit provision is required, it could cause some variations from year to year. However, as will be seen from the example given later, the effect is not likely to be material.

9. Computing the Defined Maximum

.047 In many cases, the maximum defined in section 4063 is the same as the maximum allowed for federal income tax purposes. Generally speaking, the Internal Revenue Service will allow a deduction for the normal cost of a qualified plan plus not more than 10 per cent of the past service cost. This is also the general maximum limitation included in section 4063. Differences between the maximum tax deduction and the maximum pension-cost provision can arise, however, as a result of unrealized appreciation or depreciation, or as a result of the application of the actuarial cost method. Probably the outstanding

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example of the latter is where the unit credit actuarial cost method is used for tax purposes. When this method is used, actuarial gains usually reduce the pension-cost deduction in the year they occur or in the following year. In these cases, it may be necessary to make accounting adjustments to effect a spreading or averaging of the gains.

.048 It is important to note that the 10 per cent limitation applies separately to past service cost at the adoption of a plan and to changes in prior service cost that result from amendments of the plan. For example, disregarding interest equivalents, if a company adopts a pension plan with past service cost of $100,000, the maximum accounting provision would be normal cost plus $10,000 (10 per cent of $100,000) of past service cost. If the company later amends the plan to increase benefits and the cost of the increased benefits related to service prior to the amendment is an additional $50,000, the maximum would be normal cost plus $15,000 (10 per cent of the total of $150,000) until such time as the original past service cost has been fully amortized; after that time the maximum becomes normal cost plus $5,000 (10 per cent of the $50,000 increase). This can be significant when there is a series of increases in benefits over a period of time.

.049 As previously indicated, whenever the funding differs from the cost provision, the cost provision must be increased or decreased by interest equivalents on the difference between the amount provided and the amount funded. An illustration may be helpful. When a company adopts a pension plan, it may fund immediately all of the past service cost. It might do this, for example, in order to gain the advantage of the tax-free income from the investment of the funds by the pension trust. Because the pension-cost provision with respect to the past service cost is limited to 10 per cent, there will be a deferral on the balance sheet for the other 90 per cent. Again taking past service cost of $100,000, $10,000 would be included in the pension-cost provision for the year and the other $90,000 would appear as a deferred charge. In this situation, the accrual for the following year would be reduced by the earnings of the $90,000. If the assumed interest rate was 4 per cent, the cost provision for the succeeding year would

be reduced by $3,600. Because of these reductions, the amortization period will be somewhat longer than ten years.

.050 Conversely, if the company decides to make the maximum pension-cost provisions but does not immediately make contributions to the fund or makes contributions in smaller amounts than provided, there will be an accrued pension cost on the balance sheet. The pension-cost provision for subsequent years should include an amount equivalent to interest on whatever amount is shown as an accrual on the balance sheet.

.051 Accounting for pension cost under the defined-maximum method is illustrated by Exhibit A, paragraph .059. The plan used in Exhibit A has the same past service cost, normal cost and benefits as the plan in Exhibit B, paragraph .060, to illustrate the defined-minimum method. The sameness can be seen in the initial data given under "Prior Service Cost," which is identical in the two exhibits. The pension fund, balance sheet and provision for pension cost are, of course, different. This would be expected to be so in practice. Taken together, the two exhibits illustrate how the defined maximum and minimum might differ for the same plan. Although an attempt was made to make the exhibits realistic, certain liberties were necessary to illustrate different factors in applying the two methods.

.052 Exhibit A would serve to illustrate other amortization methods by substituting the method to be used for the 10 per cent maximum.

10. Computing the Defined Minimum

.053 Under the defined-minimum method, the annual provision for pension cost is the total of normal cost, an amount equivalent to interest on any unfunded prior service cost, and, under certain conditions, a provision for vested benefits. The provision for vested benefits embraces an objective that differs from those generally found in present practice. It warrants some elaboration.

.054 First, it is essential to get a clear understanding of what is meant by "vested benefits." Vested benefits are defined in section 4063 as "benefits that are not contingent on the employee's continuing in the service of the em-

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ployer." This is consistent with the assumption of a continuing pension plan for a company with indefinite life. The amount in the pension fund, therefore, has no effect in determining the total amount of vested benefits as contemplated under section 4063. The definition also excludes any escalation in the amount of benefits through plan-termination and similar provisions. Accordingly, "vested benefits" includes benefits that, as of the date of determination, are expected to become payable (a) to employees then retired, (b) to former employees then terminated and (c) to active employees to the extent that the benefits, or any portions thereof, are not contingent on continued employee service. The value of vested benefits is computed on a present-value basis, giving effect to the usual probability assumptions concerning mortality and retirement (and sometimes also to other assumptions), but not to turnover or future changes in levels of compensation.

.055 The Board concluded that pension-cost provisions should look forward in an orderly way to the creation of a pension fund or balance-sheet accrual at least equivalent to the actuarially computed value of vested benefits. That is, the employer ultimately should maintain a fund or accrual at least sufficient to allow the payment of all benefits to all its employees who have fulfilled all the service and age requirements to be entitled to such benefits—whether or not the employees stay with the company.

.056 When provisions equivalent to the total of normal cost and the interest equivalents are made, the amount of pension cost that will be accumulated (whether funded or not) will vary widely depending on, among other things, the actuarial cost method selected and the relative ages of the employees of the company. The amount of vested benefits will vary widely, depending on the vesting terms of the plan. Some plans do not include any vesting prior to the employee's retirement. Other plans call for vesting immediately upon entry into the plan. Between these extremes there are many variations. Frequently a plan will call for vesting of a portion of the benefits when the employee has reached the age of 40 years and has ten years of service. Depending on the combination of these various factors existing in any particular case, the pension cost pro-

vided on the basis of normal cost and interest may exceed the actuarially computed value of vested benefits at any and all times. In other situations, it may fall short of the actuarially computed value of vested benefits for a period of time, or forever.

.057 In many cases, the pension fund and balance-sheet accrual may temporarily fall below the actuarially computed value of vested benefits but yet be based on an accounting method that will eventually satisfy this test. For example, when a plan is amended in a way that benefits are increased, the actuarially computed value of vested benefits may increase substantially and may exceed the pension fund and balance-sheet accrual. It may be, however—and this is not unusual—that continued cost provisions on the basis of normal cost and interest equivalents will in time again bring the pension fund and balance-sheet accrual to the point that they exceed the actuarially computed value of vested benefits at the higher level.

.058 In recognition of this, the Board initially concluded that pension-cost provisions based on normal cost and interest equivalents would be acceptable if they would result over a reasonable period of time in a pension fund and balance-sheet accrual that would exceed the actuarially computed value of vested benefits. The Board adopted 20 years as a reasonable period for reaching this objective.

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.059

EXHIBIT A
Illustration of Defined-Maximum Method

	Year 1	2	3	4	5	
Prior Service Cost (Same as Exhibit B):						
Beginning	$80,000	$ 90,000	$100,000	$110,000	$164,000	A
Increase at amendment of plan				40,000		B
"Interest" growth	3,200	3,600	4,000	6,000	6,560	4% of A + B
Normal cost	8,000	8,000	8,000	11,500	11,500	C
(Less) benefits paid	(1,200)	(1,600)	(2,000)	(3,500)	(4,000)	D
Ending	$90,000	$100,000	$110,000	$164,000	$178,060	
Pension Fund:						
Beginning	$ —0—	$ 14,800	$ 25,792	$ 36,824	$ 74,797	E
Earnings	—0—	592	1,032	1,473	2,992	4% of E
Contribution	16,000	12,000	12,000	40,000	25,000	F
(Less) benefits paid	(1,200)	(1,600)	(2,000)	(3,500)	(4,000)	D
Ending	$14,800	$ 25,792	$ 36,824	$ 74,797	$ 98,789	
Balance Sheet:						
Beginning	$ —0—	$ —0—	$ 4,000	$ 8,160	$ (8,014)	G
Provision for pension cost	16,000	16,000	16,160	23,826	23,179	H
(Less) contribution	(16,000)	(12,000)	(12,000)	(40,000)	(25,000)	F
Ending	$ —0—	$ 4,000	$ 8,160	$ (8,014)	$ (9,835)	
Pension-Cost Provision for the Year:						
Normal cost	$ 8,000	$ 8,000	$ 8,000	$ 11,500	$ 11,500	C
10% of past service cost	8,000	8,000	8,000	8,000	8,000	10% of A, Yr. 1
10% of prior service cost on amendment of plan				4,000	4,000	10% of B, Yr. 4
"Interest" on difference between accruals and funding	—0—	—0—	160	326	(321)	4% of G
Provision for the year	$16,000	$ 16,000	$ 16,160	$ 23,826	$ 23,179	H

Plan was adopted at beginning of year 1, amended to increase benefits at beginning of year 4.

Pension-cost provisions, benefit payments, and contributions are assumed to be made at the end of the year in computing "interest."

The assumed "interest" rate is 4% and there are no variations from this or any other actuarial assumptions.

.060

EXHIBIT B
Illustration of Defined-Minimum Method

	Year 1	2	3	4	5	
Prior Service Cost (Same as Exhibit A):						
Beginning	$ 80,000	$ 90,000	$100,000	$110,000	$164,000	A
Increase at amendment of plan				40,000		B
"Interest" growth	3,200	3,600	4,000	6,000	6,560	4% of A + B
Normal cost	8,000	8,000	8,000	11,500	11,500	C
(Less) benefits paid	(1,200)	(1,600)	(2,000)	(3,500)	(4,000)	D
Ending	$ 90,000	$100,000	$110,000	$164,000	$178,060	
Pension Fund:						
Beginning	$ —0—	$ 10,000	$ 20,000	$ 30,200	$ 44,628	E
Earnings	—0—	400	800	1,208	1,785	4% of E
Contribution	11,200	11,200	11,400	16,720	16,744	F
(Less) benefits paid	(1,200)	(1,600)	(2,000)	(3,500)	(4,000)	D
Ending	$ 10,000	$ 20,000	$ 30,200	$ 44,628	$ 59,157	G
Unfunded Prior Service Cost:						
Beginning	$ 80,000	$ 80,000	$ 80,000	$119,800	$119,372	H = A + B-E
"Interest" thereon	$ 3,200	$ 3,200	$ 3,200	$ 4,792	$ 4,775	I = 4% of H
Balance Sheet:						
Beginning	$ —0—	$ —0—	$ 200	$ 428	$ 469	J
Provision for pension cost	11,200	11,400	11,628	16,761	17,581	S
(Less) contribution	(11,200)	(11,200)	(11,400)	(16,720)	(16,744)	F
Ending	$ —0—	$ 200	$ 428	$ 469	$ 1,306	K
Actuarially Computed Value of Vested Benefits:						
Beginning	$ 10,000	$ 19,000	$ 28,750	$ 40,000	$ 75,000	L
Increase at amendment of plan				20,000		M
"Interest" growth	400	760	1,150	2,400	3,000	4% of L + M
Benefits vested during year	9,800	10,590	12,100	16,100	17,200	
(Less) benefits paid	(1,200)	(1,600)	(2,000)	(3,500)	(4,000)	D
Ending	$ 19,000	$ 28,750	$ 40,000	$ 75,000	$ 91,200	N
Excess of Vested Benefits Over Pension Fund and Balance Sheet Accrual:						
Beginning excess	$10,000	$ 9,000	$ 8,550	$ 9,372	$ 29,903	O = L-E-J
Ending excess before additional provision for vested benefits	9,000	8,750	9,800	30,372	32,043	P = N-G-K + R
Decrease (increase) during year	$ 1,000	$ 250	$ (1,250)	$ (21,000)	$ (2,140)	Q

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EXHIBIT B (continued)
Illustration of Defined-Minimum Method

	Year 1	2	3	4	5	
Calculation of Additional Provision for Vested Benefits:						
Test 1: 5% of beginning excess	$ 500	$ 450	$ 428	$ 469	$ 1,495	(1) = 5% of O
Test 2: Amount needed to reduce beginning excess by 5% (not less than —0—)	$ —0—	$ 200	$ 1,678	$ 21,469	$ 3,635	(2) = (1)-Q
Test 3: 40-year amortization of past service cost of $80,000	$ 4,041	$ 4,041	$ 4,041	$ 4,041	$ 4,041	
40-year amortization of prior service cost of $40,000 arising on amendment of the plan				2,021	2,021	
"Interest" on difference between accruals and funding	—0—	—0—	8	17	19	4% of J
Total	4,041	4,041	4,049	6,079	6,081	
"Interest" on unfunded prior service cost	3,200	3,200	3,200	4,792	4,775	I
Additional provision under Test 3	$ 841	$ 841	$ 849	$ 1,287	$ 1,306	(3)
Additional provision for vested benefits—Least of tests 1, 2, or 3	$ —0—	$ 200	$ 428	$ 469	$ 1,306	R
Pension-Cost Provision for Year:						
Normal cost	$ 8,000	$ 8,000	$ 8,000	$ 11,500	$ 11,500	C
"Interest" on unfunded prior service cost	3,200	3,200	3,200	4,792	4,775	I
Additional provision for vested benefits	—0—	200	428	469	1,306	R
Total provision	$11,200	$ 11,400	$ 11,628	$ 16,761	$ 17,581	S

Plan was adopted at beginning of year 1, amended to increase benefits at beginning of year 4.
Pension-cost provisions, benefit payments, and contributions are assumed to be made at the end of the year in computing "interest."
The assumed "interest" rate is 4% and there are no variations from this or any other actuarial assumptions.

.061 The exposure draft of section 4063 was written along these lines, and would have made necessary a 20-year projection of vested benefits. During the exposure period, a number of comments were received from actuaries and

others to the effect that a 20-year projection would be impracticable because of the need for additional assumptions as to the future and because of the added expense of making the projection. While this view was not held by all actuaries, the practicalities of the matter could be served without destroying the accounting objective. This was done by establishing a current test that would not require projections for future periods of time.

.062 In general, the provision for vested benefits is designed to assure that any excess of the actuarially computed value of vested benefits over the pension fund and balance-sheet accrual will decrease by at least 5 per cent each year before taking into account any net increase during the year in the excess of vested benefits. Five per cent a year was selected because in the long run it produces substantially the same result as the original 20-year projection. A simple rule calling for a 5 per cent annual reduction would be unrealistic because it could require the provision to include all additional amounts becoming vested as a result of an amendment of the plan or of an abnormally large group of employees who attain higher vesting levels in any particular year. To avoid this undesirable result, the formula had to be more complex.

.063 There are two circumstances when a company need not be concerned with vested benefits in providing for pension cost. One is where the actuarial cost method does not develop a separate amount for past service cost. The other is where the provision comprises normal cost and amortization of past service cost over 40 or fewer years. In other words, consideration of any provision for vested benefits is necessary only in connection with actuarial cost methods that develop a separate amount for past service cost and then only in connection with a method that extends the amortization of that past service cost beyond 40 years. If past service cost is included in normal cost or is being amortized, the accumulated total pension cost provisions necessarily will equal or exceed the actuarially computed value of vested benefits at or before the time the past service cost is fully amortized. In the two circumstances described in this paragraph, the only concern about vested benefits is for disclosure if their actuarially computed value

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exceeds the pension fund and balance-sheet accrual at the end of the year.

.064 Even if the circumstances just described do not exist, a provision for vested benefits may not be needed. Such a provision is not required under section 4063 unless the actuarially computed value of vested benefits exceeds the pension fund and balance-sheet accrual at both the beginning and the end of the year. In other words, if such an excess does not exist at either the beginning or the end of the year, no provision for vested benefits is required. Also, if the excess at the end of the year is at least 5 per cent less than the excess at the beginning of the year, no provision for vested benefits is required.

.065 On the other hand, if an excess exists at the beginning and at the end of the year and the ending excess is not at least 5 per cent less than that existing at the beginning of the year, a provision for vested benefits is required.

.066 The provision for vested benefits is the least of the following: (a) 5 per cent of the beginning excess, (b) the amount needed to reduce the beginning by 5 per cent or (c) an amount that would make the total pension-cost provision equal to that which would result if 40-year amortization of past service cost were used.

.067 Accounting for pension cost under the defined-minimum method is illustrated by Exhibit B. As indicated earlier, the basic plan data under "Prior Service Cost" is identical with that in Exhibit A illustrating the defined-maximum method. It might be helpful to point out that the contributions shown in Exhibit B represent normal cost and the interest equivalents for each year plus any additional provision for vested benefits accrued at the end of the preceding year. In practice it is likely that the additional provision for vested benefits would be contributed, if at all, at the same time as the normal cost and interest equivalents for the year. Exhibit B was prepared as it is, however, so that the interest equivalent on the balance-sheet accrual could be illustrated.

.068 As can be seen from Exhibit B, the value of the pension fund is an essential factor in the computations. Section 4063 does not specify how the fund should be valued.

The authors believe that the fund should be valued by the actuary in a manner consistent with the treatment given to investment gains and losses and unrealized appreciation and depreciation in computing the other elements of pension cost.

.069 For purposes of determining the excess of vested benefits, however, they believe that the pension fund may be valued at market even though the full amount of appreciation or depreciation has not been recognized in the pension-cost provisions. If so valued, methods should be employed to minimize the effects of short-term market fluctuations. Whatever valuation method is adopted should be followed consistently.

.070 In concluding the discussion about the defined-minimum method, another general observation might be helpful. It is doubtful that the provision for vested benefits will be material to most companies using the defined-minimum method. Where it is not material and continuing provisions of normal cost and interest equivalents are expected to meet the vested-benefits objective within 20 years, the authors believe it would be appropriate to omit the additional provision for vested benefits. Since that objective will be met without such additional provision, it seems reasonable not to vary the basic normal-cost-plus-interest pattern.

.071 Where the ultimate goal of the vested-benefits test will not be met without additional provisions for vested benefits, however, such provisions should be made even though they are not material in any given year. Here the cumulative effect of the additional provisions for the vested benefits becomes an important consideration.

.072 In view of the earlier discussions of differences between amounts accrued and amounts funded, and other matters that may result in the recognition of pension cost for accounting purposes in periods other than those in which it is recognized for tax purposes, it may be desirable, in concluding this article, to point out that section 4063 calls for appropriate consideration to be given to the allocation of income taxes among accounting periods.

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PART II

11. Actuarial Cost Methods

.073 An actuarial cost method is an interest and annuity type of cost allocation that gives effect to probabilities affecting the amount and incidence of future pension benefits. Although the various methods were developed by actuaries primarily as funding techniques, most of them are also appropriate for accounting purposes. Section 4063 deals with the acceptability of these methods for accounting purposes.

.074 Five often-used actuarial cost methods are specifically deemed acceptable for purposes of providing for pension cost in financial statements, when these methods are applied in conformity with the other conclusions of section 4063. These five acceptable methods are listed in Exhibit C, paragraph .081. Other methods may also be acceptable if they are "rational and systematic" and result in a "reasonable measure of pension cost from year to year." "Pay-as-you-go" (which is not an actuarial cost method) and "terminal funding" are rejected because they do not recognize pension cost prior to retirement of employees.

.075 Several basic conditions apply to the use of any method. The method should be applied consistently from year to year, the amount recognized for past and prior service cost should be reasonably stable from year to year, and the actuarial assumptions should be reasonable for all factors that have a significant effect on the long-range estimates of pension cost. (Section 4063 does not specify all of the actuarial assumptions that may be necessary in pension-cost calculations. In fact, only the more commonly used assumptions are mentioned. The selection of assumptions should be related to the facts and circumstances of each pension plan and employee group.)

.076 There are two major aspects of actuarial cost methods that should be kept in mind. First, some methods deal with past and prior service cost as a separate item; other methods include any such cost in normal cost. Second, some methods (accrued benefit cost methods) assign cost based on specific benefits deemed to be earned ("earned,"

that is in the limited sense that the employee service on which such benefits are based has been rendered) by each employee; other methods (projected benefit cost methods) assign cost based on an allocated part of all projected future benefits for each employee or group of employees. These distinctions are shown in Exhibit C.

.077 Other differences between the methods generally relate to the treatment of prospective changes in compensation, the recognition of gains and losses, and the allocation of the cost on an individual or group basis. Further discussion of the various characteristics of the different methods is beyond the scope of this article. Each of the methods is discussed in section 4063A.

.078 As an aside, it might be well to point out that in determining the actuarially computed value of vested benefits (paragraphs .089-.098) for purposes of the defined-minimum method or for purposes of disclosure, section 4063 contemplates that the accrued-benefit-cost-method approach will be used. This method, in its usual form, results in the determination of accumulated values based on service actually rendered and, if applicable, present compensation levels. When a projected benefit cost method (which takes into account estimated future service and future compensation) is used for accounting purposes, it may be necessary to compute separately or to approximate the actuarially computed value of vested benefits.

12. Actuarial Valuations

.079 Actuarial valuations are made as of a specific date. They may be used, however, for projections of results either forward or backward from that date. Consequently, the amount of pension cost for several periods may be estimated from a single actuarial valuation, sometimes in conjunction with the preceding valuation. Where shifts in employee age and service distributions and group size are not significant from year to year, it is possible for a single valuation to provide the foundation for pension-cost estimates for several years.

.080 An actuarial valuation will rarely be made as of the balance sheet date. Consequently, a computation of the actuarially computed value of vested benefits as of that

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date usually will not be available. Also, the value of the pension fund may be reported only as of the valuation date. Since a computation of the excess of the actuarially computed value of vested benefits over the total of the pension fund and net balance sheet accruals may be needed under section 4063 as of the end of the year (and sometimes also as of the beginning of the year), a practical problem is created when any of these amounts is not available as of that date. There are several possible solutions to this problem. The authors agree with the solutions indicated by Ernest L. Hicks in footnote 2 to Schedule 2 in his JOURNAL article. (*The Journal of Accountancy,* September, 1967, pp. 70-73.)

.081

EXHIBIT C

Acceptable Actuarial Cost Methods

	Past Service Cost	
	Separate Amount	*Included in Normal Cost*
Accrued Benefit Cost Method—Unit credit	X	
Projected Benefit Cost Methods:		
Entry age normal	X	
Individual level premium		X
Aggregate		X
Attained age normal	X	

. . . the appropriate as-of dates for the [actuarially computed value of vested benefits, pension fund, and net balance sheet accruals] will depend on the circumstances. Consistency is a primary consideration. Under one approach, the [actuarially computed value of vested benefits] would be as of the valuation date, and the amounts [of the pension fund and net balance sheet accruals] would be as of the end of the employer's fiscal year. If the amount of the pension fund is regularly reported only as of the valuation date, it should be satisfactory for the [actuarially computed value of vested benefits and pension fund] to be as of that date; the [net balance sheet accruals] might then include the amount funded or accrued for the fiscal year, reduced by any portion funded before the valuation date. Under still another approach, all three amounts would be as of the valuation date. Only in very rare circumstances (such as when a material, extraordinary change in the level of vesting is known to have

taken place after the valuation date) would a valuation made within the employer's fiscal year be updated.

.082 The same basic actuarial cost method may be used for both funding and cost-provision purposes even when the funding and cost provisions differ. A single actuarial valuation could serve both purposes by applying auxiliary adjustments when necessary to comply with section 4063.

13. Actuarial Gains and Losses

.083 Actuarial gains and losses arise from changes in the assumptions concerning future events used in pension-cost estimates and from differences between the estimates based on the assumptions and the actual results. Important among such assumptions are those relating to:

1. The fund earnings (interest), including both realized and unrealized investment gains and losses
2. The turnover of the work force
3. The mortality of active and retired employees
4. Compensation levels, retirement ages and other factors concerning employees.

.084 As indicated in the previous article, the treatment to be accorded actuarial gains and losses under section 4063 is likely to cause one of the most significant changes from past practice. The elimination of significant year-to-year pension-cost fluctuations resulting from actuarial gains and losses is a major objective of section 4063.

.085 Actuarial gains and losses should be dealt with "in a manner that reflects the long-range nature of pension cost." Annual determinations of pension cost are necessarily estimates. Actuarial gains and losses are, at best, an indication of the short-term accuracy of the estimates and may themselves be estimates. There is no assurance that changes in assumptions or trends based on current experience will be valid for very long. Under section 4063, therefore, actuarial gains and losses are treated as if they were an integral part of the overall assumptions concerning the future.

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.086 Consistent with the view that pension costs are long-range costs, section 4063 holds that actuarial gains and losses should be spread in a consistent manner over a reasonable period of years or determined on some average basis, either through the routine application of the actuarial method or by separate adjustments.

.087 The spreading or averaging of actuarial gains and losses is accomplished by the normal application of some actuarial cost methods and, as a consequence, likely would be automatically recognized in accordance with section 4063. This is the result when the application of a method measures normal cost by allocating to the current and future years the difference between (1) the present value of all benefits expected to become payable to current and former employees and (2) the value of the assets of the plan. Since these two values would normally comprehend any actuarial gains or losses, the actuarial gains and losses are thereby effectively spread. The pattern of spreading is complex, recognizing such factors as remaining service lives, compensation, and the various actuarial assumptions. Any of the projected benefit cost methods may be applied in this manner, although some may be applied differently.

.088 Net cumulative *gains* may also be spread by applying them to reduce the unamortized past or prior service cost *before* computing amortization or interest equivalents. Under section 4063 it is not acceptable to recognize actuarial gains in a manner that shortens the amortization period. Therefore, if past or prior service cost is being amortized, the reduced amount of unamortized past or prior service cost should be accounted for over the remaining amortization period. Since section 4063 calls for spreading over at least ten years, it would appear that this method should not be used if the remaining amortization period is less than ten years. It should be noted that section 4063 does not say that net cumulative *losses* may be added to past or prior service cost. If past or prior service cost is being amortized, however, and the remaining amortization period is between 10 and 20 years, there should be no objection to doing so.

14. What Should Be Included in the Actuarially Computed Value of Vested Benefits

Comments by Frederick P. Sloat, a member of the American Academy of Actuaries

.089 If a retirement benefit would stay with an employee if he were to terminate service on the valuation date, it is one that is ''not contingent on his continuing in the service of the employer"; therefore, it is a ''vested benefit'' and its entire value should be included in the actuarially computed value of vested benefits. If the benefit would be forfeited upon such termination of service, none of its value is included.

.090 As an illustration of some of the situations that are frequently encountered, assume that the actuarial assumptions are such that—for 100 employees in a given group who have already met the age and service requirements for vesting and, thus, have vested benefits—the following is expected to happen:

Number who will stay in service and retire at normal retirement	50
Number who will stay in service and retire at early retirement	24
Number who will terminate service at the current or a future date and later receive retirement income	12
Number who will die while in service	10
Number who will terminate service at the current or a future date, but die before receiving any retirement income	4
	100

.091 The value of the retirement benefits for the group will reflect each situation and the probability of occurrence and will be determined on the accrued benefit (unit credit) cost method. Thus, it will include the value of normal retirement benefits for the 50% who will retire at normal retirement, the value of early retirement benefits for the 24% who will retire at early retirement and the value of deferred benefits to be vested in terminating employees for the 12% who will terminate service and later receive retire-

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ment income. It will, in effect, include nothing for the 10% expected to die in service or the 4% expected to terminate service and die without receiving benefits.

.092 A plan may provide a special benefit, greater than the actuarial equivalent of the normal retirement benefit, for an employee who terminates service after having met the service required by the plan for such special benefit. In the actuarial assumptions above, say that 30 of the 74 who will reach normal or early retirement will, at some earlier date, be eligible to receive this special benefit if they terminate service, that 9 of them now have the necessary service and that only 3 out of the 9 will be expected to so terminate. In such event, the value of the special benefit will be included only for this 3 per cent.

.093 If partial vesting were to apply in event of current termination, say 60 per cent of the total benefit, only that per cent of the total array of values is included, the other 40 per cent being omitted in the same way as for employees who would not be subject to current vesting.

.094 If vesting can be forfeited by the employee's election of a refund of his own contribution, the probability of such election should be taken into account.

.095 Even though a plan provides retirement benefits on a final average salary formula, the benefit for an employee terminating service would be based on current earnings. This is like partial vesting and only the value of benefits based on current earnings would be included.

.096 For plans that do not provide specific amounts of benefits for each year of service, the benefit that would apply in event of current termination of service would be included and valued on the accrued benefit cost method.

.097 A plan may include death, disability or other benefits in addition to retirement benefits; if such a benefit would no longer apply if the employee were to terminate service, its value would not be included with the value of vested benefits. If it would apply after vesting, however, the full value of such benefits would be included for those employees currently eligible for vesting.

.098 Where the accrued benefit cost method is already being used, such as under regular group annuity funding, the value of vested benefits will usually be the value of all benefits (or the fractional portions of the benefits, in the case of partial vesting) for service to date for employees who have met the vesting requirements. Where any other actuarial cost method is being used, a corresponding accrued benefit cost method value is needed for all vested benefits.

15. Separate Adjustments for Actuarial Gains and Losses

.099 If actuarial gains and losses are spread or averaged as a separate component of the annual pension-cost provision, they are considered to be adjustments of the normal cost computed under the actuarial method in use. Spreading may be by simple straight-line allocation of each year's net gain or loss over a period of 10 to 20 years, or more complex methods may be used. A historical moving average may be used, or future expectations may be considered in conjunction with past and current experience in developing an average. The objective of avoiding significant year-to-year fluctuations should be a central consideration in selecting or evaluating any method of spreading or averaging.

.100 Exhibit D, paragraph .102, illustrates the application of a ten-year straight-line spreading technique and a five-year moving-average technique to given data. In practice it may not be necessary to record the adjustments annually. For example, if it were concluded that a difference of about $5,000 between the actual and the spread or averaged gains and losses would not be material, deferrals would be needed in the Exhibit D illustrations only in years seven and nine, and the amounts deferred could be absorbed in a few years.

.101 A combination of techniques may be appropriate. For example, the spreading approach might be applied to items not expected to recur frequently, such as a change in the interest assumption, while averaging might be applied to such recurring items as mortality and turnover adjustments. Consistency of application from year to year is important.

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EXHIBIT D

ACCOUNTING FOR THE COST OF PENSION PLANS

Application of Spreading and Averaging Techniques to Actuarial Gains and Losses

Spreading Technique—10-Year Straight-line Basis:

	Gain (Loss)		
Year	*Actual*	*Applied to Reduce Provision*	*Deferred to Future Years*
1	$ 5,000	$ 500	$ 4,500
2	2,000	700	5,800
3	6,000	1,300	10,500
4	(1,000)	1,200	8,300
5	7,000	1,900	13,400
6	3,000	2,200	14,200
7	(8,000)	1,400	4,800
8	1,000	1,500	4,300
9	10,000	2,500	11,800
10	1,000	2,600	10,200

Averaging Technique—5-Year Moving-Average:

	Gain (Loss)			
Year	*Actual*	*5-Year Total*	*Applied to Reduce Provision*	*Deferred to Future Years*
–4	$ 1,000	See Note		
–3	4,000			
–2	(2,000)			
–1	3,000			
1	5,000	$11,000	$2,200	$ 2,800
2	2,000	12,000	2,400	2,400
3	6,000	14,000	2,800	5,600
4	(1,000)	15,000	3,000	1,600
5	7,000	19,000	3,800	4,800
6	3,000	17,000	3,400	4,400
7	(8,000)	7,000	1,400	(5,000)
8	1,000	2,000	400	(4,400)
9	10,000	13,000	2,600	3,000
10	1,000	7,000	1,400	2,600

Note: Before year 1, the gains and losses were recognized in the year of determination; they are used here, however, to develop a starting point in the averaging computation.

16. Unrealized Appreciation and Depreciation

.103 The effect of unrealized gains and losses in the pension fund frequently has been omitted from estimates of annual pension cost. In some cases, turnover of fund assets has caused the spread between cost and market value to be reasonably narrow, with little unrealized appreciation

of depreciation. In other cases, however, the amounts have been significant.

.104 Under section 4063, unrealized appreciation or depreciation of pension-fund assets (other than debt securities expected to be held to maturity and redeemed at face value) is considered to be an element affecting fund earnings and, like other actuarial gains and losses, should be recognized in estimating pension cost. The objective to be met is a "rational and systematic basis that avoids giving undue weight to short-term market fluctuations." Unrealized appreciation or depreciation may be recognized by the spreading or averaging techniques described for other actuarial gains and losses or by other appropriate techniques. For example, unrealized appreciation and depreciation may be dealt with indirectly by adjusting the assumed rate of interest. Or, the value placed on fund assets for actuarial valuation purposes may be regularly adjusted to reflect an assumed long-term growth rate.

.105 Whether unrealized appreciation and depreciation are included with other actuarial gains or losses, or dealt with as a separate item, the method of determining the amount to be recognized is an important consideration. When unrealized appreciation or depreciation is spread or averaged in an appropriate manner, the total market value of the pension-fund assets may be used. In such circumstances, however, it would be desirable to have a continuing buffer guarding against a decline in market value of such magnitude as to cause the cumulative pension-cost reductions for appreciation to exceed the gain reasonably expected to be realized in the long run.

.106 When the amount of appreciation to be recognized annually as a reduction of pension cost is based on an assumed long-term growth rate, a buffer can be provided by limiting the total of cost and recognized appreciation to a specified portion of the fund's market value.

.107 Because current fluctuations in market value may be abrupt and frequent, section 4063 implies that appreciation need not be recognized if the carrying value of the fund is 75% or more of its market value; however, the 75% referred to in section 4063 is not intended to be a fixed rule.

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.108 Here, again, consistency from year to year is important.

17. Other Gain and Loss Considerations

.109 Under section 4063 certain actuarial gains and losses should be recognized in the year they occur. A characteristic of these gains and losses is that they "arise from a single occurrence not directly related to the operation of the pension plan and not in the ordinary course of the employer's business." The examples of these gains and losses given in section 4063 are those resulting from plant closings and business purchase acquisitions. A plant closing might give rise to an immediately recognizable gain to the extent of previous accruals made unnecessary by the elimination from the plan of people formerly employed at the closed plant.

.110 Employees coming into a plan by reason of an acquisition may make necessary immediate recognition of the additional cost. When purchase accounting is followed for the acquisition, any additional pension-cost accrual needed should be treated as an adjustment of the purchase price. On the other hand, when pooling-of-interests accounting is followed for an acquisition, the companies are assumed to be continuing their prior existence; therefore, any additional pension cost related to prior years' services should be treated like an increment of prior service cost arising on the amendment of a plan.

.111 Gains and losses that are immediately recognizable, it should be noted, do not arise from transactions relating to assets of the pension fund. As mentioned previously, these gains and losses are considered to be inherent in the long-range estimates of pension cost.

.112 In variable annuity and similar plans, the pension benefit formula gives effect to changes in the market value of a specified portfolio of equity investments in the fund. Consequently, the pension benefits themselves change with changes in such market values. Section 4063 recognized this type of plan by stating that pension-fund investment gains and losses should not have an effect in computing pension cost if they will be applied in determining pension benefits.

18. Changes in Accounting Method

.113 The section discussion of changes in accounting method refers only to changes from one acceptable method to another. The Board concluded that any adjustments arising from such a change should be recognized in the current and future years and should not be given retroactive effect.[4] A change in accounting method includes any change in the actuarial cost method, in the method or period for dealing with past and prior service cost, or in the method or period for dealing with actuarial gains and losses or unrealized appreciation and depreciation. A change in assumptions is considered to reflect a new circumstance and hence is not a change in method; however, the accounting for changes in circumstance should, like changes in method, be given effect in the current and future years (except, of course, actuarial gains and losses resulting from changes in circumstances of the type previously discussed as being properly recognized in the year they occur). Both method and circumstance changes are subject to the disclosure recommendations of section 4063.

.114 The transitional procedure for change from a method previously considered acceptable under Accounting Research Bulletin No. 47 but no longer acceptable under section 4063 conforms with the general procedure set forth in section 4063 for a change from one acceptable method to another. The consequences of any such change are therefore also related by section 4063 to current and future cost estimates and should not be applied retroactively.

.115 Because of the complexities of determining initial past and prior service cost for employers who previously followed methods, such as pay-as-you-go and terminal funding, that do not comply with section 4063 and because of the need to deal with any inadequacies of cost previously recognized under these or other methods, the transitional procedure includes a "fresh start" approach. Any prior service cost not covered by the pension fund or balance sheet accruals at the date section 4063 is effective (or such earlier date as it is first applied) may be treated as though created by a plan amendment on that date. This approach

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[4] It should be noted that this conclusion of the Board appears to be controlling for purposes of applying section 1051, *Accounting Changes.* [As amended effective for fiscal periods beginning after July 31, 1971, by APB Opinion No. 20.]

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may be used by any company, including those who can identify the various amounts of initial past and prior service cost. The 40-year amortization in the defined-minimum method may also be considered to begin at the effective date of section 4063.

.116 Any unamortized prior service cost as of the effective date of section 4063 should be computed under the actuarial cost method to be used for accounting purposes in the future.

19. Treatment of Overfunding

.117 Any overfunding existing at the effective date of section 4063 is to be treated as an actuarial gain in the same manner as any overfunding arising later. There is a distinction between (a) overfunding and (b) funding in excess of the amounts that would have been required under a method complying with section 4063. Overfunding refers only to a fund (together with unfunded accruals, less prepayments and deferred charges) that is in excess of all prior service cost assigned under the actuarial cost method to be used in the future. If a condition of overfunding exists, the amount of such overfunding is to be considered as an actuarial gain and spread to the future. As to (b), section 4063 rejects the reversal of pension cost recognized in prior years, even though recognized in amounts greater than necessary under section 4063.

20. Balance Sheet Presentation

.118 The amount to be included in the balance sheet as an accrued liability or a prepaid expense is usually the difference between the cost provisions and the amounts paid. Unamortized prior service cost should appear in the balance sheet only if it is a legal liability.

.119 A simultaneous asset and liability position should appear in the balance sheet whenever pension-plan arrangements impose a specific legal obligation that exceeds the total of the amounts paid or accrued. For example, if a company is liable for vested benefits, without limitation to amounts funded, accounting recognition of the unfunded, unaccrued portion of this obligation as a liability on the balance sheet is necessary; to the extent not appropriately

included in cost provisions, the cost of such benefits should appear as a deferred charge to operations of future periods.

.120 A practical way to account for such situations is to determine, at the end of each year, the amount of the legal liability not yet covered by the pension fund and balance sheet accruals. A liability and deferred charge equal to this amount would then be recorded (or the corresponding amounts as of the end of the preceding year adjusted for the net change) and classified with any other pension-cost accruals and deferred charges appearing in the balance sheet.

21. Disclosure

.121 The Board concluded that the effect of the typical pension plan is of such magnitude as to be a material consideration in evaluating financial position and results of operations and should therefore be disclosed. There may be cases, however, where the effect of the pension plan is not such as to require disclosure—for example, plans covering only a relatively small portion of the employees.

.122 Disclosure of the amount of unamortized past or prior service cost, as is often found in present practice, is not necessary under section 4063.[5] There are several reasons for the Board's conclusion. As discussed earlier, past and prior service cost is not derived in all actuarial methods. Also, some methods assign a greater past or prior service cost than would be assigned under the unit credit method for benefits based on age, compensation, salary and other conditions existing at the end of the year. As a result, the amount of past or prior service cost could vary considerably—or be non-existent—without any differences in either facts or assumptions, depending entirely on the actuarial cost method used. For these reasons, disclosure of unamortized past or prior service cost may be misleading to some and may not be useful for meaningful analysis by others.

.123 In lieu of disclosure of unamortized past or prior service cost, the Board recommended the disclosure of the

[5] However, at the time of the authors' last contact with the staff of the Securities and Exchange Commission, the Commission had not changed its requirements for the disclosure of unfunded or otherwise unprovided for past or prior service cost.

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excess of the actuarially computed value of vested benefits over the total of the pension fund and any balance sheet accruals, less any pension prepayments or deferred charges. The disclosure of such excess of vested benefits is meaningful because it should be comparable among companies, except for real distinctions between plan arrangements and employee groups, and because it relates directly to the minimum objective section 4063 sets forth for all plans. This disclosure may be necessary even though the defined-minimum method is not being followed; in fact, it could conceivably be necessary when the defined-maximum method is used—for example, upon adoption or amendment of a plan, a large portion of the past and prior service cost could represent vested benefits if the plan calls for early vesting. When the company has several plans, the disclosures may be presented in summary form.

22. Regulated Industries

.124 Section 4063 does not refer specifically to regulated industries. The absence of any such reference makes section 4063 applicable to companies in regulated industries within the framework of the principles set forth in section 6011.

23. Employees Included

.125 Section 4063 calls for inclusion in the pension-cost computations of data for all employees who may reasonably be expected to receive benefits under a pension plan. This should be done without regard to technical "eligibility." Extreme situations found in practice illustrate the need for this conclusion of the Board. In some plans, employees are not "eligible" for coverage or, for other reasons, data for them are not included in the cost calculations until they reach age 35 or 40, or until they have 10 or 15 years of service. In some plans, "eligibility" may not occur until the time of actual retirement. Pension-cost provisions that exclude data for employees who may reasonably be expected to receive benefits could be substantially smaller than the appropriate provision for the year.

.126 However, the combination of low unit cost for the younger employees and the high turnover often experienced frequently results in relatively small amounts of

pension cost for the employees excluded from the cost calculations. The cost applicable to excluded employees also tends to be offset by the higher cost provided for employees included. The net effect of exclusion is unlikely to be material in plans where the period of exclusion is only two or three years. Where the exclusion is based on a longer period of service, or is based on an age factor, the possibility of material effect is increased. When the effect is not material, employees may be omitted from the cost computations during their early years of service. Although materiality is always pertinent in applying Board Opinions, the Board covered the point explicitly in this case.

.127 In this connection, it should be remembered that materiality should be judged in relation to results of operations and financial position rather than in relation to the pension-cost provision itself.

24. Several Plans

.128 Many companies have more than one pension plan. Sometimes each plan covers a different group of employees, but often two or more plans cover a portion or all of the same employee group. Generally, each plan should be considered a separate accountable undertaking and should not be combined for purposes of determining compliance with section 4063. However, two or more plans covering substantial portions of the same employee group may be combined for that purpose if "the assets in any of the plans ultimately can be used in paying present or future benefits of another plan or plans." For example, upon a major revision of the pension structure, a new plan may be established to provide benefits for service after its effective date, with the old plan continuing to provide benefits for service previously rendered. In this situation, if any assets ultimately remaining in the old plan could be used to provide benefits under the new plan, the two could be treated as one in applying section 4063.

.129 A different accounting method may be used for each plan so long as each method conforms with section 4063.

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25. Multiemployer Plans

.130 Often multiemployer plans combine a cents-per-hour or similar defined contribution with stated benefits. The movement of employees among employers and the differing employee age and service distributions that exist among employers make it difficult, if not impossible, to correlate the defined contribution with the cost of the stated benefits related to employees' services for any individual employer. Any future adjustment of the defined contributions would be negotiated with all employers—not separately with an individual employer based only on his experience. Hence, the defined contribution ordinarily would be the best available measure of pension cost.

26. Insured Plans

.131 Insured plans generally use one of three contract forms: (1) individual policies (cost usually determined under the individual level premium method), (2) group deferred annuity contracts (cost usually determined under the unit credit method, but generally without a turnover factor) and (3) group deposit administration contracts (similar to a trust-fund arrangement—cost may be determined by any of several actuarial cost methods). The following discussion is directed to those insured plans that use only individual policies or group deferred annuity contracts as the basis for determining pension cost and for funding the plan. Employers having such plans for small employee groups are unlikely to have ready access to actuarial advice. Group deposit administration contracts are not discussed because they should be accounted for in the same manner as noninsured plans.

.132 Most of the factors of pension-cost estimation are present in plans using individual policies and group deferred annuity contracts. Some of the factors may not be apparent because they are included in the determination of the premium structure or are dealt with subsequently as "dividends" or "termination credits."

.133 Individual policies usually include past or prior service cost in normal cost whereas group deferred annuity contracts usually deal with it as a separate factor which may be paid in varying amounts at the employer's discre-

tion. In the latter case, separate adjustments may be needed to comply with section 4063.

.134 Because policy dividends generally arise from "averaged" gains of the insurance company, these dividends may be applied to reduce the provision for pension cost in the year received or credited if they do not vary significantly from year to year. If they do, a further averaging or spreading should be applied for accounting purposes.

.135 Problems in accounting for many insured plans arise in respect to termination credits and the period before coverage. Termination credits arise when, as is typical, a turnover assumption is not used. In these cases, some of the cash values built up or the premiums paid for employees who leave before their benefits have vested will be returned in the future as termination credits. The period before coverage is often set to exclude employees during the high turnover period that immediately follows employment; if so, future termination credits will tend to be minimized. When termination credits occur, they should be spread or averaged if necessary to avoid significant year-to-year fluctuations in pension-cost provisions.

.136 The most difficult problem in accounting for the cost of insured plans arises in cases where the financial statements would be materially affected by the omission of pension cost applicable to employees during the early years of their employment. In these cases, it will be necessary to estimate an additional pension-cost provision for the omitted employees. A reasonable estimate for accounting purposes often may be made without an actuarial valuation and without using an actuarial cost method.

.137 Before setting out to estimate what the additional pension-cost provision would be for omitted employees, it would usually be desirable to take a look at the broad picture of the plan, including the employee group and the premiums paid, to see whether the *entire* pension cost is material to the company's operations and financial position. There are cases where the provision for pension cost could be doubled or tripled without its having any material effect on the financial statements.

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.138 Although the authors are unable to cite any statistics, their discussions with members of the actuarial and accounting professions, as well as their own experience, have led them to believe that the omission of pension cost for employees during the early years of employment is not likely to have a material effect on the financial statements in many cases, particularly for smaller companies.

.139 A simple test of materiality could be made by estimating the additional pension-cost provision for omitted employees to be that proportion of the premiums due for the year which the number (or compensation) of omitted employees bears to the corresponding amount for included employees. The resulting estimated amount (which usually would be larger than a refined estimate) could be compared with income before taxes and other pertinent factors to determine materiality. A variation of this approach could be to base this estimate on only the proportion of omitted employees expected to remain with the company until they become insured.

.140 If preliminary tests indicate that the effect of omitting employees is material, or leave the matter in doubt, more refined techniques should be applied. Should this be necessary, the following techniques are possible ways to deal with the problem.

.141 For each employee not yet covered, the estimated premiums to be paid after coverage could be totaled and then accrued by allocation over his remaining service life. The estimated premiums might be obtained from the insurance agent or based on the premiums being paid for the youngest covered employee. Premiums paid after coverage could be charged against the accrual. If the employee subsequently terminates, any amount accrued in excess of premiums paid would be treated as an additional termination credit. In time, this form of accounting would include all covered employees in the cumulative accruals. This approach could be modified by excluding employees with less than two or three years of service if the effect, giving due regard to turnover, were not material. Interest equivalents on the accruals should be added if the effect would be material.

.142 Another approach would be to estimate what the premium would be if the employees were covered immediately after employment. This amount could be accrued during the years prior to coverage, and the amount thus accumulated could be spread to the years after coverage as a credit against premiums charged to expense. Again, interest equivalents on the accruals should be added if the effect would be material.

.143 The effect of turnover, in rather simple form, could be applied by a variation of the approaches just discussed. Assume, for example, that the computations are to exclude data for employees who do not have one full year of service, and that the plan coverage begins after five years of service. Further assume that, say, 25 per cent of employees with one year's service are expected to continue in service and become covered. In the four years before coverage, the additional cost for employees after one year of service could be based on 25 per cent of the total amount computed for the year the employees attained one full year of service. If the company had ten employees attaining one year's service in the current year and the estimated annual premium for each was $200, the additional cost would be $500 (10 × $200 × 25%). This amount would be accrued each year before coverage even though one or more of the employees terminated. In the first year of coverage and thereafter, the accruals during the preceding four years could be spread over the average remaining service lives of any of the ten employees who are still active, or the accruals could be spread as actuarial gains.

.144 The procedures suggested do not include all of the factors that could be applied in computing the pension cost applicable to employees in years before coverage. Adjustments for such actuarial factors as past service cost and interest or annuity computations could be introduced. These would increase the complexity of the computations and likely would require the services of an actuary.

.145 The additional cost provision for vested benefits, or disclosure of vested benefits, would not normally be a problem with individual policy plans. It is not likely that benefits vest before the benefits are covered by premium

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payments. This factor should be reviewed, however, for possible applicability to these plans.

27. Conclusion

.146 In conclusion, the authors would like to express a thought that may seem inconsistent with much of what has been said in this and the preceding article. Many of the rules and formula-type parts of section 4063 represent virgin territory in accounting for the cost of pension plans. Nevertheless, the accounting followed by most companies heretofore probably will conform with section 4063 in all material respects. There will be many cases, of course, where important changes will have to be made. By and large, these will be cases where the CPA has already been concerned about the pension cost but has not taken a strong stand because of what he has found to be generally accepted in practice. Section 4063 should change that.

.147 The authors hope that section 4063 will not be viewed as a rule-bookish structure that encloses the accountant in a maze of formulas limiting the exercise of judgment to interpretation, but rather that it will prove to be a working tool that will result in a substantial step forward in accounting for the cost of pension plans.

ACTUARIAL CONSIDERATIONS INVOLVED IN PENSION COST UNDER SECTION 4063

By Frederick P. Sloat

28. Questions and Answers

.148 Section 4063 requires wider understanding of the actuarial, as well as of the accounting, procedures applicable in accounting for the cost of pension plans. The accountant's efforts in determining a proper charge for annual pension expense and the actuary's role in this undertaking must, of course, be closely co-ordinated.

.149 From the actuarial view, section 4063 has stimulated many questions whose answers will more clearly delineate the actuarial responsibility in accounting for pensions. A representative selection of questions and answers follows.

.150 *Why does section 4063.07 state that "generally pension cost should be determined from a study by an actuary"?*

.151 The computations for a pension plan to take into account the financial effects of expected future occurrences are performed by actuarial techniques and require actuarial judgment. The determination of pension cost has always been considered a function of the actuary.

.152 *Has section 4063 altered any concepts held by pension technicians?*

.153 Many of us who have been involved with pensions have become so used to considering the cost of a pension plan to be whatever an employer has funded that we are surprised to find that this may not be the only way to measure its cost. The amounts paid toward funding are governed by tax considerations and also by a company's cash position. The former must bear some overall relationship to pension costs, but not necessarily on a year-by-year correlation. As to the latter, cash considerations need not relate to a year's pension costs.

.154 *What is the basis of the terminology used for pension cost matters?*

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.155 Pension plan development has evolved without a precise terminology so that the same words have come to mean different things, and many concepts have a variety of names. Regardless of the terms used, it would be very desirable if each term meant only one thing and if each concept had only one name. For any particular undertaking, a glossary may be needed. The Committee on Pension and Profit-Sharing Terminology [1] of the American Risk & Insurance Association is working to develop a more precise terminology; the American Institute of CPAs' research study, the foundation for section 4063, incorporated many of the committee's terms, including those that had already been promulgated and those that were being developed. Older terms were also used in the study, recognizing the needs of the accounting profession and others to relate the study to familiar terms. Section 4063 continued this approach, and section 4063 and its glossary are consistent with proposals of the Committee on Pension and Profit-Sharing Terminology.

.156 *Section 4063 is obviously intended to apply to any arrangement whereby a company undertakes to provide its employees with retirement benefits. Section 4063 specifies that deferred compensation contracts and profit-sharing plans must be treated as pension plans in certain situations. How do you decide whether these arrangements are equivalent to a pension plan?*

.157 Section 4063 would apply to deferred compensation contracts if such contracts, taken together, are equivalent to a pension plan. This will not apply in many instances where deferred compensation contracts exist, but auditors may need to investigate this type carefully. As to the deferred profit-sharing plan, section 4063 would apply to the extent that such an arrangement is, in substance, a pension plan or part of one. An example might be a profit-sharing plan providing minimum pension benefits. If an arrangement is deemed to be in the nature of a pension plan, the actuarial considerations relating to pensions are applicable.

.158 *How about a pension plan where the cost is incurred in a foreign country?*

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[1] Mr. Sloat is a member of this committee.

.159 Section 4063 says it would apply if the cost is included in financial statements prepared in conformity with generally accepted accounting principles in the United States. The cost of a plan for a wholly owned foreign subsidiary of a United States company, when included in a consolidated income statement, would be an example. Section 4063 refers, however, to plans that are reasonably similar to those contemplated by it. Thus, there may be bona fide conditions that make an exception necessary; for example, where plans may be affected by foreign laws quite unlike those of this country.

.160 *Section 4063 refers to various methods of determining pension cost. Why is there more than one method?*

.161 Pension benefits are spread over many years and depend on many factors. A man works for a number of years and the amount of his pension, the payment of it and the period over which it will be paid depend upon future events. If the problem were simply to provide for a fixed payment over a fixed number of years at a fixed rate of investment return, the cost would be definitely determinable, and the only problem would be its allocation to each year he worked. But, under a pension plan, none of these factors are fixed, and problems arise because of the plan's long-term nature and because educated guesses have to be made to measure the probable effect of the contingencies. If an employee works for a company from 1930 to 1970 and retires, his pension payments begin in 1970 and will continue for approximately 15 years. The purpose of an actuarial valuation is to provide for pension payments in advance of retirement. More than one logical method exists for doing this over the 1930-70 period.

.162 *If the employer doesn't get around to setting up a plan until 1960 and then amends it in 1969, why should the cost relate to the years of employment and not to 1970, for an employee who retires in that year, or over the years after 1970 when the pension is being paid out?*

.163 Pension costs are deemed to be associated to a large extent with the plan itself rather than with specific employees. The actuarial computations take into consideration employees who are already at or near retirement as part of the past or prior service costs to be amortized.

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.164 *How about the actuarial cost methods that are mentioned neither in the body of section 4063 nor in section 4063A?*

.165 There are some methods that are disguised forms of terminal funding, such as meeting pension costs only when employees have reached the earliest age at which they can retire—say, 55. If the valuation includes all employees, other than those with relatively short service and those who are at the young ages where only short-service employees would be found, the actuarial cost method would undoubtedly be an adaptation of one or more of those methods contemplated in section 4063.

.166 *How would the auditor know which method was being used?*

.167 He should ask the actuary whether the method being used is one of those described in section 4063A or is identifiable as an adaptation or variation of one of such methods.

.168 *Since the actuarial cost method is just a beginning, aren't there many variations, depending upon the combination of actuarial assumptions?*

.169 Yes. Unreasonable assumptions can destroy the appropriateness of any method. There is usually, however, quite a wide range in which the assumptions can reasonably be located. A familiar and easy illustration is the interest rate. Currently, a rate of 2 per cent or of 10 per cent, taking two extremes, would obviously be illogical. But, given a particular situation, it is difficult to say that any rate within a range of from 3½ per cent to 5 per cent would be unacceptable.

.170 *As section 4063 carefully distinguishes between funding and accounting, will the actuarial basis be the same for each? If not, the auditor will want to know why one basis is used for funding and another for accrual of cost.*

.171 Many companies have become accustomed to the flexibility available in determining the annual payments for funding and for tax purposes. In light of the year-to-year consistency requirement in accounting under section 4063, these companies may well have to use a different approach.

A company may also want to take a cautious tack and set a method and use assumptions that will produce lower accrual costs because of a feeling that it will have to stick with whatever it starts with when bad years occur. It is important for such companies to be informed by their accountants as to what would be involved in making future changes in the actuarial bases of determining accruals.

.172 *Section 4063 refers to averaging gains and losses. How is an averaging method applied?*

.173 You would need the experience of prior years as a guide. If there have been successive gains, let's say, by the fund earning an average of one-half per cent over the assumed rate, the average amount would be anticipated next year and the cost accrual reduced accordingly.

.174 *If the gain in a particular year isn't the same as the average being used, how do you treat the difference?*

.175 Over some period, the differences will have to be taken into account, to the extent that the average and the actual gains or losses do not offset each other.

.176 *Doesn't this have the same effect as using different actuarial assumptions?*

.177 Yes, but with averaging they are not projected into the future, and the expected averaging is readily modified from year to year as experience unfolds. Incidentally, averaging can be the most useful where an employer has been following the immediate recognition basis and can no longer do this under section 4063. If the employer starts to spread his gains over the approved 10- to 20-year period, only a small part of one year's gains can be used the first year. The next year there will be another segment of the first-year gains plus the first segment of the second-year gains—resulting in a pyramiding effect. Averaging will obviate this effect or at least diminish it.

.178 *Section 4063.36 provides that if employees are omitted from the calculations because of age or length of service, or for other reasons, they should be included in the pension cost, unless the effect of omitting them is not material. Can the actuary satisfactorily estimate the effect of this situation without making an actual calculation?*

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.179 Generally, the actuarial assumptions include the expected rates of service termination. If done precisely, the rates would vary with length of service as well as with age, with very high rates in the first year or two of employment. If employees with only one or two years of service are included, use of realistic termination rates would very likely show their cost to be negligible.

.180 *What about plans that have an age eligibility clause, such as 25 or 30?*

.181 Here, the difference might be more significant, just as it could be with a relatively long service requirement. In some instances, the actuary might feel that he has sufficient knowledge of the trends to estimate the probable maximum effect of omitting the employees. Often, however, he would need the valuation data for omitted employees to gauge the effect, particularly with a high age limit, such as 30 or over.

.182 *What basis should be used for valuing the pension fund to determine the amount of excess vested benefits over the fund?*

.183 Since this was left unspecified in section 4063, it is in order to use current market values or some other basis giving a proper current measure of the assets on hand. The effect of following the chosen method in subsequent years should be given consideration.

.184 *The disclosure provision (section 4063.46) requires a company to show the excess of the value of vested benefits over amounts funded or accrued. Why does section 4063.17 take vesting into account only when calculating accruals under the minimum method?*

.185 If past service cost is being amortized, the value of all vested benefits will be recognized at some point along the amortization schedule. But if it is not being amortized, the actuarial value of vested benefits might never be fully recognized or, if the amortization period is too long, recognition could be prolonged. Since vesting recognition can be accomplished by amortizing past or prior service cost, it was a logical step to limit the vesting increment to that which would be available in the event of amortization over the longest period that would not be considered as unduly

prolonging the recognition of vested benefits, set by section 4063 as 40 years. This has the effect of saying that, if past service is being amortized over a period of no longer than 40 years, the minimum test will automatically be met.

.186 *A company is not using minimum accrual and believes that available assets exceed the value of vested benefits so that disclosure of any excess is not needed. Can the actuary estimate whether there is any excess of value of vested benefits over assets without making some detailed calculations?*

.187 In many cases he can. It is not possible to set up rules or guides, but an actuary will often be able to do so in particular situations. It is much like a doctor making a medical diagnosis. He notes various symptoms and has acquired a certain intuition from years of observation and a well-developed sixth sense. Where the actuary is able to state that, in his professional judgment, the assets equal or exceed the value of vested benefits, it can be accepted. The probable error in such a test should be well within the range of materiality.

.188 *Does the actuarial value of vested benefits call for any amounts that are not already incorporated in the actuarial valuation of a plan?*

.189 No. Such amounts, however, would not usually be identified separately and therefore will need to be isolated for purposes of section 4063. It is this difficult separation that causes the problems in reprograming valuation computations.

.190 *A plan may include death, disability or other benefits in addition to retirement benefits. Are these included in the value of vested benefits?*

.191 If such a benefit no longer applied if the employee were to terminate service, its value need not be included with the value of vested benefits. If the benefit continued to apply after termination of service, it would be included. Note that the value of vested benefits does not just mean the value of the benefits for those employees who will terminate service and take their vested benefits with them. Rather, it is the full value of providing such of the benefits, regardless of when they will become payable (but with actuarial account taken of the probability of pay-

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ment in various situations), which benefits could become payable even if termination of the employee's service occurred on the valuation date. [ED. NOTE: This is described in more detail by Mr. Sloat in paragraphs .089-.098.

.192 *For minimum accrual of vested benefits, it is necessary to know their value at the beginning and at the end of the year. What if the company doesn't have this figure at the beginning of the year, as may be the case in this first year of applying section 4063?*

.193 The figure would normally not be available at the first of the year and it would be costly to obtain during the first year of section 4063's application. There seem to be several possible alternatives. One is to add 5 per cent of the year-end excess value of the vested benefits; this would always be equal to or *greater* than the precise amount required. Another alternative is to use a 40-year amortization amount; this can never be *less* than the amount required. Whether use of the correctly calculated amount in the next year requires any footnote reference indicating a change in accounting method is the auditor's responsibility. In most cases, the footnote could probably be omitted because the effect of the change is immaterial. But, again, that is the auditor's final determination in each case.

.194 *Take the case of a company with a small number of employees and whose pension plan utilizes individual life policies. Will this employer have to hire an actuary to comply with section 4063?*

.195 No. Section 4063.41 is intended to recognize this situation. The amount of the premiums less dividends under the policies is a satisfactory basis of pension cost. Gains arise in the form of dividends on the policies, and these are usually determined by insurance companies to maintain a reasonable level trend year by year. Since the dividends are based on the experience of large blocks of policies, they are not affected by fluctuations that tend to occur in a small group. Thus, section 4063.41 says: Premiums less dividends comply with the purposes of section 4063.

.196 *What happens when employees terminate their service and the surrender values of their policies are returned to the company?*

.197 That is a different matter. Surrender values fluctuate with the experience under the plan and can be substantial in some years, sometimes enough to pay all the premiums for a year or more. This is the kind of situation that requires spreading. A 10- to 20-year range is indicated by section 4063.

.198 *What is the situation with respect to employees who are not yet eligible for the plan, say, where eligibility is something like two years of service and age 30?*

.199 Here, again, it's a question of doing without an actuary. The company or the auditor can probably make a pretty fair estimate of what the maximum cost could be for those employees by taking the premium for the youngest employee at age 30 and using it for the ineligible employees. If this calculation produces a total amount that is not considered material, that is an adequate test because it's bound to be on the high side. If it is material, a closer estimate is needed; here the insurance broker selling the policies might be able to help.

.200 *What about a group annuity contract a small client might have?*

.201 The dividends might fluctuate more, but section 4063 notes that, even here, the insurance company procedure usually furnishes acceptable results.

.202 *Where a company has a separate fund used to build up sums to provide additional retirement income other than that available from the group annuity contract or the individual policies, how is it handled?*

.203 The special provisions of section 4063.41 apply only where individual policies or group annuity contracts are used exclusively. When you have a plan with a separate fund, then you are in the same position as with a trust or deposit administration plan. The individual policy or the group annuity contract is just part of the total operation of the plan. This plan would probably need an actuary —but may already have some actuarial help, perhaps from the insurance company to determine the amounts for the separate fund.

→ *The next page is 13,201.* ←

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AC Section U4064

Deferred Compensation Contracts: Accounting Interpretations

1. Accounting for Key-Man Life Insurance

.001 *Question*—Is the "ratable charge" method of accounting for the cost of nonterm life insurance policies on corporate officers an acceptable accounting method?

.002 *Answer*—No, the ratable charge method is not acceptable for use by a corporation to account for the cost of officers' life insurance policies. Under this method, the net cost of the policy (total premiums to be paid minus total cash surrender value for a paid-up policy) is amortized over the life of the policy by the straight-line method, producing a "level" annual charge. The method assumes that a critical unknown—the length of time an officer will remain in the corporation's employment—can be predicted with much greater certainty than is usually justifiable. If the policy should be discontinued prior to the payment of all scheduled premiums (for example, because of termination of the officer's employment or a change in management's policies), the ratable charge method would result in a "writeoff" of a large unamortized deferred charge.

.003 The generally accepted method of accounting for nonterm insurance on the life of a corporate officer is to charge the increase in the cash surrender value of the policy to an asset account and to charge the remaining balance of the annual premium to expense. Advocates of the ratable charge method cite the large charges to expense under the generally accepted method in the early years of a policy as being too conservative and inconsistent with the "matching" and "going concern" concepts in accounting.

.004 Admittedly the generally accepted method is conservative, but it reflects the economic realities of the transaction. And "matching" should not be confused with "leveling." Finally, the going concern concept recognizes that businesses continue in existence, but the fact that a business continues is not an argument for deferring costs unless a future period will in fact be benefited.

[Issue Date: November, 1970.]

→ *The next page is 13,301.* ←

AC Section U4091

Accounting for Income Taxes: Accounting Interpretations of Section 4091

1. Accounting for Income Tax Surcharge Rate Changes

[.001—.005] (Deleted)

INTRODUCTION

2. Historical Development

.006 The issuance of section 4091, *Income Taxes,* represents the culmination of many years of study and consideration. Section 4091 is the most complete and authoritative statement ever issued on the subject. In many respects, it is a codification of practices followed by many companies in the past, although these practices were not necessarily expressed in official pronouncements.

.007 The principal problems in accounting for income taxes arise from transactions that affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income in a different reporting period. The practice of interperiod allocation of income taxes has evolved for more than twenty-five years, particularly since the enactment of the United States Internal Revenue Code of 1954 which permitted the use of accelerated depreciation methods for tax purposes. As would be expected when an accounting procedure develops over a long period of time, various approaches to allocation have been followed by different companies. The objective of section 4091 is to provide guidelines to cover the recognition and presentation of income taxes in financial statements.

.008 After several years of research by Professor Homer A. Black, with the assistance of the Accounting Research Division of the American Institute of Certified Public Accountants, Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes,* was published in May 1966. Concurrent with publication of the

Study, a subcommittee of the Accounting Principles Board began consideration of the subject. The subcommittee presented a point outline of the substantive issues involved for consideration by the Board before drafting section 4091. Numerous discussions were held within the Board, with extensive consideration by the subcommittee between Board meetings.

.009 In the summer of 1967, the subcommittee held informal meetings with more than twenty industry associations, user groups, and government agencies.

.010 Subsequently, a public exposure draft of section 4091 was distributed to members of the AICPA, listed companies, and others. Approximately 1,000 letters of comment were received and considered by the Board. A substantial number of the letters objected to a proposed requirement that realized investment credits be deferred and amortized over the life of the related property. As a result and in order to permit further study, particularly of transition problems, the Board deleted that section from the proposed section. Accordingly, section 4094, dealing with the *"Investment Credit"*, continues in effect.

.011 Section 4091 was issued in December 1967, effective for fiscal periods beginning after December 31, 1967. The conclusions significantly modify the views previously expressed by the predecessor Committee on Accounting Procedure and by the Board and vary in some important respects from the recommendations of Accounting Research Study No. 9.

3. Subjects Included in Section 4091

.012 Section 4091 reaffirms the general concept that "income taxes are an expense of business enterprises earning income subject to tax." By definition, income taxes include taxes based on income determined under provisions of the United States Internal Revenue Code and foreign, state and other taxes (including franchise taxes) based on income.[1]

.013 The major subjects covered by section 4091 are (1) interperiod allocation of income tax expense because of

[1] In some situations (such as for the State of California), application of section 4091 requires the current accrual of certain taxes measured by income in the years the income is earned, even though the taxes constitute a fee for the privilege of doing business in a succeeding period and are payable in that period.

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timing differences, (2) accounting for operating loss carry-backs and carryforwards, and (3) financial statement presentation of income taxes, including allocation within a period (intraperiod allocation).

.014 The Board also reaffirmed its conclusion, expressed in section 4092, that deferred taxes should not be accounted for on a discounted basis pending further study of the broader aspects of discounting as it is related to financial accounting in general.

.015 Section 4091, as in the case of all other Opinions of the Board, is not intended to apply to immaterial items.

4. Exclusions from the Section

.016 As mentioned previously, accounting for investment credits continues to be governed by section 4094. However, in applying section 4091, consideration should be given to the effect of investment credits in certain situations not covered in those sections, as discussed in this article.

.017 Section 4091 applies to all other aspects of accounting for income taxes and to all industry situations except as specifically indicated.

.018 Section 4091 does not apply to regulated industries in those circumstances where the standards described in section 6011 are met. Section 6011 states that there may be differences in the application of generally accepted accounting principles to regulated industries because of the effect of the rate-making process and that different treatments, therefore, may be necessary in order to achieve an appropriate matching of expenses and revenues.

.019 The Board deferred consideration of the special problems of allocation among components of a business enterprise pending resolution of the broader problems of recognition and allocation of all revenues and expenses in these situations. (As amended, effective after December 31, 1973, by APB Opinion No. 28, *Interim Financial Reporting*.)

.020 In section 4095, *Accounting for Income Taxes—Special Areas,* the Board has examined the characteristics of the tax consequences of transactions in four special areas

and sets forth its conclusions on appropriate accounting treatments. The four special areas are: (1) undistributed earnings of subsidiaries, (2) "general reserves" of stock savings and loan associations, (3) amounts designated as "policyholders' surplus" by stock life insurance companies, and (4) income from investments in corporate joint ventures accounted for by the equity method in accordance with section 5131, *The Equity Method of Accounting for Investments in Common Stock.* [As amended by APB Opinion No. 23, December, 1971.]

.021 One specialized industry situation having tax consequences somewhat similar to those for timing differences has been excluded pending further study. This situation has certain unique aspects which create problems in the measurement and recognition of its tax consequences. The exclusion is deposits in statutory reserve funds by United States steamship companies. Section 4091 is, however, applicable to this industry in all other respects including timing differences. [As amended by APB Opinion No. 23, December, 1971. As modified, effective for financial statements issued on or after December 1, 1975, by FASB Statement No. 9.]

INTERPERIOD TAX ALLOCATION

5. Objective

.022 Section 4091 adopted the comprehensive allocation concept which requires interperiod allocation of income taxes in the case of all material timing differences, both recurring and nonrecurring. The objective of interperiod allocation of income taxes is to match the income tax expense reported in an income statement for a specific period with the revenues and other expenses reported for that period. Stated another way, reported income tax expense should represent the tax effects or tax consequences of the revenues and expenses included in income before income taxes (which is referred to in section 4091 as "pretax accounting income").

.023 The Board rejected the partial allocation viewpoint which generally would require interperiod allocation only for nonrecurring differences. Under prior pronouncements of the Committee on Accounting Procedure, inter-

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period allocation was required for nonrecurring differences and for some but not all recurring differences.[2] Practice had been mixed with regard to types of recurring differences where allocation was not specifically required under prior pronouncements.

[2] ARB No. 43, Chapter 10, Section B, *Taxes: Income Taxes,* paragraph 1, stated that "The section does not apply where there is a presumption that particular differences between the tax return and the income statement will recur regularly over a comparatively long period of time."

6. Alternative Methods Considered by the APB

.024 Section 4091 adopted the deferred method of applying tax allocation and rejected the alternatives—the liability and the net of tax methods.[3] The three methods are discussed in detail in Accounting Research Study No. 9 and are summarized in section 4091. Each of the three methods was considered by the Accounting Principles Board in its deliberations.

.025 Generally, the same amount of net income would be reported under each of the three tax allocation methods if tax rates never changed or no new taxes were imposed. The effect on net income of changes in tax rates or the imposition of new taxes, however, will vary depending upon which of the three methods is used. Also, the net of tax method may yield different net income amounts when depreciation or amortization expense is capitalized or included in inventories and treated as a cost of future periods. Financial statement presentation varies depending upon the method used.

.026 The deferred method of allocation ". . . is a procedure whereby the tax effects of current timing differences are deferred currently and allocated to income tax expense of future periods when the timing differences reverse. The deferred method emphasizes the tax effects of timing differences on income of the period in which the differences originate. The deferred taxes are determined on the basis of the tax rates in effect at the time the timing differences originate [4] and are not adjusted for subsequent changes in tax rates or to reflect the imposition of new taxes." The tax effects of transactions which reduce taxes

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[3] Prior pronouncements permitted the use of any of the three methods—deferred, liability or net of tax. For example, see ARB No. 43, Chapter 9, Section C, *Depreciation: Emergency Facilities—Depreciation, Amortization and Income Taxes* (paragraphs 11-13); ARB No. 44 (Revised), *Declining-balance Depreciation* (paragraphs 4, 5, 7 and 10); ARB No. 51, *Consolidated Financial Statements* (paragraph 17); APB Opinion No. 5, *Reporting of Leases in Financial Statements of Lessee* (paragraph 21), and APB Opinion No. 6, *Status of Accounting Research Bulletins* (paragraph 23).

[4] The Revenue and Expenditure Control Act of 1968, which became law on June 28, 1968, imposes a 10% income tax surcharge retroactive to January 1, 1968 for corporations. The surcharge should be considered for financial accounting purposes under section 4091 as a change in tax rates effective as of that date even though it may be only a temporary change. Accordingly, the tax effects of timing differences originating in a taxable period subject to the surcharge should be computed as if the law had actually been in effect on January 1, 1968. (Also see section U 4091.001.)

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currently payable (or create a refund of taxes because of a loss carryback) are treated as deferred tax credits; the tax effects of transactions which increase taxes currently payable (or reduce the amount of a refund of taxes because of a loss carryback) are treated as deferred tax charges. Such deferred credits and charges are amortized to income tax expense in future years as the original timing differences reverse and enter into the determination of pretax accounting income.

.027 Advocates of the liability method consider income tax expense for a period to represent the taxes paid or to be paid on the components of pretax accounting income. Differences between tax expense for accounting purposes and taxes currently payable, which result from timing differences, are viewed as either liabilities for taxes payable in the future, or assets for prepaid taxes. Under the liability method, taxes are computed at the rates in effect or expected to be in effect when the components of pretax accounting income are reported in an income tax return. Adjustments of the liability or prepaid accounts are made whenever tax rates change or new taxes are imposed.

.028 The advocates of the net of tax method consider that tax allocation (determined by either the deferred or liability methods) should give explicit recognition to the fact that taxability and tax deductibility are factors in the valuation of assets and liabilities and the related revenues and expenses. Under the net of tax method, deferred tax accounts are not presented separately in the balance sheet, but instead are shown as reductions of the related assets and liabilities. Also, some advocates of the net of tax method would follow a similar procedure in the income statement and show the income statement effects of tax allocation as adjustments to the related revenue and expense accounts.

.029 Under either the deferred or the liability methods, it is possible to determine from the financial statements the effects of tax allocation; this is not possible under the net of tax method without extensive additional disclosures.

.030 The deferred method is considered to be preferable to the liability method because, although deferred

tax charges and deferred tax credits are similar in some respects to receivables and payables, they do not represent receivables and payables in the usual sense. Also, the deferred method has the practical advantage that it neither requires assumptions as to future tax rates or the imposition of new taxes, nor does it require adjustments of balance sheet deferred tax accounts when tax rates change or new taxes are imposed.

.031 In substance, the deferred method, being income statement oriented, measures the tax cost or tax benefit of a timing difference on the basis of the tax rates in effect at the time the difference originates. The liability method, being balance sheet oriented, relates the cost or benefit to the amount actually payable or expected to be payable. For example, assume that a company owns one building and adopts accelerated depreciation for tax purposes and straight-line depreciation for accounting purposes. Under the deferred method, the tax effects would be equal to the reduction or increase in income taxes payable attributable to the difference between depreciation claimed for tax purposes and the amount recognized for accounting purposes. Under the liability method, the tax effects would be based on the taxes expected to be payable over the period in which the property will be held. Conceivably, such tax effects could be computed at "capital gains" rates if there was an intention to dispose of the property at a later date and it was apparent that a capital gain would result.

.032 Deferred taxes relating to an originating timing difference are computed, under the deferred method, as the difference in income taxes payable that would result from (a) including the effect of the timing difference in the calculation of income taxes payable and (b) excluding the effect of the timing difference from such calculation.

.033 The deferred method may be applied to each individual transaction or similar transactions may be grouped. When similar transactions are grouped, either (1) originating differences and reversing differences may each be considered separately, or (2) the originating and reversing differences may be combined.

.034 Differences between pretax accounting income and taxable income may be either "timing differences"

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which require interperiod tax allocation or "permanent differences" which do not require interperiod tax allocation. The distinction between timing differences and permanent differences can best be explained by considering the technical definitions included in section 4091 together with specific examples.

7. Timing Differences

.035 Timing differences are defined as—

> "Differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or 'turn around' in one or more subsequent periods. Some timing differences reduce income taxes that would otherwise be payable currently; others increase income taxes that would otherwise be payable currently."

.036 When timing differences occur, the income tax currently payable as shown on the income tax return for a period may not be the appropriate amount of income tax expense to match with the pretax accounting income for the period. In order to obtain proper matching, it is usually necessary to report as income tax expense an amount that is more or less than income taxes currently payable. In substance, section 4091 requires the recognition of the tax effects as income tax expense in the same periods as the related transactions are recognized in the determination of net income for financial accounting purposes. The cumulative effects of timing differences at any date appear in the balance sheet as deferred taxes—either deferred charges or deferred credits.

.037 Transactions which give rise to timing differences are classified into four categories—(1) revenues or gains taxed *after* accrual for accounting purposes, (2) expenses or losses deducted for tax purposes *after* accrual for accounting purposes, (3) revenues or gains taxed *before* accrual for accounting purposes, and (4) expenses or losses deducted for tax purposes *before* accrual for accounting purposes.

.038 For example, the gross profit on installment sales is customarily recognized for accounting purposes at the

time of sale. However, under certain circumstances, it is possible to defer the inclusion of gross profit in taxable income until subsequent periods when the receivables arising from the installment sales are collected. Thus, in the period of sale, an originating timing difference occurs because gross profit is included in accounting income, but not in taxable income. In subsequent periods, a reverse timing difference occurs when the installment accounts receivable are collected and gross profit is recognized in the tax returns but not in the accounts.

.039 A simplified illustration of an originating timing difference is presented below. The illustration assumes that a company has sold merchandise on the installment basis for the first time and recognizes the gross profit thereon for accounting purposes at the time of sale but elects the installment method for tax purposes.

Year 1

Pretax accounting income	$1,000,000
Gross margin on uncollected installment sales at end of year	200,000
Taxable income	$ 800,000
Taxes estimated to be payable (assuming a 48% rate less surtax exemption)	$ 377,500
Charge equivalent to reduction in income taxes arising from installment method of reporting for tax purposes (excess of 48% of $1,000,000, less $6,500, over $377,500; or 48% of $200,000)	96,000
Income tax expenses as shown in income statement	$ 473,500

.040 A deferred tax is amortized when the reverse timing difference takes place. Thus, in the case of installment sales, as the installment receivables are collected, and the gross profit is recognized for tax purposes, income tax expense is reduced by the amortization of the deferred tax credits previously recorded.

.041 Continuing the preceding illustration, the amortization of deferred taxes related to the reverse timing difference appears as follows:

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Year 2

Pretax accounting income	$1,000,000
Gross margin on prior year's sales collected during the current year	200,000
Taxable income	$1,200,000
Taxes estimated to be payable (assuming a 48% rate less surtax exemption plus 10% surcharge)	$ 626,450
Amortization of deferred taxes set up in prior year (credit)	(96,000)
Income tax expenses as shown in income statement	$ 530,450

.042 These illustrations show the effect of a timing difference arising from the use of the installment method for tax purposes and the effect of a change in the tax rate.

.043 In a typical case where installment sales occur each year, there would be both originating differences and reversing differences each year. Accordingly, the increase or decrease in the deferred tax credit balance would be the combination of the tax effects from originating differences and the tax effects of reversing differences. Thus, income tax expense appearing in the financial statements might be higher or lower than taxes currently payable.

.044 It should be noted that at least two periods are affected by each initial timing difference—the period in which the difference originates and a subsequent period (or periods) when the initial difference reverses.

.045 Another example of a relatively simple kind of recurring timing difference is a provision for product warranty expenses which originates in one period and reverses in one or more future periods. The provision is recorded for accounting purposes during the period when the warrantied products are sold. However, an income tax deduction is not allowed until the period when expenditures under the warranty are made. For the period when the timing difference originates, warranty expense for accounting purposes exceeds warranty expense for tax purposes; and, consequently, taxable income is greater than pretax accounting income and income taxes payable are greater than

income tax expense for accounting purposes. In effect, a portion of the income taxes is prepaid. During a subsequent period a reverse timing difference occurs when expenditures under the warranty are made. In the period of reversal, warranty expense for tax purposes exceeds warranty expense for accounting purposes; consequently, taxable income and income taxes are reduced.

.046 In the not uncommon situation where the warranty period runs for more than one year, the reverse timing differences occur in part during each year of the warranty period. Under these circumstances, the total of the reverse timing differences for several periods will be equal to the original timing difference occurring during the period when the warrantied products were sold. In many cases it will be impracticable to relate recurring originating timing differences to the reverse timing differences because of the number of transactions involved. This problem becomes particularly important when the tax rates applied to originating differences change from period to period. In these cases an arbitrary assumption as to reversal may be necessary. Application of either first-in, first-out, or averaging techniques would be appropriate in these situations.

.047 A more complex example of timing difference occurs when an accelerated method of depreciation is used for tax purposes, while the straight-line method is used for accounting purposes. In such cases, the depreciation accounting following the purchase of a unit of depreciable property results in originating timing differences each period for a number of periods during which tax depreciation exceeds accounting depreciation. In later periods reverse timing differences occur as accounting depreciation exceeds tax depreciation. The reversal period is, of course, known. Even for this type of timing difference, however, an arbitrary flow assumption—either first-in, first-out or averaging—may be necessary in order to relate specific reverse timing differences to specific originating timing differences. The problems of specific identification of reverse timing differences with originating timing differences become further complicated if not impossible, if a composite rate of depreciation is used for a group of assets, the individual units of which have different life cycles.

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8. Permanent Differences

.048 Permanent differences are defined as—

> "Differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or 'turn around' in other periods."

.049 Timing differences involve both an originating difference and, subsequently, a reverse difference. Differences between accounting and taxable income, however, are permanent if an originating difference is *never* followed by a reverse difference. Interperiod tax allocation should not be applied to permanent differences because the amount of income tax payable is the proper income tax expense to match with the revenues and other expenses reported for the period in which the differences occur.

.050 Permanent differences may arise under the tax law because specified revenues are exempt from taxation or specified expenses are not deductible. Examples of exempt revenues are life insurance proceeds and interest on municipal obligations. Examples of non-deductible expenses are premiums paid on officers' life insurance and fines. Amortization of goodwill recorded for accounting purposes gives rise to a permanent difference if it is not deductible for tax purposes.

.051 Permanent differences also arise if items enter into the determination of taxable income but are never recognized in determining accounting income. Examples are the excess of statutory depletion over cost depletion and the special deduction for certain dividends received which are recognized for tax purposes but not for accounting purposes.

.052 A permanent difference also results if different bases of carrying property for accounting purposes and for tax purposes produce amounts for depreciation or amortization different for tax purposes than for accounting purposes. Also, gains or losses for tax purposes upon dispositions of such property may differ from those recognized for accounting purposes. Different bases for property frequently result from write-downs of assets in a reorganization. Different bases may also occur from business combinations accounted for as purchases and treated as

tax-free exchanges or from business combinations accounted for as poolings of interests and treated as taxable exchanges. Similarly, in the case of a donation of property, accounting expense could be recorded on the basis of the net carrying amount of the property whereas the tax deduction would be for the fair value on the date of gift.

[.053] [Superseded, effective for fiscal periods beginning after December 31, 1972, by APB Opinion No. 25.] (See section 4062.)

[.054] [Superseded, effective for fiscal periods beginning after December 31, 1972, by APB Opinion No. 25.] (See section 4062.)

.055 In summary, tax benefits or tax costs related to transactions affecting income for a period should be reflected in the income statement for that period. If there are no timing differences affecting income for a period, the income statement will show only the taxes estimated to be payable for the period as income tax expense; any tax benefits or tax costs related to permanent differences occurring in the period pertain to that period.

9. Computation of Deferred Taxes

.056 Section 4091 requires that "The tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income." In computing such differentials, "taxable income" is defined as "the excess of revenues over deductions or the excess of deductions over revenues to be reported for income tax purposes for a period" except that "deductions" do not include loss carrybacks or loss carryforwards. Accordingly, in theory, a separate computation is required for each originating timing difference in order to determine what the tax would have been both with and without including the timing difference. In practice, the same result will often be obtained if the current tax rate is simply applied to the amount of the timing difference. In some cases, however, the same result will not be obtained by use of the "short-cut" approach. Differences may result from the effect of the investment credit or a foreign tax credit, the existence of an operating

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loss for the period, or the fact that an operating loss would be incurred if a timing difference is excluded.

.057 Two alternative approaches to the computation of the tax effects of timing differences are set forth in section 4091.36, which states:

> "In computing the tax effects referred to in paragraph .35 timing differences may be considered individually or similar timing differences may be grouped. The net change in deferred taxes for a period for a group of similar timing differences may be determined on the basis of either (a) a combination of amounts representing the tax effects arising from timing differences originating in the period at the current tax rates and reversals of tax effects arising from timing differences originating in prior periods at the applicable tax rates reflected in the accounts as of the beginning of the period; or (b) if the applicable deferred taxes have been provided in accordance with this section on the cumulative timing differences as of the beginning of the period, the amount representing the tax effects at the current tax rates of the net change during the period in the cumulative timing differences."

.058 Similar timing differences refer to individual timing differences which arise from the same kinds of transactions. For example, all differences between accounting depreciation and tax depreciation may be grouped together as similar differences even though they may relate to many individual assets acquired during various years. Also, differences between accounting and taxable income arising from deferral for tax purposes of gross margin on installment sales may be grouped together as similar differences even though they may represent many individual sales occurring over a number of different periods. However, depreciation timing differences should not be combined with gross margin timing differences.

.059 For convenience, the method of computation set forth in (a) in the preceding quotation is referred to as the "gross change method," because, for each group of similar timing differences, separate computations are made for the tax effects of originating differences based on current tax rates and for the tax effects of reversing differences at the applicable tax rates reflected in the accounts at the beginning of the period. The method of computation described under (b) is referred to as the "net change method," because a single computation is made at the current tax rates for the net cumulative effect of both originating and reversing differences occurring during a period relating to a particular group of similar timing differences.

.060 For each kind of "similar" differences, a company may choose to compute deferred taxes either on individual transactions or for groups of transactions and in the latter case by either the gross change or net change methods. Once chosen, the same method should be consistently employed for the specific kind of similar differences. If the method of computation is changed, a consistency exception will be required in the auditor's report where the effect is material.

.061 Under all three methods of computation (individual transaction, gross change, or net change) the tax effect is based on a differential calculation.[6] Under either

[6] The calculation should take into consideration all taxes based on income—United States, foreign, state and local. As a practical matter, where companies are subject to a number of jurisdictions which have income

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the individual transaction or the gross change methods the reversal of tax effects of timing differences originating prior to the effective date of section 4091 may be recognized only if the applicable deferred taxes had been provided for in accordance with section 4091 either in the prior periods, or retroactively as of the effective date of section 4091. The net change method may be employed only if the deferred taxes applicable to the net cumulative differences of prior periods were provided in those periods or retroactively as of the effective date of section 4091.

.062 The provisions discussed in the preceding paragraphs were included in section 4091 so that a company that was not applying interperiod tax allocation for any particular kind of timing difference prior to the effective date of section 4091 could not use the tax effects of the reversal of that difference to offset deferred taxes required to be recognized for current originating timing differences.

.063 For example, assume that certain expenditures are capitalized when incurred and amortized in subsequent periods for accounting purposes, but are deducted when incurred for tax purposes, and that no provision has been made in the past for the applicable deferred taxes. After the effective date of section 4091, deferred tax credits (equivalent to the tax benefits received) must be provided by a charge against income with respect to any expenditures which are capitalized for accounting purposes but are claimed as tax deductions in the period of expenditure. However, as these costs which were capitalized prior to the effective date of section 4091 are amortized during periods *after* the effective date, the tax effects of such reverse timing differences may not be considered as a reduction of the provision for deferred taxes required for differences originating *after* the effective date. [As modified, effective for fiscal years beginning on or after January 1, 1975, pursuant to FASB Statement No. 2.] (See section 4211.)

.064 Illustrations of the procedures followed in computing deferred taxes comparing the gross change method with the net change method are presented in Exhibits I and Ia. They are not intended as typical illustrations but

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taxes, the rates to be used in the calculation are often determined by increasing the United States income tax rate by a percent equivalent to the effect of the taxes imposed by the other jurisdictions.

rather to illustrate some of the complications that may be encountered in practice. The illustrations also demonstrate that the current provision for deferred taxes is not necessarily the amount obtained by applying the current statutory tax rate to the amounts of the timing differences.

10. Amortization of Deferred Taxes

.065 The amortization of deferred taxes upon reversal of nonrecurring timing differences usually presents no special problems. If the entire reverse timing difference occurs during one period subsequent to the period of origination, the entire deferred tax set up at the time of origination is amortized to income tax expense during the period of reversal. If the timing difference reverses over two or more periods, the deferred tax recognized at the time of origination is amortized in each of the subsequent periods of reversal in proportion to the amount of the reverse timing difference in each period relative to the total original timing difference.

.066 Sometimes when the gross change method of computing deferred taxes is employed for recurring timing differences, it may be possible to associate specific reverse timing differences with specific originating timing difference. Under such circumstances, the amortization of deferred taxes is similar to that previously described for nonrecurring timing differences. There are instances of recurring timing differences, however, in which it is not possible to associate a specific reverse difference with a specific originating difference. Often in such circumstances the total deferred tax account applicable to the particular type of, or group of similar, timing differences has been accumulated over a number of years at varying rates. It is appropriate in such circumstances to amortize a portion of the aggregate deferred tax balance at the beginning of the period by use of either the first-in, first-out flow assumption or the average rate assumption.

.067 Under the first-in, first-out assumption, the earliest additions to the deferred tax account are amortized first. Application of the first-in, first-out assumption requires a record of amounts of deferred taxes by year of addition. Under the average rate assumption, the amount of deferred tax amortized is determined by applying the

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ratio of aggregate deferred taxes to aggregate timing differences at the beginning of the period, to the amount of the reverse timing difference during the period. The practice adopted for amortization of deferred taxes, where specific identification is not possible, should be consistently followed; otherwise, if the effect is material a consistency exception will be required in the auditor's report.

.068 Amortization procedures are different when the net change method of computing deferred taxes is employed. Under the net change method no amortization of deferred taxes is recorded for periods in which the aggregate timing differences increase. In each period in which the aggregate timing differences decrease, deferred taxes are amortized. Such amortization is computed as the difference between income tax on taxable income and income tax on taxable income less the reduction in aggregate timing differences. The amortization of deferred taxes, however, cannot exceed the amounts previously provided. In a period when reversal of all timing differences of a particular type occurs, the entire related deferred tax account should be amortized regardless of the amount determined under the differential computation. For example, a company that has been using the installment method of accounting for gross margin on installment sales for tax purposes may decide to abandon the installment method by selling all installment receivables. The entire amount of deferred tax credits relative to installment sales which was carried over from the preceding period should then be amortized.

.069 EXHIBIT I

COMPUTATION OF DEFERRED TAXES UNDER ALTERNATIVE APPROACHES FOR TWO KINDS OF TIMING DIFFERENCES

Assumptions

1. All prior deferred taxes are at an average rate of 48%
2. Current period tax rate is 48% less surtax exemption of $6 and plus 10% surcharge
3. Current period investment credit is $0

	Gross Change Method	*Net Change Method*
	(thousands of dollars)	
Computation of taxable income		
Pretax accounting income	$500	$500
Timing differences from use of accelerated depreciation for tax purposes and straightline depreciation for accounting purposes:		
Originating—tax depreciation in excess of accounting depreciation	(500)	
Reversing—accounting depreciation in excess of tax depreciation	100	
Net change		(400)
Timing differences from use of installment method for tax purposes and accrual method for accounting purposes:		
Originating—gross margin on current period sales uncollected at end of period	(300)	
Reversing—gross margin on prior period sales collected during current period	400	
Net change		100
Taxable income	$200	$200
Computation of tax estimated to be currently payable		
48% rate	$ 96	$ 96
Surtax exemption	(6)	(6)
10% surcharge	9	9
	$ 99	$ 99

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	Gross Change Method	Net Change Method
	(thousands of dollars)	
Computation of deferred tax on depreciation timing difference		
Taxable income	$200	$200
Originating or net change in depreciation timing differences	500	400
Adjusted taxable income—"without" timing differences	$700	$600
Tax on adjusted taxable income	$363 (a)	$310 (a)
Tax currently payable	99	99
Differential equivalent to tax effects of timing differences to be added to deferred tax credit	$264	$211
Computation of deferred tax on deferred gross margin timing differences		
Taxable income	$200	$200
Originating or net change in gross margin timing differences	300	(100)
Adjusted taxable income—"without" timing differences	$500	$100
Tax on adjusted taxable income	$257 (a)	$ 46 (a)
Tax currently payable	99	99
Differential equivalent to tax effects of timing differences to be added to (or deducted from) deferred tax credit	$158	$(53)
Summary of changes in deferred tax credit balance		
Additions to deferred credits arising from originating differences:		
Depreciation	$264	
Deferred gross margin	158	
Arising from increase in cumulative depreciation differences		$211
Amortization of deferred credits arising from reversing differences:		
Depreciation—(48% of $100)	(48)	
Deferred gross margin—(48% of $400)	(192)	
Net amortization arising from reduction in cumulative deferred gross margin		(53)
Net Increase	$182 (b)	$158 (b)

Notes:

(a) 48% of adjusted taxable income ("without" timing difference), less surtax exemption of $6 and plus 10% surcharge.

(b) The difference between the net increase in the deferred tax credit balance of $182 under the gross change method and $158 under the net change method, or $24 (in effect 4.8% of $500, the aggregate amount of reversing timing differences) represents the effect of using (1) under the gross change method the current tax rate for originating differences and the effective prior period rates for reversing differences and (2) under the net change method the current tax rate for the cumulative net effect of both originating and reversing differences.

.070

EXHIBIT Ia

COMPUTATION OF DEFERRED TAXES UNDER ALTERNATIVE APPROACHES FOR TWO KINDS OF TIMING DIFFERENCES

Assumptions

Same as Exhibit I, except current period investment credit is $50.

	Gross Change Method	*Net Change Method*
	(thousands of dollars)	
Computation of taxable income		
Same as Exhibit I		
Computation of tax estimated to be currently payable		
48% rate	$ 96	$ 96
Surtax exemption	(6)	(6)
10% surcharge	9	9
Allowable investment credit	(50)	(50)
	$ 49	$ 49
Computation of deferred tax on depreciation timing difference		
Taxable income	200	$200
Originating or net change in depreciation timing differences	500	400
Adjusted taxable income—"without" timing differences	$700	$600
Tax on adjusted taxable income	$313 (a)	$260 (a)
Tax currently payable	49	49
Differential equivalent to tax effects of timing differences to be added to deferred tax credit	$264	$211

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	Gross Change Method	Net Change Method
	(thousands of dollars)	
Computation of deferred tax on deferred gross margin timing differences		
Taxable income	$200	$200
Originating or net change in gross margin timing differences	300	(100)
Adjusted taxable income—"without" timing differences	$500	$100
Tax on adjusted taxable income	$207 (a)	$ 10 (b)
Tax currently payable	49	49
Differential equivalent to tax effects of timing differences to be added to (or deducted from) deferred tax credit	158	$(39)
Summary of changes in deferred tax credit balance		
Additions to deferred credits arising from originating differences:		
Depreciation	$264	
Deferred gross margin	158	
Arising from increase in cumulative depreciation differences		$211
Amortization of deferred credits arising from reversing differences:		
Depreciation—(48% of $100)	(48)	
Deferred gross margin—(48% of $400)	(192)	
Net amortization arising from reduction in cumulative deferred gross margin		(39)
Net increase	$182	$172 (c)

Notes:

(a) 48% of adjusted taxable income ("without" timing difference), less surtax exemption of $6, plus 10% surcharge and less allowable investment credit of $50.

(b) 48% of adjusted taxable income ("without" timing difference), less surtax exemption of $6, plus 10% surcharge and less maximum investment credit of $36 ($25 plus 50% of the difference between $46 and $25).

(c) The difference between the net increase in the deferred tax credit balance under the net change method of $158 in Exhibit I and $172 in Exhibit Ia, or $14, arises from the influence of the investment credit. It should be noted that under the gross change method the full investment credit of $50 is utilized in all of the computations "with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income." Under the net change method the utilization of the investment credit is limited to $36 in the computation of the tax effects of deferred gross margin timing differences whereas $50 is utilized in the computation of depreciation timing differences. (See section on "Investment Credit Carrybacks and Carryforwards.")

OPERATING LOSSES

.071 Tax benefits are usually available when operating losses are incurred. Such benefits are obtained either (a) from refunds of taxes paid in prior profitable years—by carryback of losses, or (b) as reductions of taxes otherwise payable in future profitable years—by carryforward of losses.[7] The basic accounting concept of matching revenues and expenses suggests that it is appropriate to record the tax benefit from an operating loss in the income statement of the loss year.

11. Loss Carrybacks

.072 Refunds of taxes paid in prior years arising from carrybacks of operating losses should be recognized during the loss year. This is required to achieve proper matching inasmuch as current realization of the refund is assured. The refunds should be reflected in the balance sheet as current assets.

.073 An illustration of the presentation of an operating loss carryback, assuming that pretax accounting income and taxable income are identical, follows.

Loss before refundable income taxes	$1,000,000
Refund of prior years' income taxes arising from carryback of operating loss	485,000
Net loss	$ 515,000

(Note: The refund should be computed at the amount actually refundable regardless of current tax rates.)

.074 A loss carryback may occur at a time when net deferred tax credits exist. Under these circumstances "appropriate adjustments of existing net deferred tax credits may also be necessary in the loss period." The tax effects of the loss carryback included in the income statement should be based on income (loss) reported for accounting purposes rather than for tax purposes, the objective being to reflect in income the carryback refund which would exist if there were no timing differences. The difference between this amount and the amount currently refundable should be added to or deducted from the appropriate balance sheet deferred tax account. This is accomplished by recomput-

[7] This section is also applicable to other unused deductions and credits that may be carried backward or forward in determining taxable income (for example, capital losses, contribution carryovers and foreign tax credits).

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ing the net deferred tax amounts for the carryback periods and the current period on a cumulative basis. Such computation is illustrated in Exhibit II.

.075 **EXHIBIT II**

APPLICATION OF LOSS CARRYBACK AGAINST EXISTING DEFERRED TAX CREDITS

	Income (Loss) Before Income Taxes		*Income Tax Expense (Credit)*			
Year	*Accounting*	*Taxable*	*Current*	*Deferred*	*Total*	*Cumulative Net Deferred Tax Credits*
1	$ 15,000	$ 5,000	$ 2,500	$ 5,000	$ 7,500	$ 5,000
2	15,000	5,000	2,500	5,000	7,500	10,000
3	15,000	5,000	2,500	5,000	7,500	15,000
4	15,000	5,000	2,500	5,000	7,500	20,000
5	(35,000)	(45,000)	(7,500) (A)	(10,000) (B)	(17,500)	10,000 (C)
6	5,000	15,000	—0— (A)	2,500 (D)	2,500	12,500

Assumptions:

1. 50% tax rate for all years.
2. Surtax exemptions and investment credits ignored.

Notes:

(A) Taxes paid in years 2, 3 and 4 aggregating $7,500 become refundable as a result of the carryback of the loss from year 5. No tax is payable in year 6 because of the loss carryforward from year 5.

(B) For years 2 through 5 cumulative accounting income is $10,000, which at a 50% rate requires a deferred tax credit of $5,000. Accordingly a reduction in deferred tax credits of $10,000 is required. In effect, a loss carryforward has been recognized to that extent. (See section on "Recognition of Carryforwards as Offset to Deferred Tax Credits.")

(C) The cumulative deferred tax credit at end of year 5 consists of $5,000 from year 1 plus $5,000 for years 2 through 5.

(D) Represents the tax benefit ($2,500) of the loss carryforward to year 6 previously recognized in year 5.

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12. Loss Carryforwards—Conflict of Concepts

.076 The procedures applied to loss carryforwards differ from those applied to loss carrybacks. The existence of a carryforward means that a company has incurred operating losses which exhausted benefits available from carrybacks and which can be realized only as a carryforward. Usually a company in a carryforward position is experiencing financial difficulties so serious that doubt exists as to future realization of the carryforward. In such cases a company may not have shown profits in any recent year—or in its entire history. The recording of the tax benefit of a loss carryforward during the loss year under such circumstances would be contrary to the accounting concept that revenues or gains should not be recognized if realization is doubtful.

.077 Section 4091 takes the position, relative to loss carryforwards, that the realization concept should take precedence over the matching concept. Therefore, loss carryforward benefits usually should be recognized only when realized through subsequent profitable operations. However, section 4091 also states that the future tax benefit of a loss carryforward should be recorded as an asset during the loss year in those cases where realization is *assured beyond any reasonable doubt.*

.078 In the usual case of a loss carryforward—where realization is *not* assured beyond any reasonable doubt—tax benefits can be recognized *only* during subsequent years *as they are realized.* Thus, even though in a period subsequent to the loss year the future realization of a carryforward becomes assured beyond any reasonable doubt, it is not permissible under section 4091 to recognize the future tax benefit until it is actually realized.

.079 When a loss carryforward is realized and recognized subsequent to the loss period, income statement presentation is a problem. Under the matching concept, the benefit applies to the loss period and not to the period of realization; this suggests retroactive adjustment of the loss period. However the criteria set forth in section 2014, *Prior Period Adjustments,* greatly restrict prior period adjustments. Therefore, it is not appropriate to adjust the loss period retroactively. [As amended, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.] (See section 2014.)

.080 In order to keep within the criteria of section 2012, it is necessary to include the tax benefit from a loss carryforward in the income statement of the year of realization. However, because it seemed illogical to consider such a credit to be a part of ordinary income, the Board decided that such tax benefits should be presented as extraordinary credits in the year of realization. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.]

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.081 A loss carryforward benefit recognized in the year realized could be presented as shown in Exhibit III.

.082

EXHIBIT III

RECOGNITION OF LOSS CARRYFORWARD BENEFIT IN YEAR REALIZED

Income before income taxes and extraordinary items		$1,000,000
Income tax expense:		
Currently payable	$200,000	
Tax effect of loss carryforward	300,000	500,000
Income before extraordinary items		$ 500,000
Extraordinary items:		
Reduction of income taxes arising from carry-forward of prior years' operating losses	$300,000	
Loss on major devaluation of foreign currency (less applicable income tax of $100,000)	(100,000)	200,000
Net income		$ 700,000

Assumptions:

1. 50% tax rate for all years.
2. Surtax exemptions and investment credits ignored.

13. Assurance Beyond Any Reasonable Doubt

.083 Section 4091 provides that the future tax benefit of a loss carryforward should be recognized as an asset during the loss period if realization is "assured beyond any reasonable doubt." Consequently, the meaning of the phrase "assured beyond any reasonable doubt" is quite important. It was the Board's intention that recognition of future tax benefits of carryforwards should be restricted to unusual cases.

.084 Section 4091 cites, by way of example, circumstances under which carryforwards may be recognized during the loss year as follows:

> "Realization of the tax benefit of a loss carryforward would appear to be assured beyond any reasonable doubt when both of the following conditions exist: (a) the loss results from an identifiable, isolated and nonrecurring cause and the company either has been continuously profitable over a long period or has suffered occasional losses which were more than offset by taxable income in subsequent years, and (b) future taxable income is virtually certain to be large enough

> to offset the loss carryforward and will occur soon enough to provide realization during the carryforward period."

.085 The use of the words "identifiable, isolated, and nonrecurring" in the above quotation was intended to rule out recognition of loss carryforwards resulting from generally unsuccessful business operations of an entity. Thus, operating losses resulting because of depressed economic conditions or because of changes in consumer preferences or in technology do not give rise to a situation where a future tax benefit may be recognized. Loss carryforwards resulting from the introduction of products or services which have not achieved sufficient acceptance to produce profits do not qualify for recognition prior to realization. Such non-recognition of loss carryforwards applies both to companies in existence for many years that have moved into a new area of business and to newly-formed companies in the developmental stage.

.086 Examples of the kinds of situations giving rise to loss carryforwards that may qualify for recognition during the loss period are:

(1) Losses resulting from the expropriation of a foreign subsidiary, or from the abandonment of one of several operations where the continuing operations are and have been profitable and are virtually certain to be profitable enough to offset the loss carryforwards, and

(2) Losses of one or more subsidiaries of a profitable parent company where the carryforward will be made available as an offset against other taxable income by filing a consolidated income tax return, or by claiming a bad debt deduction, or by some other means. On the other hand, it would not be appropriate to record a loss carryforward of a subsidiary company even though the parent and other subsidiaries are profitable if there are no specific plans to obtain the tax benefit from the loss.

.087 In those rare cases where operating loss carryforwards are expected to be realized beyond any reasonable doubt as offsets against future taxable income, the potential tax benefits should be reflected in the balance sheet as

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assets, and should be classified as current or noncurrent depending on the extent to which realization is expected to occur within the current operating cycle.

14. Recognition of Carryforwards as Offsets to Deferred Tax Credits

.088 It may happen that an operating loss carryforward arises at a time when net deferred tax credits exist because of prior timing differences. Even though the realization of an operating loss carryforward is not assured beyond any reasonable doubt, it may be necessary if net deferred tax credits exist to recognize a portion or all of the loss carryforward as an offset to such net deferred tax credits. Section 4091 provides that, in such situations:

> "net tax credits should be eliminated to the extent of the lower of (a) the tax effect of the loss carryforward, or (b) the amortization of the net deferred tax credits that would otherwise have occurred during the carryforward period. If the loss carryforward is realized in whole or in part in periods subsequent to the loss period, the amounts eliminated from the deferred tax credit accounts should be reinstated (at the then current tax rates) on a cumulative basis as, and to the extent that, the tax benefit of the loss carryforward is realized."

.089 The limiting factor in the amount of loss carryforward that may be recognized by way of offset against net deferred tax credits is indicated in clause (b) of the preceding quotation.

.090 The justification for recognizing loss carryforwards as an offset to deferred tax credits is that it would be unrealistic to require recognition of deferred tax credits while at the same time denying recognition of deferred tax charges, in the form of a loss carryforward. This follows because both the deferred credits and the deferred charges will reverse during the same future accounting periods. However, net deferred credits which will not be amortized until after the expiration of the loss carryforward period cannot be offset by loss carryforwards.

.091 If both current and non-current net deferred tax credits exist when the future benefit of a loss carryforward

is recognized as an offset, such benefit should be allocated between current and non-current deferred tax credits on a proportional basis.

.092 As the loss carryforward benefit is realized, the net deferred credits eliminated to give recognition to the carryforward, as well as credits related to originating timing differences of the loss year, should be reinstated at the then current rates (i. e., at the rates at which the loss carryforward is realized) before recognition is given to the realization of any remaining loss carryforwards. At the same time amortization of such deferred credits that would otherwise have occurred should also be recognized.

.093 The interaction of net deferred tax credits and loss carryforwards is illustrated in Exhibit IV.

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EXHIBIT IV

EXAMPLE OF LOSS CARRYFORWARD RECOGNIZED AS OFFSET TO NET DEFERRED TAX CREDITS

(All amounts in thousands of dollars)

	Income before income taxes		Depreciation		Income tax expense (1)			Cumulative net deferred tax credits
Year	*Accounting*	*Taxable*	*Accounting*	*Tax*	*Current (2)*	*Deferred (F)*	*Total*	
1	$ 15,000	$ 5,000	$ 10,000	$ 20,000	$ 2,500	$ 5,000	$ 7,500	$ 5,000
2	15,000	5,000	10,000	20,000	2,500	5,000	7,500	10,000
3	15,000	5,000	10,000	20,000	2,500	5,000	7,500	15,000
4	15,000	5,000	10,000	20,000	2,500	5,000	7,500	20,000
5	(54,000) (3)	(64,000) (3)	10,000	20,000	(7,500) (A)	(15,000) (B) (2,000) (C)	(24,500)	3,000
6	2,000	6,000	10,000	6,000	—	(2,000) 3,000	1,000 (D)	4,000
7	2,000	6,000	10,000	6,000	—	(2,000) 3,000	1,000 (D)	5,000
8	2,000	6,000	10,000	6,000	—	(2,000) 3,000	1,000 (D)	6,000
9	2,000	6,000	10,000	6,000	—	(2,000) 3,000	1,000 (D)	7,000
10	5,000	9,000	10,000	6,000	—	(2,000) 4,500	2,500 (D)	9,500
11	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	7,000
12	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	5,700
13	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	3,800
14	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	1,900
15	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	—
	$ 69,000	$ 69,000	$150,000	$150,000	$ 42,500	$ —	$ 42,500	$ —

ADDITIONAL ASSUMPTIONS:

(1) 50% tax rate for all years and surtax exemptions and investment credits ignored.

(2) Equal to amount payable (or refundable) each year.

(3) Loss carryforward of $9,000 on accounting and $49,000 on tax basis is not assured beyond any reasonable doubt.

Notes:

(A) Refund of taxes paid in years 2-4 available because of loss carryback.

(B) Adjustment of deferred credit from timing difference recognized in years 2-4 (carryback period) in accordance with section 4091.43. No deferred credit is required for year 5 since tax refund computed with timing difference is same as refund computed without timing difference.

(C) The tax benefit of the loss carryforward that may be recognized is the lower of (1) the tax effect of carryforward for accounting purposes of $4,500 (computed as 50% of $9,000); or (2) the amortization of remaining deferred tax credits that would otherwise occur during the carryforward period of $2,000 (computed as $20,000—timing difference reversing in years 6-10—divided by $50,000—aggregate timing difference at end of year 5—or 40% applied to $5,000 deferred credit from year 1). The $2,000 limitation prevails.

(D) During each of the years 6 through 10, amortization of deferred tax credits on a cumulative basis of $2,000 is recognized on the basis of 50% of $4,000 reverse timing differences. In each of these years, deferred credits are restored to the extent of realization of the loss carryforward equal to tax that would otherwise be currently payable in year 6 through 9 of $3,000 each year, and in year 10 of $4,500. Full benefit of carryforward is added to deferred credits because aggregate net deferred credits never exceed amounts that would have been recorded if there had been no operating loss.

(E) The accumulated deferred tax at the end of year 10 is $9,500 which must be amortized equally during each of the years 11 through 15 since timing differences reverse in equal annual amounts of $6,000 during those years.

(F) The average rate assumption has been used in the amortization of deferred tax credits upon reversal of the depreciation timing differences. A first-in, first-out assumption could have been applied. (See section on "Amortization of Deferred Taxes.")

15. Deferred Tax Charges Existing When Loss Carryforward Arises

.095 A company may incur operating losses sufficient to put it in a loss carryforward position at the same time that unamortized net deferred tax charges exist. To the extent the deferred charges arose in the three preceding profitable years, they would normally be eliminated through carryback of losses. However, balances prior to that period may still remain. If the realization of the tax benefit of the carryforward is not assured beyond any reasonable doubt, the question arises as to the propriety of continuing to carry the remaining deferred tax charges. In these situations unamortized net deferred tax charges represent the tax effects of additional expenses not recognized for tax purposes but recognized for accounting purposes. Therefore, if it is not appropriate to recognize the effect of the tax loss carryforward in the year of loss, it may not be appropriate to recognize or to continue to carry as deferred charges the tax effects of the additional expenses recognized for accounting purposes. Accordingly, in the situations cited

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the net deferred tax charges should be evaluated as to realizability in the same manner as are other assets.

.096 In other situations companies may incur losses which, because of the nature of the timing differences, are larger for accounting purposes than the amounts carried forward for tax purposes and there is no assurance of future realization of the carryforward benefit. No recognition is given to the tax effects (deferred tax charges) of the timing differences (additional accounting loss carryforwards) inasmuch as the tax effects would be zero under the "with" and "without" computations. Therefore, when these timing differences reverse, the tax benefits realized will not be offset by amortization of deferred charges which would otherwise have been provided. Accordingly, in these situations the tax benefits realized from these timing differences (additional accounting loss carryforwards) should be included in the income statement as extraordinary credits (see Exhibit V) in the same manner as benefits obtained upon future realization of tax loss carryforwards (see Exhibit III).

.097

EXHIBIT V

RECOGNITION OF ADDITIONAL ACCOUNTING LOSS CARRYFORWARD BENEFIT IN YEAR REALIZED

Income before income taxes and extraordinary items		$1,000,000
Income tax expense:		
Currently payable	$200,000	
Tax effect of losses (or expenses) deducted from income for accounting purposes in prior loss periods, but for tax purposes in current period	300,000	500,000
Income before extraordinary items		$ 500,000
Extraordinary items:		
Reduction of income taxes arising from deduction of prior years' accounting losses (or expenses)	$300,000	
Loss on major devaluation of foreign currency (less applicable income tax of $100,000)	(100,000)	200,000
Net Income		$ 700,000

Assumptions:

1. 50% tax rate for all years.
2. Surtax exemptions and investment credits ignored.

16. Loss Carryforward Arising Prior to Quasi-Reorganization

.098 A company which goes through a quasi-reorganization (including for this purpose the application of a deficit in retained earnings to contributed capital) is likely to be in a loss carryforward position. The proper accounting for the future tax benefit of such loss carryforwards poses a question because the losses occurred prior to quasi-reorganization, but the tax benefit from the carryforward is available as an offset against taxable income after quasi-reorganization. Normally, it would be inappropriate to recognize the potential future tax benefits from the carryforward at the date of the quasi-reorganization because realization would not be assured beyond any reasonable doubt. Also, the deficit from operations prior to the quasi-reorganization is written off to contributed capital; in effect a new enterprise is said to have been established.

.099 When a tax benefit is realized from such loss carryforwards, section 4091 provides that such benefits should be added to contributed capital because the benefits are attributable to the loss periods prior to the quasi-reorganization. Thus, the benefits are treated as a part of the capital of the new enterprise.

.100 In some instances, losses may also occur subsequent to the quasi-reorganization and the question may arise as to whether realization of the loss carryforwards applies to losses incurred prior or subsequent to quasi-reorganization. Under the tax law the earliest loss carryforward must be utilized first. For accounting purposes the tax benefits from loss carryforwards should be allocated between losses before and after the quasi-reorganization in the same manner that they are available under the tax laws.

.101 The above requirements apply to the tax effects of loss carryforwards realized after the effective date of section 4091 even though the related quasi-reorganization occurred prior to the effective date.

.102 The concepts described in the preceding paragraphs relative to quasi-reorganizations apply equally to reorganizations under the bankruptcy laws where a deficit is written off to capital.

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17. Purchased Loss Carryforwards

.103 Occasionally when a corporation acquires another business in a transaction accounted for as a purchase, one of the assets acquired is the future tax benefit of a loss carryforward. Such future tax benefit should be recorded as an asset at the date of purchase only if its realization is assured beyond any reasonable doubt. In the normal case, however, where such assurance does not exist, the tax benefits of such a loss carryforward ". . . should be recognized only when the tax benefits are actually realized and should be recorded as retroactive adjustments of the purchase transactions . . .".

.104 This is based on the concept that accounting for the acquisition of a business as a purchase requires the allocation of the purchase price to the assets acquired. When a loss carryforward exists it may be considered as an important part of the assets acquired. It is likely that in arriving at the purchase price the parties assigned some value to the loss carryforward. Therefore, when the purchase price is being allocated, the future tax benefit of the carryforward should, in theory, be recorded as a receivable. However, inasmuch as it may not be recorded as a receivable unless its recovery is assured beyond any reasonable doubt, the effect of not recognizing it at the date of the purchase may be to increase the goodwill or reduce the "negative goodwill" that would otherwise be recognized.

.105 Therefore, if and when a tax benefit is realized from the purchased loss carryforward, a retroactive adjustment of the purchase transaction is required. This would normally be accomplished by an adjustment of goodwill or "negative goodwill." In some cases adjustment of tangible assets and depreciation may also be required. Such accounting treatment should be applied to tax benefits realized after the effective date of section 4091 even though the related purchase occurred before the effective date.

18. Investment Credit: Carrybacks and Carryforwards

.106 Section 4094.21 states: "The amount of a carryback of unused investment credit may be set up as an asset (a claim for refund of income taxes) and be added to the allowable investment credit in accounting for the effect of the credit in the year in which the property is placed

in service. A carryforward of unused investment credit should ordinarily be reflected only in the year in which the amount becomes 'allowable', in which case the unused amount would not appear as an asset." Section 4094 remains in effect without modification by APB Opinion No. 11.

.107 APB Opinion No. 2 required that the "deferral" method should be followed in accounting for investment credits; APB Opinion No. 4 stated that the "flow-through" method was also acceptable. This method is now predominant in practice. Under the "deferral" method investment credits actually realized, including those realized through carryback or carryforward, are deferred and amortized over the productive life of the acquired property.

.108 Under the "flow-through" method investment credits generally are treated as reductions of income tax expense of the year in which the credits are actually realized. Practice does not treat the realization of investment credit carryforwards as extraordinary items in the year of realization, as is required for operating loss carryforwards under section 4091.

.109 As discussed in the section on "Computation of Deferred Taxes," the effect of the investment credit must also be recognized in computing deferred taxes for timing differences originating in the current period. This occurs because deferred taxes are computed as the differential in taxes (giving effect to investment credits) arising from including and excluding the timing difference.

.110 If tax allocation results in net deferred credits the differential calculations will recognize as income for financial accounting purposes, through a reduction in the deferred tax provisions, that portion of available investment credits that would have been allowable had taxes payable been based on pretax accounting income. In effect investment credit carryforwards are being recognized as offsets against net deferred tax credits in a manner similar to that followed for operating loss carryforwards. The carryforwards utilized should be limited to the lower of (a) the amount of the carryforward benefit or (b) the amortization of the net deferred credits that would otherwise have occurred during the carryforward period. The total amount of investment credits that may be reflected in these

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computations is limited to the amount actually available (either currently or as a carryforward).

.111 As the investment credit carryforward benefits are realized, reductions of net deferred credits resulting from application of unused investment credits should be reinstated at the then current rates (i. e., at the rates at which the investment credit carryforwards are realized) before recognition is given to the realization of any remaining investment credits. At the same time amortization of such deferred credits that would otherwise have occurred should also be recognized.

.112 If allocation results in a net deferred charge an opposite effect should be obtained—a portion of the investment credit actually realized will be deducted from the deferred charge and omitted from income of the current period for financial accounting purposes.

.113

EXHIBIT VI

EXAMPLE OF EFFECT OF INVESTMENT CREDIT WHEN TAXABLE INCOME IS ZERO (thousands of dollars)

Assumed Facts		
Pretax accounting income		$500
Additional depreciation for tax purposes		500
Taxable income		$ -0-
Available investment credits		$100
Tax rate		52.8% (less surtax exemption)
Deferred tax computation		
Tax on taxable income		$ -0-
Tax on taxable income without timing difference:		
52.8% of $500 less surtax exemption		$257
Less investment credits (maximum—$25 plus 50% of tax in excess of $25 or $141) limited to $100		100
		$157
Differential equal to deferred tax credit		$157
Financial statement presentation		
Income before income taxes		$500
Income tax expense:		
Currently payable	$ -0-	
Deferred	157	157
Net income		$343

(Note: If more than one kind of timing difference is involved and the available investment credits are less than the maximum based on pretax accounting income, then the available credits should be applied in proportion to the amounts of the respective timing differences.)

.114

EXHIBIT VII

ILLUSTRATION OF DEFERRED TAX COMPUTATION WHEN INVESTMENT CREDIT CARRYFORWARD EXISTS
(thousands of dollars)

Assumptions:		
Pretax accounting income		$1,000
Excess depreciation (assuming no cumulative timing differences from prior years exist)		500
Taxable income		$ 500
Available investment credits		$ 400
Deferred taxes:		
Taxable income with timing difference		$ 500
Tax thereon:		
52.8% less surtax exemption		$ 257
Investment credits ($25 plus 50% of tax in excess of $25)		141
Tax payable		$ 116
Taxable income without timing difference		$1,000
Tax thereon:		
52.8% less surtax exemption		$ 521
Investment credits ($25 plus 50% of tax in excess of $25)		$ 273
Tax		$ 248
Differential equal to deferred tax credits		$ 132
Investment credits:		
Available		$ 400
Realized		141
Carryforward		$ 259
Investment credit benefit received in computation of deferred taxes:		
Deferred taxes without considering investment credits ($521 less $257)	$264	
Deferred taxes as computed above	132	$ 132
Investment credit carryforward to future years		$ 127
Summary:		
Income before income taxes		$1,000
Income tax expense:		
Currently payable (after giving effect to investment credits realized of $141)	$116	
Deferred taxes	132	248
Net income		$ 752

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FINANCIAL STATEMENT PRESENTATION

19. Allocation Within a Period

.115 Section 4091 requires income tax expense for any period to be allocated among income before extraordinary items, extraordinary items, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other stockholders' equity accounts. The amount of income tax expense for the period allocated to income before extraordinary items is computed as the amount of income tax expense (after giving effect to related investment credits) that would have been determined by excluding from pretax accounting income all transactions that are not included in the determination of income before extraordinary items. The difference between income tax expense allocated to income before extraordinary items and the total income tax expense for the period (after giving effect to investment credits) is then allocated among the extraordinary items (and to adjustments of prior periods and direct entries to stockholders' equity accounts).

.116 If exclusion of extraordinary losses from a net loss for a period results in income before extraordinary items, an appropriate provision should be made for the income tax expense that would have been applicable to such income. This imputed tax provision should then be reversed by application against the extraordinary loss.

.117 If exclusion of extraordinary items from pretax accounting income results in a loss before extraordinary items, a credit tax provision should be allocated to such loss. The credit would be equivalent to the tax that would be refundable from an operating loss carryback equal to the loss before extraordinary items. The sum of such credit tax provision and total income tax expense for the period should then be allocated among the items excluded from pretax accounting income in the determination of the loss before extraordinary items. Often the income tax expense allocated to the extraordinary items will differ from the tax that normally would be associated with such items, as illustrated in the example on next page.

.118 If there is more than one item of revenue and expense included in extraordinary items, adjustments of

prior periods and direct entries to stockholders' equity accounts, it is necessary to allocate the total income tax effects applicable to them among the individual items. The tax effect applicable to each individual item should be determined as the differential in income taxes resulting from including and excluding the specific item and should be determined in the same manner as for a timing difference. The amount of income tax expense allocated to all excluded items should then be allocated to the individual items on the basis of the proportion that the tax effect of each item bears to the aggregate tax effects.

Loss before income taxes and extraordinary capital gain	$ (200,000)
Income tax credit (assuming a 50% rate)	100,000
Loss before extraordinary credit	$ (100,000)
Extraordinary long-term capital gain of $600,000, less applicable income tax of $250,000 [8]	350,000
Net income	$ 250,000

.119 In certain unusual cases, an item recognized in the determination of taxable income may not enter into the reporting of results of operations but, instead, for accounting purposes represents a capital transaction which is reflected by a direct entry in a stockholders' equity account. In such cases, the tax effect of such an item should be related to the transaction affecting the stockholders' equity account and not considered to be an increase or decrease of income tax expense for the period. An example of such a direct entry to stockholders' equity accounts arises in connection with that portion of a loan loss reserve of a bank which is recorded in the accounts and is deducted for tax purposes but is in excess of allowances required for accounting purposes and is, therefore, treated as appropriated surplus.

.120 When a transaction is includable in the determination of taxable income for a period but is treated as a

[8] The amount of $250,000 represents the sum of 25% of $600,000, or $150,000 (the alternative tax), plus $100,000, the tax credit attributable to the carryback of the loss from operations under the "with" and "without" computations. This $100,000 tax credit is, in effect, lost inasmuch as the alternative tax computation available because of the long-term capital gain does not provide for any recognition of the loss from operations.

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prior period adjustment for accounting purposes, the tax effects should be allocated to such prior periods. When a change in accounting method is made by retroactive restatement of prior years' operations, the applicable income tax expense should be determined on the basis of the applicable rates for those prior periods.

20. Income Statement Presentation

.121 All taxes based on income, including foreign, state and local, should be reflected in income tax expense in the income statement.

.122 The components of income tax expense for the period should be disclosed separately. This disclosure of components may be done either on the income statement or in a note. The components of income tax expense that must be disclosed separately for the period, allocated among income before extraordinary items, extraordinary items, adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts, are as follows:

(a) Taxes estimated to be payable,

(b) Tax effects of timing differences,

(c) Tax effects of investment credits (whether on the deferral method or the flow-through method) and

(d) Tax effects of operating losses.

.123 An example of income statement presentation of income tax expense follows:

	1968	*1967*
Income before income taxes	$800,000	$700,000
United States, foreign and state income taxes (Note A)	300,000	350,000
Net income	$500,000	$350,000

Note A—Income tax expense differs from amounts currently payable because certain revenues and expenses are reported in the income statement in periods which differ from those in which they are subject to taxation. The principal differences in timing between the income statement and taxable income involve (a) depreciation expenses recorded under the straightline method in the income statement and by accelerated methods for tax purposes and (b) provision for product warranties recorded in the income statement as warrantied products are sold but deducted for tax purposes when services under the warranties are performed. The differences between income tax expense and taxes currently payable are reflected in deferred tax accounts in the balance sheet. Income tax expense consists of the following:

	1968	1967
Currently payable before giving effect to investment credits	$550	$350
Investment credits realized	(175)	(50)
Deferred—net	(75)	50
	$300	$350

21. Balance Sheet Presentation

.124 The Opinions of the Board require that income tax accounts be presented in the balance sheet so as to provide separate classification of the following elements:

(a) Taxes estimated to be currently payable,

(b) Net amount of current deferred charges and current deferred credits relating to timing differences,

(c) Net amount of noncurrent deferred charges and noncurrent deferred credits relating to timing differences,

(d) Refundable taxes arising from carrybacks of operating losses, investment credits and similar items,

(e) Future tax benefits of carryforwards of operating losses and similar items (in those unusual cases where they have been recognized because realization is assured beyond any reasonable doubt) and

(f) Deferred investment credits (applicable when the deferral method of accounting for investment credits is employed).

.125 The distinction between current and noncurrent deferred taxes due to timing differences is based on the classification of the asset or liability related to each specific timing difference. For example, deferred taxes arising from timing differences in depreciation expense are classified with noncurrent liabilities because the related depreciable assets are noncurrent. On the other hand, if installment receivables are included in current assets, the deferred tax credits arising from the use of installment method for tax purposes are classified with current liabilities.

.126 The Board considered the possibility of presenting current deferred tax charges separately from current deferred tax credits, with similar separation of noncurrent

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deferred tax charges from noncurent deferred tax credits. However, the Board concluded that allowing the netting of deferred charges and credits achieved a simpler presentation while allowing the reader of the financial statement to determine the effect on the balance sheet of interperiod tax allocation. It was considered necessary, however, to separate the net current deferred taxes from the net noncurrent deferred taxes in order to conform with accepted principles for determining working capital.

22. General Disclosures

.127 In addition to the presentation of components of income tax presented in the income statement and in the balance sheet, section 4091 requires the following general disclosures:

> "(a) Amounts of any operating loss carryforwards not recognized in the loss period, together with expiration dates (indicating separately amounts which, upon recognition, would be credited to deferred tax accounts);
>
> (b) Significant amounts of any other unused deductions or credits, together with expiration dates; and
>
> (c) Reasons for significant variations in the customary relationships between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business.
>
> The Board recommends that the nature of significant differences between pretax accounting income and taxable income be disclosed."

In addition, section 4094 requires disclosure of the method adopted (deferral or flow-through) in accounting for investment credits and the amounts of unused carryforwards, together with expiration dates. These requirements are consistent with the disclosure requirements cited above in section 4091.

23. Transitional Problems

.128 Section 4091 was effective for fiscal periods that began after December 31, 1967. Retroactive application was not mandatory but was encouraged. The obvious advantage of applying section 4091 retroactively was to

achieve complete comparability among all reported periods—both then and in the future.

.129 If a company did not elect to apply section 4091 retroactively, it was nevertheless necessary to make changes in presentation of deferred taxes that related to periods prior to the effective date. For example, a company that was, prior to the effective date, presenting deferred tax accounts as direct reductions of related assets and liabilities—"net of tax" presentation—was required to change the presentation of balance sheets at the end of fiscal periods beginning after December 31, 1967. This was required even though the amounts of deferred taxes carried over from prior years had not been recomputed to conform to the provisions of section 4091.

.130 The net of tax presentation is also prohibited in income statements for periods subject to section 4091. When comparative income statements are presented which include years beginning both before and after the effective date of section 4091, it is not required that "net of tax presentation" be eliminated from the former income statements but it would certainly be highly desirable even though the amounts of deferred taxes are not recomputed.

.131 Deferred tax accounts relating to timing differences may be computed either on the basis of individual transactions or, with respect to similar timing differences, under the "gross change" or "net change" methods. Irrespective of which basis or method is elected, no recognition (beyond systematic amortization of previously recorded deferred taxes) can be given in the computation of the current deferred tax provision to the reversal of tax effects arising from timing differences originating prior to the effective date of section 4091 unless the applicable deferred taxes have been provided for in accordance with section 4091, either during the periods in which the timing differences originated or, retroactively, as of the effective date of section 4091. The method or methods adopted should be consistently applied. If the methods are changed, disclosure of a change in accounting is necessary in accordance with section 1051, *Accounting Changes*. [As amended, effective for fiscal years beginning after July 31, 1971, by APB Opinion No. 20.]

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.132 There are cases in which a company, prior to the effective date of section 4091, did not apply interperiod tax allocation procedures for significant timing differences in accordance with section 4091, but was required to do so subsequent to the effective date. It should be noted that under such circumstances if the provisions of section 4091 were not applied retroactively, there may be a significant lack of comparability among income statements for a number of years. This will occur because it will be necessary to recognize deferred taxes for timing differences that originate subsequent to the effective date of section 4091, whereas it will not be permissible to reflect in the provision for deferred taxes the tax effects of similar timing differences that reverse during the same period. The effect of this procedure will be to place the accounts of the company on a full allocation basis gradually over a period of time. The period of time required for full allocation to be achieved and the significance of the lack of comparability will depend on the "rollover period" of the timing differences involved, and their materiality.

.133 An example of a possible extreme lack of comparability could occur in the case where a company has not been providing deferred taxes relating to provisions for product warranty costs where the warranty period is relatively short, say two or three years. In such a case, during the first few years following the effective date of section 4091, the provision (credit) for deferred taxes in the income statement will vary widely (decreasing in amount) even though there is no change in tax rates or in the ending amount of the warranty reserve. Such lack of comparability, assuming it is significant, requires explanation in a note to the financial statements. It is obvious that under these circumstances retroactive application would be highly desirable.

.134 Some companies adopted tax allocation procedures for depreciation timing differences at the effective date of section 4074 on a prospective basis and did not retroactively provide deferred taxes for accumulated timing differences at that date. Such companies should consider the advisability of providing such deferred taxes retroactively on the basis provided in section 4091.

.135 If a company decides to give retroactive effect to section 4091, the computations of deferred taxes relating to timing differences for prior periods should be based on the provisions of section 4091 and should be applied to all material items of those prior periods. It is unacceptable to compute such deferred taxes under the "liability" approach, which has been rejected in section 4091, even though the liability approach would have been acceptable if it had been followed in prior years. On the other hand, where deferred taxes have been provided in prior years under the liability method, recomputation under the deferred method should be required only when the differences are material.

.136 The Board recognized that it was not practicable to discuss in section 4091 all of the problems that could arise in the application of the principles stated in section 4091. Likewise it was not practicable in this article to indicate or suggest solutions to some existing problems or to anticipate solutions to new problems. Further experience in the implementation of section 4091 will undoubtedly lead to new or different treatments.

[Issue Date: 1969.]

24. Franchise Taxes Based on Income

.137 *Question*—The Ohio corporation franchise/income tax law enacted December 20, 1971 imposes a tax based on the value of a corporation's issued and outstanding shares of capital stock. The value of the issued and outstanding stock is deemed to be (a) the stockholders' equity in the corporation (subject to certain adjustments) as of the beginning of the corporation's annual accounting period that includes the first day of January of the tax year or (b) the corporation's net income (subject to certain adjustments) for the year, or portion of the year, preceding the commencement of its annual accounting period that includes the first day of January. The amount of the tax payable is the greater of the applicable tax rate applied to stockholders' equity or net income, but no less than $50, and is first due on January 1, 1972. To what period does the tax charge belong?

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.138 *Interpretation*—A franchise tax unrelated to income is a privilege tax which should be charged as an expense of the year to which the privilege relates. A franchise tax which, in effect, is based solely on income is considered to be an income tax under section 4091. The tax should be accrued in the year the income to which it relates is earned, even though the tax constitutes a fee for the privilege of doing business in a succeeding period and is payable in that period.

.139 The Ohio corporation franchise/income tax is considered to be composed of two elements for accounting purposes, a franchise tax and an income tax. To the extent the tax is based on stockholders' equity, it is a franchise tax which should be accrued in the year to which the privilege relates. If there is additional tax due, based on income, that excess is considered to be an income tax which should be accrued in the year the income was earned.

.140 In many instances corporations will have issued prior to the enactment of the Ohio law their financial statements for years ending in 1971. In such cases the additional tax expense for years ending in 1971 should be treated as a prior period adjustment when the corporation next issues its financial statements.

[Issue Date: March, 1972]

25. "Leveraged" Lease Accounting

[.141—.142] [Superseded, effective January 1, 1977, by FASB Statement No. 13] (see section 4053).

The next page is 13,401.

AC Section U4094

Accounting For The Investment Credit: Accounting Interpretations of Section 4094

1. Tax Credit Disclosure

.001 *Question*—What disclosure is required in relation to accounting for the investment tax credit?

.002 *Interpretation*—Section 4094.18 specifies that full disclosure of the method followed and amounts involved, when material, in accounting for the investment credit is essential. For this purpose, materiality should be measured in relation to the income tax provision, net income, and the trend of earnings. Generally, all amounts of investment credit should be revealed unless they are clearly insignificant. (Modified by Interpretation No. 2 below.)

[Issue Date: February, 1972.]

2. Tax Credit Disclosure (Modification)

.003 Accounting Interpretation No. 1, issued in February 1972, stated, "full disclosure of the method followed and amounts involved, when material, in accounting for the investment credit is essential. For this purpose, materiality should be measured in relation to the income tax provision, net income, and the trend of earnings. Generally, all amounts of investment credit should be revealed unless they are clearly insignificant." That Interpretation is reaffirmed, except for the foregoing references to materiality as it relates to disclosure of the *method.*

.004 The 1971 Act and the Treasury releases require a taxpayer to disclose in financial reports the method of accounting used for the investment credit but no materiality guideline is given. Accordingly, until such time as a guideline may be issued, the *method* of accounting for the investment credit should be disclosed in all financial reports for taxable years ending after December 9, 1971 even though the *amount* is not material and is not disclosed and dis-

closure would not otherwise be required. If more than one *method* is used (for example, the deferral method for "old" credits and the flow-through method for "new" credits), all *methods* should be disclosed. The amounts may be omitted only if they are clearly insignificant.

[Issue Date: April, 1972]

3. Acceptable Methods of Accounting for Investment Credits Under 1971 Act

.005 *Question*—What methods may be used to account for investment credits allowable under the Revenue Act of 1971?

.006 *Interpretation*—In a news release dated January 10, 1972, the Treasury Department interpreted the Act to mean that the flow-through and the deferral methods are the only acceptable methods to account for investment credits allowable under the 1971 Act for taxable years ending after December 9, 1971.

.007 Under the flow-through method, the credit is reflected as a reduction of tax expense in the year it is recognized in the financial statements.

.008 Under the deferral method, the credit is reflected as a reduction of tax expense ratably over the period during which the asset is depreciated and follows the depreciation method used for financial reporting purposes. The amortization period may be the specific life of each asset or the composite life of all depreciable assets. However, amortization over the period the asset must be held to avoid recapture of the credit rather than life of the asset is not acceptable because it is not based on depreciable life.

.009 A financing institution may include the investment credit as part of the proceeds from leased property accounted for by the financing method and include it in determining the yield from the "loan" which is reflected in income over the term of the lease. However, the financing institution may account for the investment credit on property purchased for its own use by either the flow-through or the deferral method.

.010 The investment credit may be passed through to a lessee for leased property. The lessee should account for

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the credit by whichever method is used for purchased property. If the deferral method is used and the leased property is not capitalized, the term of the lease, generally including renewal options which are reasonably expected to be exercised, is the period over which the credit should be amortized.

[Issue Date: April, 1972]

4. Change in Method of Accounting for Investment Credit

.011 *Question*—The Revenue Act of 1971 provides that a taxpayer need not use a particular method of accounting for the investment credit in financial reports subject to the jurisdiction of, or made to, any federal agency. However, once a method is adopted, a taxpayer may not under the Act change to another method unless the Secretary of the Treasury or his delegate consents. (Therefore, a taxpayer has a one-time "free choice" to select a method different from the one used in the past to account for the investment credit under the 1971 Act but must continue to use the method selected.) The Treasury Department issued news releases on December 21, 1971 and January 10, 1972 specifying December 10, 1971 as the effective date for the accounting requirements for the credit under the Act in financial reports issued by taxpayers and describing methods of accounting for it. How do the 1971 Act and the Treasury Department releases affect the application of section 1051, Accounting Changes, by taxpayers who change their method of accounting for the investment credit in financial reports issued to shareholders?

.012 *Interpretation*—This Accounting Interpretation sets forth our understanding of how section 1051 [1] should be applied under the Act and the Treasury releases in accounting and reporting for the investment credit in general purpose financial statements issued by companies subject to the jurisdiction of, or making reports to, federal agencies. These would include, for example, annual reports to shareholders and other investors under the jurisdiction of the SEC, ICC, CAB, SBA, etc. The conclusions of this Interpretation should be applied to all financial statements prepared in accordance with generally accepted accounting

[1] Section 1051 is effective for fiscal years beginning after July 31, 1971, but earlier application is encouraged.

principles even though they are issued by companies whose financial reports are not under the jurisdiction of, or who do not report to, a federal agency. (It is our understanding that a tax return is not deemed a financial report to come under the provisions of the 1971 Act discussed in this Interpretation.) If anything in this Interpretation should conflict with any requirement issued by the Treasury, the requirement of the Treasury prevails for those financial statements.

"Old" Investment Credits

.013 Section 1051.16 specifies that the previously adopted method of accounting for a tax credit which is being discontinued or terminated should not be changed. Therefore, the method of accounting used for investment credits previously reported in financial statements covering taxable years ending before December 10, 1971 should be continued for those credits in financial statements issued after December 9, 1971. Thus, an investment credit received in 1968 and accounted for by the deferral method should under section 1051 continue to be amortized on the same basis as before even though the taxpayer elects to use the flow-through method under the one-time "free choice" to account for 1971 Act investment credits. Likewise, a 1968 investment credit which was accounted for by the flow-through method should not be reinstated, either by retroactive restatement or by a "catch-up" accounting change adjustment, even though the taxpayer elects the deferral method under the one-time "free choice" to account for 1971 Act investment credits.

.014 Under section 1051.16, the "old" investment credit in the above examples is considered terminated as of December 9, 1971 in view of the Treasury Department releases. The adoption of a different method to account for 1971 Act investment credits under the one-time "free choice" is, therefore, considered similar to the adoption of a different method of amortization for newly acquired assets as provided by section 1051.24.

"New" Credits Arising Before Cutoff Date

.015 An investment credit arising under the Revenue Act of 1971 but allowable in a taxable year ending before

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December 10, 1971 (for example, from property purchased in September 1971 by a taxpayer with a November 30 taxable year) may be accounted for either by the method used in prior years to account for the investment credit or by the method the taxpayer will use under the one-time "free choice." In these circumstances, those taxpayers who use the "old" method may exercise their one-time "free choice" in the following year. Those taxpayers who change to a different method for the 1971 Act credit should continue that method in accounting for investment credits allowable in following taxable years ending after December 9, 1971.

Carrybacks and Carryforwards

.016 In practice, the investment credit is recognized in financial statements[2] by including it in the "with and without" computation of the tax effect of a timing difference which is specified by section 4091.35. This practice continues to be appropriate in taxable years ending after December 9, 1971 although the credit is a carryback or a carryforward for income tax purposes. Thus, when different methods are used to account for the credit in different years and carrybacks or carryforwards are involved, the method applicable to a particular credit is the method used for the year in which the credit is recognized in the financial statements.

.017 Therefore, an investment credit arising from an investment made during a taxable year ending after December 9, 1971 but carried back to produce a refund from a taxable year ending prior to December 10, 1971 should be accounted for by the method selected under the one-time "free choice." An investment credit arising under prior Revenue Acts which has not been previously accounted for and which is allowable in a taxable year ending after December 9, 1971 (for example, from property purchased in 1968 for which all or part of the credit was carried forward to calendar 1971) should be accounted for by the method selected under the one-time "free choice."

.018 The Treasury Department releases do not apply to investment credits which have been reported in annual income statements covering taxable years ending before December 10, 1971 even though the credits may be carried

[2] See sections U4091.106-.114, "Investment Credit Carrybacks and Carryforwards" and sections 4091.44-.47 for rationale.

forward to reduce tax liability in years ending after December 9, 1971. Therefore, those investment credit carryforwards realized after that date should be accounted for in the normal manner by crediting the assets set up to recognize the investment credit carryforward or by restoring the deferred tax credit when the carryforward credit is realized.

.019 An investment credit recognized in a carryforward year rather than in the year it arises should be included in the determination of income before extraordinary items in the carryforward year.

Consistency Exception in Auditor's Report

.020 A change in the method of accounting for the investment credit (either by selection of a different method under the one-time "free choice" or later by permission of the Secretary of the Treasury or his delegate) would call for a consistency exception in an independent auditor's report if it has a material effect on the financial statements in the current year (see Accounting Interpretation No. 2 on tax credit disclosure). The effect of the change under the one-time "free choice" should be disclosed in the manner specified by section 1051.24. The effect of a Treasury-approved change should be disclosed in the manner specified by section 1051.21.

[Issue Date: April, 1972]

5. Investment Credit Is Prior Period Adjustment

.021 *Question*—The Revenue Act of 1971 allows an investment credit retroactively to some taxpayers whose fiscal years closed prior to enactment of the Act on December 10, 1971. To what accounting period does this credit belong?

.022 *Interpretation*—An investment credit arising under the Revenue Act of 1971 and allowable in a taxable year ending before December 10, 1971 is considered to be an event of a fiscal year ending before December 10, 1971. If the financial statements have not yet been issued, they should be adjusted to reflect the credit as a type 1 subsequent event (see AU section 560, Volume 1, AICPA PROFESSIONAL STANDARDS).

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If the financial statements have already been issued, the credit should be treated as a prior period adjustment as described by section 2010.17 (see also section 2011.18).

.023 The credit may be accounted for by the method used in prior years to account for the investment credit or by a different method. If a different method is used, that method should be used thereafter to account for investment credits allowable in following taxable years ending after December 9, 1971. (See Accounting Interpretation No. 4 on change in method of accounting for the investment credit.)

[Issue Date: April, 1972]

6. Investment Credit in Consolidation

.024 *Question*—The Revenue Act of 1971 specifies that a taxpayer shall not be required to use a particular method of accounting for the investment credit in reports subject to the jurisdiction of a federal agency. However, a taxpayer must continue to use the method adopted in all such reports subsequently issued unless consent to change is granted by the Secretary of the Treasury or his delegate. May different methods of accounting for the investment credit be adopted by the various legal entities that file separate income tax returns but are included in consolidated financial statements?

.025 *Interpretation*—No, a single method of accounting for the investment credit should be adopted under the one-time "free choice" by a parent company and its subsidiaries in consolidated financial statements (including subsidiaries carried on the equity method) and other financial reports subject to the jurisdiction of, or made to, a federal agency.

[Issue Date: April, 1972]

The next page is 13,451.

AC Section U4095

Accounting for Income Taxes— Special Areas: Accounting Interpretations of Section 4095

1. Disclosure of Untaxed Undistributed Earnings of Subsidiary

.001 *Question*—Section 4095.14b requires disclosure of the cumulative amount of undistributed earnings of a subsidiary on which the parent company has not accrued income taxes. Is the amount to be disclosed the total amount of undistributed earnings on which income taxes have not been accrued or may an amount that will not be taxed, with appropriate tax planning under existing statutes, be excluded?

.002 *Interpretation*—The amount to be disclosed under section 4095.14b is the cumulative undistributed earnings which under existing law would be subject to income taxes if distributed currently but for which the parent company has not accrued income taxes. If under existing law, however, a short-term postponement of the distribution would permit the earnings to be distributed tax free to the parent, those earnings need not be included in the amount disclosed. Thus, for example, the amount disclosed would include that portion of the undistributed earnings of a DISC subsidiary on which tax has not been accrued, the undistributed earnings of a foreign subsidiary on which tax has not been accrued and the tax would not be offset by an available foreign tax credit, and the undistributed earnings of a less than 80 percent owned domestic subsidiary.

.003 The amount disclosed would not include the undistributed earnings of an 80 percent or more owned domestic subsidiary that is included in a consolidated income tax return, or where the parent has elected a single surtax

exemption for all members of an affiliated group which file separate tax returns, since a dividend paid from those earnings would be eligible for the 100 percent dividends received deduction. Likewise, the undistributed earnings of a subsidiary that is expected to be remitted to the parent company in a tax free liquidation would not be included in the amount disclosed.

.004 The undistributed earnings of an 80 percent or more owned domestic subsidiary that files a separate tax return with multiple surtax exemptions for the affiliated group should not be included in the amount disclosed in most situations. Under present law, dividends paid out of earnings accumulated after 1974 will be eligible for the 100 percent dividends received deduction. Income taxes should, however, be accrued for any pre-1975 multiple surtax year accumulated earnings which are *not* considered to be invested for an indefinite period of time when the tax planning alternatives of filing a consolidated return or a tax free liquidation are not practical. In the unusual situations when pre-1975 accumulated undistributed earnings are considered invested for an indefinite period of time and the consolidated return and tax free liquidation alternatives are not practical, such pre-1975 accumulated undistributed earnings should be included in the amount to be disclosed.

.005 Care should be exercised in drafting the footnote required by section 4095.14b so that readers may be fully apprised of tax implications of unremitted earnings of subsidiaries. The following is illustrative: "It is the policy of the Company to accrue appropriate U. S. and foreign income taxes on earnings of subsidiary companies which are intended to be remitted to the parent company in the near future. Unremitted earnings of subsidiaries which have been, or are intended to be, permanently reinvested [disclosure of purpose], exclusive of those amounts which if remitted in the near future would result in little or no such tax by operation of relevant statutes currently in effect, aggregated $.......... at December 31, 1972."

[Issue Date: March, 1973.]

The next page is 13,601.

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AC Section U4111

Interest on Receivables and Payables: Accounting Interpretations of Section 4111

1. Advance Not Requiring Imputation

.001 *Question*—Section 4111 requires interest to be imputed for some rights to receive or obligations to pay money on fixed or determinable dates. In certain transactions, pipeline companies make advances to encourage exploration. These advances are satisfied by delivery of future production, but there is also a definite obligation to repay if the future production is insufficient to discharge the obligation by a definite date. Does section 4111 apply to such advances?

.002 *Interpretation*—No, paragraph .03b states that the section is not intended to apply to "amounts which do not require repayment in the future, but rather will be applied to the purchase price of the property, goods, or service involved (e.g., deposits or progress payments on construction contracts, advance payments for acquisition of resources and raw materials, advances to encourage exploration in the extractive industries)." The advance described in the question above is covered by the exclusion in paragraph .03b even though there may be an obligation to repay should the future production prove insufficient to discharge the obligation.

[Issue Date: June, 1972.]

→ *The next page is 13,701.* ←

AC Section U5131

The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of Section 5131

1. Intercompany Profit Eliminations Under Equity Method

.001 *Question*—In applying the equity method of accounting, intercompany profits or losses on assets still remaining with an investor or investee should be eliminated, giving effect to any income taxes on the intercompany transactions. (See section 5131.19a and sections 2051.07 and 2051.16.) Should all of the intercompany profit or loss be eliminated or only that portion related to the investor's common stock interest in the investee?

.002 *Interpretation*—Section 5131.19 normally requires an investor's net income and stockholder's equity to be the same from application of the equity method as would result from consolidation. Because the equity method is a "one-line" consolidation, however, the details reported in the investor's financial statements under the equity method will not be the same as would be reported in consolidated financial statements (see section 5131.19c). All intercompany transactions are eliminated in consolidation, but under the equity method intercompany profits or losses are normally eliminated only on assets still remaining on the books of an investor or an investee.

.003 Section 2051.13 provides for complete elimination of intercompany profits or losses in consolidation. It also states that the elimination of intercompany profit or loss may be allocated proportionately between the majority and minority interests. Whether all or a proportionate part of the intercompany profit or loss should be eliminated under the equity method depends largely upon the relationship between the investor and investee.

.004 When an investor controls an investee through majority voting interest and enters into a transaction with an investee which is not on an "arm's length" basis, none of the intercompany profit or loss from the transaction

should be recognized in income by the investor until it has been realized through transactions with third parties. The same treatment also applies for an investee established with the cooperation of an investor (including an investee established for the financing and operation or leasing of property sold to the investee by the investor) when control is exercised through guarantees of indebtedness, extension of credit and other special arrangements by the investor for the benefit of the investee, or because of ownership by the investor of warrants, convertible securities, etc. issued by the investee.

.005 In other cases, it would be appropriate for the investor to eliminate intercompany profit in relation to the investor's common stock interest in the investee. In these cases, the percentage of intercompany profit to be eliminated would be the same regardless of whether the transaction is "downstream" (i. e., a sale by the investor to the investee) or "upstream" (i. e., a sale by the investee to the investor). The following examples illustrate how these eliminations might be made. The examples assume an investor owns 30 percent of the common stock of an investee, the investment is accounted for under the equity method, and the income tax rate to both the investor and the investee is 40 percent.

.006 Assume an investor sells inventory items to the investee ("downstream"). At the investee's balance sheet date, the investee holds inventory for which the investor has recorded a gross profit of $100,000. The investor's net income would be reduced $18,000 to reflect a $30,000 reduction in gross profit and a $12,000 reduction in income tax expense. The elimination of intercompany profit might be reflected in the investor's balance sheet in various ways; for example, the investor might present $12,000 as a deferred tax charge (this is a "timing" difference under section 4091) and $30,000 as a deferred income credit. The income statement and balance sheet presentations will depend upon what is the most meaningful in the circumstances.

.007 Assume an investee sells inventory items to the investor ("upstream"). At the investor's balance sheet date, the investor holds inventory for which the investee has recorded a gross profit of $100,000. In computing the

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investor's equity "pickup," $60,000 ($100,000 less 40% of income tax) would be deducted from the investee's net income and $18,000 (the investor's share of the intercompany gross profit after income tax) would thereby be eliminated from the investor's equity income. Usually, the investor's investment account would also reflect the $18,000 intercompany profit elimination, but the elimination might also be reflected in various other ways; for example, the investor's inventory might be reduced $18,000.

[Issue Date: December, 1971.]

2. Investments in Partnerships and Ventures

.008 *Question*—Do the provisions of section 5131 apply to investments in partnerships and unincorporated joint ventures?

.009 *Interpretation*—Section 5131 applies only to investments in common stock of corporations and does not cover investments in partnerships and unincorporated joint ventures (also called undivided interests in ventures). Many of the provisions of section 5131 would be appropriate in accounting for investments in these unincorporated entities, however, as discussed below.

.010 Partnership profits and losses accrued by investor-partners are generally reflected in their financial statements as described in sections 5131.19c and 5131.19d. Likewise, most of the other provisions of section 5131.19 would be appropriate in accounting for a partnership interest, such as the elimination of intercompany profits and losses (see section 5131.19a).

.011 Income taxes should be provided on the profits accrued by investor-partners regardless of the tax basis employed in the partnership return. The tax liabilities applicable to partnership interests relate directly to the partners, and the accounting for income taxes generally contemplated by section 4091 is appropriate. [As amended by APB Opinion No. 23, December, 1971.]

.012 Generally, the above discussion of partnerships would also apply to unincorporated joint ventures, particularly the elimination of intercompany profits and the accounting for income taxes. However, because the investor-venturer owns an undivided interest in each asset

and is proportionately liable for its share of each liability, the provisions of section 5131.19c may not apply in some industries. For example, where it is the established industry practice (such as in some oil and gas venture accounting), the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

[Issue Date: December, 1971.]

3. Early Disclosure of Material Equity Adjustment

.013 *Question*—Section 5131 requires the equity method of accounting to be applied for a qualifying investment in common stock for fiscal periods beginning after December 31, 1971. The Board encouraged earlier adoption of section 5131. If a company owns an investment in 1971 for which it does not adopt the equity method until 1972 when the retroactive application will materially change the originally reported 1971 net income, should the amount of the change be disclosed in the 1971 financial statements when they are first issued?

.014 *Interpretation*—Yes, as a minimum the company should disclose in its 1971 financial statements the effect later retroactive application of the equity method will have on 1971 net income. In fact, the company should consider adopting the equity method in 1971 even though not required to do so.

.015 The Board issued section 5131 in March 1971 and provided a relatively long interval before its effective date because of the time required for companies to accumulate information, arrange for audits of investee companies, etc. Extenuating circumstances may therefore exist for not applying the equity method in 1971. However, any material effect of subsequent retroactive application should be disclosed in the 1971 financial statements.

[Issue Date: February, 1972.]

→ *The next page is 13,751.* ←

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AC Section U5141

Accounting for Intangible Assets: Accounting Interpretations of Section 5141

1. Intangible Assets

.001 *Question*—Section 5141 requires that intangible assets acquired after October 31, 1970 be amortized over a period not exceeding 40 years. Does this section encourage the capitalization of identifiable internally developed intangible assets which have been generally charged to expense in the past?

.002 *Interpretation*—Section 5141 does not change present accounting practice for intangible assets in any way except to require that intangible assets acquired after October 31, 1970 be amortized. Paragraph .06 notes that the costs of some identifiable intangible assets are now capitalized as deferred assets by some companies while other companies record the costs as expenses when incurred. This paragraph also specifies that the question of whether the costs of identifiable internally developed intangible assets are to be capitalized or charged to expense is not covered by the section. Therefore, the section does not encourage capitalizing the costs of a large initial advertising campaign for a new product or capitalizing the costs of training new employees.

[Issue Date: April, 1971.]

2. Goodwill in a Step Acquisition

.003 *Question*—Goodwill and other intangible assets acquired before November 1, 1970 (the effective date of section 5141) are not required to be amortized until their term of existence becomes limited (see Chapter 5 of ARB No. 43). Section 5141 requires all intangible assets acquired after October 31, 1970 to be amortized. When a company purchases two or more blocks of voting common stock of another company at various dates before and after November 1, 1970 and eventually obtains control or the ability to exercise significant influence over operating and financial

policies of the other company, how should the investor company subsequently account for any "goodwill" related to the investment?

.004 *Interpretation*—When a company in a series of purchases on a step-by-step basis acquires either a subsidiary which is consolidated or an investment which is accounted for under the equity method, the company should identify the cost of each investment, the fair value of the underlying assets acquired and the goodwill for each step purchase. This process would then identify the goodwill associated with each step purchase made before November 1, 1970 or after October 31, 1970 for each investment.[1]

.005 Goodwill associated with each step purchase acquired prior to November 1, 1970 should be accounted for in accordance with Chapter 5 of ARB No. 43 as amended by section 2010. Although amortization is not required in the absence of evidence that the goodwill has a limited term of existence, section 5141.35 encourages prospective amortization of such goodwill. Retroactive amortization is prohibited by section 5141.34.

.006 Goodwill associated with each step purchase acquired after October 31, 1970 should be amortized in accordance with section 5141. The period of amortization may not exceed forty years as specified by section 5141.29.

[Issue Date: March, 1973.]

→ *The next page is 13,901.* ←

[1] The accounting for a step acquisition of a subsidiary which is consolidated is described by section 2051.09 (see also sections 1091.87, 1091.93, and 1091.94). As specified by sections 5131.19b and 5131.19n, similar procedures apply for a step acquisition of an investment carried under the equity method.

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AC Section U5362

Early Extinguishment of Debt: Accounting Interpretations of Section 5362

1. Debt Tendered to Exercise Warrants

.001 *Question*—Section 5362 stipulates that gain or loss should be recognized currently in income when any form of debt security is reacquired by the issuer before its scheduled maturity except through conversion by the holder. Does section 5362 apply to debt tendered to exercise warrants which were originally issued with that debt but which were detachable?

.002 *Interpretation*—Section 5362 does not apply to debt tendered to exercise detachable warrants which were originally issued with that debt if the debt is permitted to be tendered towards the exercise price of the warrants under the terms of the securities at issuance. The tendering of the debt in such a case would be a conversion "pursuant to the existing conversion privileges of the holder" (see section 5362.02).

.003 Section 5362 does not apply to a conversion of debt nor does the section specify the accounting for conversion of debt. In practice, however, the carrying amount of the debt, including any unamortized premium or discount, is credited to the capital accounts upon conversion to reflect the stock issued and no gain or loss is recognized.

[Issue Date: March, 1973.]

AC

CROSS-REFERENCE TABLES

. . . finding list of pronouncements . . . sources of sections in current text . . . schedule of changes in accounting pronouncements . . . finding list of accounting interpretations . . . AICPA Industry Audit/Accounting Guides and Statements of Position

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APPENDIX A

Finding List of Pronouncements

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Opinion 6, Par. 22	(Superseded by APB Opinion 16)	
Opinion 6, Par. 23	(Superseded by APB Opinion 11)	
Opinion 7	(Superseded by FASB Statement No. 13)	
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Opinion 9	Reporting the Results of Operations	2010

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Opinion 9, Par. 20, 21, 22	(Superseded by APB Opinion 30)	
Opinion 9, Par. 23, 24	(Superseded by FASB Statement No. 16)	
Opinion 9, Par. 25	(Superseded by APB Opinion 20)	
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Opinion 9, Exh. A-D	(Superseded by APB Opinion 30)	
Opinion 10, Par. 2, 3, 4	(Superseded by APB Opinion 18)	
Opinion 10, Par. 5	(Superseded by APB Opinion 16)	
Opinion 10, Par. 6	Tax Allocation Accounts—Discounting	4092
Opinion 10, Par. 7	Offsetting Securities Against Taxes Payable	2032
Opinion 10, Par. 8, 9	(Superseded by APB Opinion 14)	
Opinion 10, Par. 10, 11	Liquidation Preference of Preferred Stock	5515
Opinion 10, Par. 12	Installment Method of Accounting	4020
Opinion 11	Accounting for Income Taxes	4091-4091A
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Opinion 11, Par. 41	(Superseded by APB Opinion 23)	
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Opinion 15	Earnings per Share	2011-2011D
Opinion 16	Business Combinations	1091
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Statement 14	Financial Reporting for Segments of a Business Enterprise	2081
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Statement 19	Financial Accounting and Reporting by Oil and Gas Producing Companies	6021
Statement 20	Accounting for Forward Exchange Contracts	1084
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Interpretation 4	Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method: An Interpretation of FASB Statement No. 2	4211-1
Interpretation 5	(Superseded by FASB Statement No. 7)	
Interpretation 6	Applicability of FASB Statement No. 2 to Computer Software: An Interpretation of FASB Statement No. 2	4211-3
Interpretation 7	Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises: An Interpretation of FASB Statement No. 7	2062-1
Interpretation 8	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security: An Interpretation of FASB Statement No. 6	2033-1
Interpretation 9	Applying APB Opinion Nos. 16 and 17 When a Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method: An Interpretation of APB Opinion Nos. 16 and 17	1091-1

FASB Interpretations		Sec.
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Interpretation 11	Changes in Market Value after the Balance Sheet Date: An Interpretation of FASB Statement No. 12	5132–2
Interpretation 12	Accounting for Previously Established Allowance Accounts: An Interpretation of FASB Statement No. 12	5132–3
Interpretation 13	Consolidation of a Parent and Its Subsidiaries Having Different Balance Sheet Dates: An Interpretation of FASB Statement No. 12	5132–4
Interpretation 14	Reasonable Estimation of the Amount of a Loss: An Interpretation of FASB Statement No. 5	4311–1
Interpretation 15	Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company: An Interpretation of FASB Statement No. 8	1083–1
Interpretation 16	Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable: An Interpretation of FASB Statement No. 12	5132–5
Interpretation 17	Applying the Lower of Cost or Market Rule in Translated Financial Statements: An Interpretation of FASB Statement No. 8	1083–2
Interpretation 18	Accounting for Income Taxes in Interim Periods: An Interpretation of APB Opinion No. 28	2071-1
Interpretation 19	Lessee Guarantee of the Residual Value of Leased Property: An Interpretation of FASB Statement No. 13	4053-1
Interpretation 20	Reporting Accounting Changes under AICPA Statements of Position: An Interpretation of APB Opinion No. 20	1051-2
Interpretation 21	Accounting for Leases in a Business Combination: An Interpretation of FASB Statement No. 13	4053-2
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	Disclosure of Accounting Policies	9001

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2	Valuation and Presentation of Inventories in the Context of the Historical Cost System	9002
3	Consolidated Financial Statements	9003
4	Depreciation Accounting	9004
5	Information to be Disclosed in Financial Statements	9005
6	Accounting Responses to Changing Prices	9006
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8	Unusual and Prior Period Items and Changes in Accounting Policies	9008
9	Accounting for Research and Development Activities	9009

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APPENDIX B

Sources of Sections in Current Text

Sections in Volumes 3 & 4 are cross-referenced to Accounting Research Bulletins, Opinions and Statements of the Accounting Principles Board, Statements and Interpretations of the Financial Accounting Standards Board, and Statements of the International Accounting Standards Committee

Sec.		Source
	Financial Accounting—General	
100	Preface	ARB 43
510	Introduction	ARB 43
520	Excerpts from AICPA Code of Professional Ethics	Rule of Conduct 203
1010	Fundamentals of Financial Accounting	APB Stmt. 1
1020	Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises	APB Stmt. 4
1021	Purpose and Nature of the Statement	APB Stmt. 4, Chap. 1, as amended
1022	Summary of the Statement	APB Stmt. 4, Chap. 2, as amended
1023	The Environment of Financial Accounting	APB Stmt. 4, Chap. 3, as amended
1024	Objectives of Financial Accounting and Financial Statements	APB Stmt. 4, Chap. 4, as amended
1025	Basic Features and Basic Elements of Financial Accounting	APB Stmt. 4, Chap. 5
1026	Generally Accepted Accounting Principles—Pervasive Principles	APB Stmt. 4, Chap. 6, as amended
1027	Generally Accepted Accounting Principles—Broad Operating Principles	APB Stmt. 4, Chap. 7, as amended
1028	Generally Accepted Accounting Principles—Detailed Operating Principles	APB Stmt. 4, Chap. 8, as amended
1029	Financial Accounting in the Future	APB Stmt. 4, Chap. 9, as amended
1041	Accounting for Nonmonetary Transactions	APB Opinion 29
1051	Accounting Changes	APB Opinion 20, as amended
1051–1	Accounting Changes Related to the Cost of Inventory: An Interpretation of Section 1051	FASB Int. 1

Sec.		Source
1051-2	Reporting Accounting Changes under AICPA Statements of Position: An Interpretation of Section 1051	FASB Int. 20
1071	Financial Statements Restated for General Price-Level Changes	APB Stmt. 3, as amended
1081	Foreign Operations and Foreign Exchange	ARB 43, Chap. 12, as amended
1083	Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements	FASB Stmt. 8
1083-1	Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company: An Interpretation of Section 1083	FASB Int. 15
1083-2	Applying the Lower of Cost or Market Rule in Translated Financial Statements: An Interpretation of Section 1083	FASB Int. 17
1084	Accounting for Forward Exchange Contracts	FASB Stmt. 20
1091	Accounting for Business Combinations	APB Opinion 16, as amended
1091-1	Applying Sections 1091 and 5141 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method: An Interpretation of Sections 1091 and 5141	FASB Int. 9
1092	Extension of "Grandfather" Provisions for Business Combinations	FASB Stmt. 10
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2010	Reporting the Results of Operations	APB Opinion 9, as amended
2011	Earnings Per Share	APB Opinion 15, as amended
2012	Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions	APB Opinion 30, as amended
2013	Reporting Gains and Losses from Extinguishment of Debt	FASB Stmt. 4
2014	Prior Period Adjustments	FASB Stmt. 16
2021	Reporting Changes in Financial Position	APB Opinion 19, as amended
2031	Current Assets and Current Liabilities	ARB 43, Chap. 3A, as amended
2032	Offsetting Securities Against Taxes Payable	APB Opinion 10, Par. 7
2033	Classification of Short-Term Obligations Expected To Be Refinanced	FASB Stmt. 6
2033-1	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security: An Interpretation of Section 2033	FASB Int. 8

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Sec.		Source
2041	Comparative Financial Statements	ARB 43, Chap. 2A, as amended
2042	Capital Changes	APB Opinion 12, Pars. 9, 10
2043	Disclosure of Depreciable Assets and Depreciation	APB Opinion 12, Pars. 4, 5
2044	Classification and Disclosure of Allowances	APB Opinion 12, Pars. 2, 3
2045	Disclosure of Accounting Policies	APB Opinion 22, as amended
2051	Consolidated Financial Statements	ARB 43, Chap. 1A, Par. 3; ARB 51, as amended
2062	Accounting and Reporting by Development Stage Enterprises	FASB Stmt. 7
2062–1	Applying Section 2062 in Financial Statements of Established Operating Enterprises: An Interpretation of Section 2062	FASB Int. 7
2071	Interim Financial Reporting	APB Opinion 28, as amended
2071–1	Accounting for Income Taxes in Interim Periods: An Interpretation of Section 2071	FASB Int. 18
2072	Reporting Accounting Changes in Interim Financial Statements	FASB Stmt. 3
2081	Financial Reporting for Segments of a Business Enterprise	FASB Stmt. 14
2082	Financial Reporting for Segments of a Business Enterprise—Interim Financial Statements	FASB Stmt. 18
2083	Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises	FASB Stmt. 21

Revenue & Expense

Sec.		Source
4010	Unrealized Profit	ARB 43, Chap. 1A, Par. 1
4020	Installment Method of Accounting	APB Opinion 10, Par. 12
4031	Long-Term Construction-Type Contracts	ARB 45
4041	Cost-Plus-Fixed-Fee Contracts	ARB 43, Chap. 11A
4042	Renegotiation	ARB 43, Chap. 11B, as amended
4043	Terminated War and Defense Contracts	ARB 43, Chap. 11C
4053	Accounting for Leases	FASB Stmt. 13
4053–1	Lessee Guarantee of the Residual Value of Leased Property: An Interpretation of Section 4053	FASB Int. 19

Sec.		Source
4053-2	Accounting for Leases in a Business Combination: An Interpretation of Section 4053	FASB Int. 21
4054	Accounting for Leases—Initial Direct Costs	FASB Stmt. 17
4055	Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt	FASB Stmt. 22
4061	Compensation Involved in Stock Option and Stock Purchase Plans	ARB 43, Chap. 13B, as amended
4062	Accounting for Stock Issued to Employees	APB Opinion 25
4063	Accounting for the Cost of Pension Plans	APB Opinion 8
4063-1	Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974: An Interpretation of Section 4063	FASB Int. 3
4064	Deferred Compensation Contracts	APB Opinion 12, Pars. 6—8
4071	Depreciation and High Costs	ARB 43, Chap. 9A
4072	Depreciation on Appreciation	APB Opinion 6, Par. 17
4073	Emergency Facilities—Depreciation and Amortization	ARB 43, Chap. 9C, as amended
4074	Declining-Balance Depreciation	ARB 44 (Revised), as amended
4081	Accounting for Real and Personal Property Taxes	ARB 43, Chap. 10A, as amended
4091	Accounting for Income Taxes	APB Opinion 11, as amended
4091-1	Applicability of Indefinite Reversal Criteria to Timing Differences: An Interpretation of Sections 4091 and 4095	FASB Int. 22
4092	Tax Allocation Accounts—Discounting	APB Opinion 10, Par. 6
4093	New Depreciation Guidelines and Rules	APB Opinion 1, as amended
4094	Accounting for the Investment Credit	APB Opinions 2 and 4, as amended
4095	Accounting for Income Taxes—Special Areas	APB Opinion 23, as amended
4096	Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (other than Subsidiaries and Corporate Joint Ventures)	APB Opinion 24
4097	Accounting for Income Taxes—Oil and Gas Producing Companies	FASB Stmt. 9
4111	Interest on Receivables and Payables	APB Opinion 21
4211	Accounting for Research and Development Costs	FASB Stmt. 2

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Sec.		Source
4211-1	Applicability of Section 4211 to Business Combinations Accounted for by the Purchase Method: An Interpretation of Section 4211	FASB Int. 4
4211-3	Applicability of Section 4211 to Computer Software: An Interpretation of Section 4211	FASB Int. 6
4311	Accounting for Contingencies	FASB Stmt. 5, as amended
4311-1	Reasonable Estimation of the Amount of a Loss: An Interpretation of Section 4311	FASB Int. 14
4312	Accounting for Contingencies—Transition Method	FASB Stmt. 11
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5111	Receivables from Officers, Employees or Affiliated Companies	ARB 43, Chap. 1A, Par. 5
5121	Inventory Pricing	ARB 43, Chap. 4, as amended
5131	The Equity Method of Accounting for Investments in Common Stock	APB Opinion 18, as amended
5132	Accounting for Certain Marketable Securities	FASB Stmt. 12
5132-1	Application of Section 5132 to Personal Financial Statements: An Interpretation of Section 5132	FASB Int. 10
5132-2	Changes in Market Value after the Balance Sheet Date: An Interpretation of Section 5132	FASB Int. 11
5132-3	Accounting for Previously Established Allowance Accounts: An Interpretation of Section 5132	FASB Int. 12
5132-4	Consolidation of a Parent and Its Subsidiaries Having Different Balance Sheet Dates: An Interpretation of Section 5132	FASB Int. 13
5132-5	Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable: An Interpretation of Section 5132	FASB Int. 16
5141	Accounting for Intangible Assets	APB Opinion 17, as amended
	Liabilities & Deferred Credits	
5361	Amortization of Debt Discount and Expense or Premium	APB Opinion 12, Pars. 16, 17
5362	Early Extinguishment of Debt	APB Opinion 26, as amended
5363	Accounting by Debtors and Creditors for Troubled Debt Restructurings	FASB Stmt. 15

Sec.		Source
	Capital	
5511	Capital Surplus	ARB 43, Chap. 1A, Par. 2
5512	Donated Stock	ARB 43, Chap. 1A, Par. 6
5515	Liquidation Preference of Preferred Stock	APB Opinion 10, Pars. 10, 11, as amended
5516	Convertible Debt and Debt Issued with Stock Purchase Warrants	APB Opinion 14
5541	Accounting for Treasury Stock	ARB 43, Chap. 1A, Par. 4
5542	Profits or Losses on Treasury Stock	ARB 43, Chap. 1B, as amended
5561	Stock Dividends and Stock Split-Ups	ARB 43, Chap. 7B, as amended
5581	Quasi-Reorganization or Corporate Readjustment	ARB 43, Chap. 7A
5582	Discontinuance of Dating Earned Surplus	ARB 46
	Special Industry Applications	
6011	Accounting Principles for Regulated Industries	APB Opinion 2, Addendum
6021	Financial Accounting and Reporting by Oil and Gas Producing Companies	FASB Stmt. 19
	International Accounting Standards	
9000	Preface to Statement of International Accounting Standards	Preface
9001	Disclosure of Accounting Policies	IAS 1
9002	Valuation and Presentation of Inventories in the Context of the Historical Cost System	IAS 2
9003	Consolidated Financial Statements	IAS 3
9004	Depreciation Accounting	IAS 4
9005	Information to be Disclosed in Financial Statements	IAS 5
9006	Accounting Responses to Changing Prices	IAS 6
9007	Statement of Changes in Financial Position	IAS 7
9008	Unusual and Prior Period Items and Changes in Accounting Policies	IAS 8
9009	Accounting for Research and Development Activities	IAS 9

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APPENDIX C

Schedule of Changes in Accounting Pronouncements

The following schedule lists the changes that have been made in Accounting Research Bulletins 43 through 51, the Opinions and Statements of the Accounting Principles Board, and pronouncements of the Financial Accounting Standards Board.

ARB	Chap.	Par.		Date of Change
43	1B		Amended by APB 6, Par. 12, 13	12/31/65
43	2A	3	Amended by APB 20	7/31/71
43	2B		Superseded by APB 9	12/31/66
43	3A	6	Amended by APB 21, Par. 16	10/ 1/71
43	3A	8	Amended by FASB Stmt. 6	12/31/75
43	3A	10	Amended by APB 6, Par. 14	12/31/65
43	3B		Superseded by APB 10, Par. 7	12/31/66
43	4	14	Amended by APB 20	7/31/71
43	5	5	Amended by APB 9	12/31/66
43	5	6	Amended by APB 9	12/31/66
43	5	7	Amended by APB 6, Par. 15	12/31/65
43	5	8	Amended by APB 9	12/31/66
43	5	9	Amended by APB 9	12/31/66
43	5	10	Superseded by APB 16	10/31/70
43	5		Superseded by APB 17	10/31/70
43	6		Superseded by FASB 5	7/ 1/75
43	7B	6	Amended by APB 6, Par. 16	12/31/65
43	7C		Superseded by ARB 48	1/57
43	8		Superseded by APB 9	12/31/66
43	9B		Superseded by APB 6, Par. 17	12/31/65
43	9C		Amended by APB 6, Par. 23	12/31/65
43	9C	11-13	Amended by APB 11	12/31/67
43	10A	19	Amended by APB 9	12/31/66
43	10A	19	Amended by FASB Stmt. 16	10/15/77
43	10B		Amended by APB 6, Par. 23	12/31/65
43	10B	15, 17	Amended by APB 9	12/31/66
43	10B		Superseded by APB 11	12/31/67
43	11B	8	Amended by APB 11	12/31/67
43	11B	9	Amended by APB 9	12/31/66
43	11B	9	Amended by APB 30	9/30/73
43	11B	9	Amended by FASB Stmt. 16	10/15/77
43	12	5	Amended by FASB Stmt. 8	1/ 1/76
43	12	7	Superseded by FASB Stmt. 8	1/ 1/76
43	12	10-22	Superseded by FASB Stmt. 8	1/ 1/76
43	12	12	Amended by APB 6, Par. 18	12/31/65
43	12	18	Amended by APB 6, Par. 18	12/31/65
43	12	21	Amended by APB 9	12/31/66
43	12	21	Amended by APB 30	9/30/73

ARB	Chap.	Par.		Date of Change
43	13A		Superseded by APB 8	12/31/66
43	13B		Amended by APB 25	12/31/72
43	14		Superseded by APB 5	9/64
43	15	4	Amended by APB 21	10/1/71
43	15	7	Amended by APB 9	12/31/66
43	15	11	Amended by APB 11	12/31/67
43	15	12	Amended by APB 6, Par. 19	12/31/65
43	15	17	Amended by APB 9	12/31/66
43	15		Superseded by APB 26	1/ 1/73
44			Superseded by ARB 44 (Revised)	7/58
44 (Rev.)			Amended by APB 6, Par. 23	12/31/65
44 (Rev.)		3	Amended by APB 20	7/31/71
44 (Rev.)		9	Amended by APB 6, Par. 20	12/31/65
44 (Rev.)		4, 5, 7, 10	Amended by APB 11	12/31/67
Letter, Dated April 15, 1959			Superseded by APB 11	12/31/67
47			Superseded by APB 8	12/31/66
48		5	Amended by APB 6, Par. 22	12/31/65
48		6	Amended by APB 6, Par. 22	12/31/65
48		12	Amended by APB 10, Par. 5	12/31/66
48			Superseded by APB 16	10/31/70
49			Superseded by APB 9	12/31/66
50			Superseded by FASB 5	7/ 1/75
51		7, 8	Superseded by APB 16	10/31/70
51		16	Superseded by APB 23	12/31/71
51		17	Amended by APB 11	12/31/67
51		19	Amended by APB 10, Par. 2-4	12/31/66
51		20	Amended by APB 10, Par. 2-4	12/31/66
51		19-21	Amended by APB 18	12/31/71
APB Opinions				
1		1, 5, 6	Amended by APB 11	12/31/67
2			Amended by APB 4	3/64
3			Superseded by APB 19	9/30/71
5		14	Amended by APB 31	12/31/73
5		16-18	Superseded by APB 31	12/31/73
5		20	Amended by APB 31	12/31/73
5		21	Amended by APB 11	12/31/67
5		23	Amended by APB 31	12/31/73
5			Superseded by FASB Stmt. 13	1/ 1/77
6		12c	Superseded by APB 16	10/31/70
6		15	Superseded by APB 17	10/31/70
6		18	Superseded by FASB Stmt. 8	1/ 1/76
6		19	Superseded by APB 26	1/ 1/73
6		21	Superseded by APB 11	12/31/67
6		22	Superseded by APB 16	10/31/70
6		23	Superseded by APB 11	12/31/67
7		8	Amended by APB 27	12/31/72
7		12	Superseded by APB 27	12/31/72
7			Superseded by FASB Stmt. 13	1/ 1/77
9		3	Amended by APB 30	9/30/73
9		3	Amended by FASB Stmt. 16	10/15/77

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APB Opinions	Par.		Date of Change
9	6	Amended by APB 13	12/31/68
9	8	Amended by APB 30	9/30/73
9	8	Amended by FASB Stmt. 16	10/15/77
9	17	Amended by APB 30	9/30/73
9	18	Amended by APB 20	7/31/71
9	18	Amended by FASB Stmt. 16	10/15/77
9	20	Amended by APB 20	7/31/71
9	20-22	Superseded by APB 30	9/30/73
9	23-24	Superseded by FASB Stmt. 16	10/15/77
9	25	Superseded by APB 20	7/31/71
9	27	Amended by APB 30	9/30/73
9	29	Amended by APB 30	9/30/73
9	Exh. A-D	Superseded by APB 30	9/20/73
9	30-51, Exh. E	Superseded by APB 15	12/31/68
10	2-4	Superseded by APB 18	12/31/71
10	5	Superseded by APB 16	10/31/70
10	8, 9	Superseded by APB 14	12/31/66
10	11b	Amended by APB 15	12/31/68
11	6	Amended by APB 28	12/31/73
11	38, 39	Superseded by APB 23	12/31/71
11	40	Superseded by FASB Stmt. 9	12/ 1/75
11	41	Superseded by APB 23	12/31/71
12	11-15	Superseded by APB 14	12/31/66
15	13	Amended by APB 20	7/31/71
15	13	Amended by APB 30	9/30/73
15	30	Amended by APB 30	9/30/73
15	45	Amended by FASB Stmt. 21	4/30/78
16	99	Amended by FASB Stmt. 10	11/ 1/75
17	4	Amended by FASB Stmt. 2	1/1/75
17	6	Amended by FASB Stmt. 2	1/1/75
17	31	Amended by APB 30	9/30/73
18	15	Superseded by FASB Stmt. 13	1/ 1/77
18	19d	Amended by APB 30	9/30/73
18	19j	Superseded by APB 23	12/31/71
19	10	Amended by APB 30	9/30/73
20	5	Amended by APB 30	9/30/73
22	13	Amended by FASB Stmt. 2	1/ 1/75
22	13	Amended by FASB Stmt. 8	1/ 1/76
23	2	Amended by FASB Stmt. 9	12/ 1/75
26	2	Amended by FASB Stmt. 15	12/31/77
26	20	Amended by APB 30	9/30/73
26	20	Amended by FASB Stmt. 4	3/31/75
27		Superseded by FASB Stmt. 13	1/ 1/77
28	27	Superseded by FASB Stmt. 3	12/31/74
28	31	Amended by FASB Stmt. 3	12/31/74
30		Amended by FASB Stmt. 4	3/31/75
30	25	Amended by FASB Stmt. 16	10/15/77
31		Superseded by FASB Stmt. 13	1/ 1/77

APB Statements	Par.		Date of Change
2		Superseded by FASB Stmt. 14	12/16/76
3	App. B	Amended by APB 21	10/1/71
4	8, 14, 15 35, 46, 80, 190, 191, 194	Amended by APB 19	9/30/71
4	183, 187, 196	Amended by APB 18	12/31/71
4	178, 199	Amended by APB 20	7/31/71
4	145, 181	Amended by APB 21	10/1/71
4	10, 81, 191, 199	Amended by APB 22	12/31/71
4	182, 198, 199	Amended by APB 29	9/30/73
4	198	Amended by APB 30	9/30/73
FASB Statements			
1		Superseded by FASB Stmt. 8	1/ 1/76
5	20	Amended by FASB Stmt. 11	12/31/75
8	27	Amended by FASB Stmt. 20	1/ 1/78
8	35	Amended by FASB Stmt. 20	1/ 1/78
9		Superseded by FASB Stmt. 19	12/15/78
13	5m	Amended by FASB Stmt. 17	1/1/78
13	14	Amended by FASB Stmt. 22	7/1/78
13	17f	Amended by FASB Stmt. 22	7/1/78
14	4	Superseded by FASB Stmt. 18	12/1/77
14	41	Amended by FASB Stmt. 18	12/1/77
14	41	Amended by FASB Stmt. 21	4/30/78
14	73	Superseded by FASB Stmt. 18	12/1/77
FASB Interpretations			
2		Superseded by FASB Stmt. 15	12/31/77
5		Superseded by FASB Stmt. 7	1/1/76

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APPENDIX D

Finding List of Accounting Interpretations

Sections of the current text are cross-referenced to AICPA Accounting Interpretations and FASB Interpretations. Section numbers preceded by the letter "U" refer to AICPA Accounting Interpretations

Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
1051	.04	Reporting Accounting Changes under AICPA Statements of Position (FASB Int. 20)	1051-2.01
	.16	Accounting Changes Related to the Cost of Inventory (FASB Int. 1)	1051-1.01
	.16	Change in Method of Accounting for Investment Credit (No. 4)	U4094.011
	.18	EPS for "Catch-up" Adjustment (No. 2)	U1051.010
	.19	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
	.19	EPS for "Catch-up" Adjustment (No. 2)	U1051.010
	.20	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
	.20	EPS for "Catch-up" Adjustment (No. 2)	U1051.010
	.21	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
	.21	Change in Method of Accounting for Investment Credit (No. 4)	U4094.011
	.24	Change in Method of Accounting for Investment Credit (No. 4)	U4094.011
	.27	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
	.28	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
	.29	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
	.31	Reasonable Estimation of the Amount of a Loss (FASB Int. 14)	4311-1.01
	.34	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
	.36	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
1083	.007	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.011	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.012	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.013	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01

Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
1083	.014	Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company (FASB Int. 15)	1083-1.01
	.014	Applying the Lower of Cost or Market Rule in Translated Financial Statements ((FASB Int. 17)	1083-2.01
	.016	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.032	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.033	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.035	Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company (FASB Int. 15)	1083-1.01
	.035	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.036	Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company (FASB Int. 15)	1083-1.01
	.036	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.046	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.166	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
	.192	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
1091	.05	Applying Purchase Accounting (No. 8)	U1091.025
	.05	Acquisition of Minority Interest (No. 26)	U1091.099
	.05	Entities under Common Control in a Business Combination (No. 27)	U1091.103
	.05	Transfers and Exchanges Between Companies Under Common Control (No. 39)	U1091.151
	.28	Forced Sale of Stock (No. 34)	U1091.136
	.43	Applying Purchase Accounting (No. 8)	U1091.025
	.43	Acquisition of Minority Interest (No. 26)	U1091.099
	.43	Entities under Common Control in a Business Combination (No. 27)	U1091.103
	.43	Several Companies in a Single Business Combination (No. 38)	U1091.147
	.43	Transfers and Exchanges Between Companies Under Common Control (No. 39)	U1091.151
	.45	Use of Restricted Stock To Effect a Business Combination (No. 11)	U1091.036
	.45	All Shares Must Be Exchanged to Pool (No. 25)	U1091.090
	.46	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
	.46	Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method (FASB Int. 4)	4211-1.01

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Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
1091	.46	Ratio of Exchange (No. 1)	U1091.001
	.46	Notification to Stockholders (No. 2)	U1091.005
	.46	Intercorporate Investment Exceeding 10 Per Cent Limit (No. 3)	U1091.009
	.46	Consummation Date for a Business Combination (No. 4)	U1091.011
	.46	"Two-Year" Provisions at Effective Date (No. 9)	U1091.032
	.46	Effect of Termination (No. 10)	U1091.034
	.46	Use of Restricted Stock To Effect a Business Combination (No. 11)	U1091.036
	.46	Wholly Owned Subsidiary (No. 18)	U1091.061
	.46	Disposition of Assets to Comply with an Order (No. 22)	U1091.077
	.46	"Grandfather" for Subsidiaries (No. 24)	U1091.086
	.46	All Shares Must Be Exchanged to Pool (No. 25)	U1091.090
	.46	Acquisition of Minority Interest (No. 26)	U1091.099
	.46	Entities under Common Control in a Business Combination (No. 27)	U1091.103
	.46	Pooling by Subsidiary of Personal Holding Company (No. 28)	U1091.112
	.46	Option May Initiate Combination (No. 29)	U1091.115
	.46	No Pooling with Wholly Owned Sub. (No. 36)	U1091.141
	.46	Several Companies in a Single Business Combination (No. 38)	U1091.147
	.47	Ratio of Exchange (No. 1)	U1091.001
	.47	Consummation Date for a Business Combination (No. 4)	U1091.011
	.47	Pooling Not Completed within One Year (No. 5)	U1091.016
	.47	Registered Stock Exchanged for Restricted Stock (No. 6)	U1091.019
	.47	Pooling under "Old Rules" (No. 7)	U1091.021
	.47	Applying Purchase Accounting (No. 8)	U1091.025
	.47	"Two-Year" Provisions at Effective Date (No. 9)	U1091.032
	.47	Effect of Termination (No. 10)	U1091.034
	.47	Use of Restricted Stock To Effect a Business Combination (No. 11)	U1091.036
	.47	Warrants May Defeat Pooling (No. 12)	U1091.040
	.47	Two-Class Common for Pooling (No. 13)	U1091.045
	.47	Contingent Shares Defeat Pooling (No. 14)	U1091.048
	.47	Equity and Debt Issued for Common Before Pooling (No. 19)	U1091.065
	.47	Treasury Stock Allowed for Pooling (No. 20)	U1091.067
	.47	Disposition of Assets to Comply with an Order (No. 22)	U1091.077
	.47	"Grandfather" for Subsidiaries (No. 24)	U1091.086
	.47	All Shares Must Be Exchanged to Pool (No. 25)	U1091.090
	.47	Entities under Common Control in a Business Combination (No. 27)	U1091.103

Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
1091	.47	Option May Initiate Combination (No. 29)	U1091.115
	.47	Representations in a Pooling (No. 30)	U1091.119
	.47	Employment Contingencies in a Pooling (No. 31)	U1091.126
	.47	Stock Options in a Pooling (No. 32)	U1091.130
	.47	Several Companies in a Single Business Combination (No. 38)	U1091.147
	.48	Use of Restricted Stock to Effect a Business Combination (No. 11)	U1091.036
	.48	Pooling with "Bailout" (No. 21)	U1091.074
	.48	Disposition of Assets to Comply with an Order (No. 22)	U1091.077
	.48	"Grandfather" for Subsidiaries (No. 24)	U1091.086
	.48	Pooling Contingent on "Bailout" (No. 37)	U1091.144
	.51	Consummation Date for a Business Combination (No. 4)	U1091.011
	.53	Representations in a Pooling (No. 30)	U1091.119
	.54	Treasury Stock Allowed for Pooling (No. 20)	U1091.067
	.55	Paragraph .99 Is Not Mandatory (No. 15)	U1091.050
	.55	Intercorporate Investment at 10/31/70 (No. 17)	U1091.057
	.58	Costs of Maintaining an "Acquisitions" Department (No. 33)	U1091.133
	.61	Consummation Date for a Business Combination (No. 4)	U1091.011
	.61	Retroactive Disclosure of Pooling (No. 23)	U1091.080
	.65	Retroactive Disclosure of Pooling (No. 23)	U1091.080
	.66	Applying Purchase Accounting (No. 8)	U1091.025
	.69	Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method (FASB Int. 4)	4211-1.01
	.76	Costs of Maintaining an "Acquisitions" Department (No. 33)	U1091.133
	.76	Registration Costs in a Purchase (No. 35)	U1091.138
	.87	Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method (FASB Int. 9)	1091-1.01
	.87	Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method (FASB Int. 4)	4211-1.01
	.87	Goodwill in a Step Acquisition (No. 2)	U5141.003
	.88	Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method (FASB Int. 9)	1091-1.01
	.88	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
	.88	Registration Costs in a Purchase (No. 35)	U1091.138
	.93	Consummation Date for a Business Combination (No. 4)	U1091.011

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Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
1091	.93	Goodwill in a Step Acquisition (No. 2)	U5141.003
	.94	Goodwill in a Step Acquisition (No. 2)	U5141.003
	.97	Pooling Not Completed within One Year (No. 5)	U1091.016
	.97	Pooling under "Old Rules" (No. 7)	U1091.021
	.98	Pooling under "Old Rules" (No. 7)	U1091.021
	.99	Paragraph .99 Is Not Mandatory (No. 15)	U1091.050
	.99	Changes in Intercorporate Investments (No. 16)	U1091.054
	.99	Intercorporate Investment at 10/31/70 (No. 17)	U1091.057
	.99	"Grandfather" for Subsidiaries (No. 24)	U1091.086
	.99	Acquisition of Minority Interest (No. 26)	U1091.099
2010	.17	Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises (FASB Int. 7)	2062-1.01
	.17	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
	.17	Investment Credit Is Prior Period Adjustment (No. 5)	U4094.021
	.25	Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises (FASB Int. 7)	2062-1.01
2011	.05	Corporations and Financial Presentations Excepted (No. 9)	U2011.068
	.05	Closely Held Corporations (No. 10)	U2011.072
	.05	Subchapter S Corporations (No. 13)	U2011.081
	.05	Unaudited Financial Statements (No. 14)	U2011.082
	.06	Corporations and Financial Presentations Excepted (No. 9)	U2011.068
	.06	Closely Held Corporations (No. 10)	U2011.072
	.06	Subchapter S Corporations (No. 13)	U2011.081
	.06	Unaudited Financial Statements (No. 14)	U2011.082
	.12	Presentation of Earnings per Share	U2011.010
	.12	Reporting Loss per Share (No. 15)	U2011.083
	.13	Presentation of Earnings per Share	U2011.010
	.13	Dual Presentation (No. 6)	U2011.061
	.13	Primary Earnings per Share (No. 7)	U2011.064
	.13	Fully Diluted Earnings per Share (No. 8)	U2011.066
	.13	EPS for Extraordinary Items (No. 16)	U2011.084
	.14	Presentation of Earnings per Share	U2011.010
	.14	Supplementary Data	U2011.046
	.14	Other Potentially Dilutive Securities (No. 3)	U2011.054
	.14	Dilution—Dilutive Security (No. 4)	U2011.056
	.14	Dilution Less Than 3% (No. 11)	U2011.073
	.14	Simple Capital Structure (No. 17)	U2011.087
	.14	Complex Capital Structure (No. 18)	U2011.088

Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2011	.14	EPS for Simple and Complex Capital Structures (No. 19)	U2011.090
	.14	Dual Presentation for Corporation with Simple Capital Structure (No. 20)	U2011.092
	.14	Earnings Applicable to Common Stock (No. 24)	U2011.101
	.14	Supplementary Data (No. 101)	U2011.354
	.15	Presentation of Earnings per Share	U2011.010
	.15	Classification of Securities	U2011.013
	.15	Disclosure	U2011.045
	.15	Primary Earnings per Share (No. 7)	U2011.064
	.15	Fully Diluted Earnings per Share (No. 8)	U2011.066
	.15	Dilution Less Than 3% (No. 11)	U2011.073
	.15	3% Test (No. 12)	U2011.076
	.15	Complex Capital Structure (No. 18)	U2011.088
	.15	EPS for Simple and Complex Capital Structures (No. 19)	U2011.090
	.15	Earnings Applicable to Common Stock (No. 24)	U2011.101
	.15	Classification and Assumed Conversion (No. 26)	U2011.111
	.15	Conversion Assumed for Primary Only (No. 43)	U2011.147
	.15	Explanation of 20% Provision (No. 74)	U2011.255
	.16	Fully Diluted Earnings per Share	U2011.019
	.16	Disclosure	U2011.045
	.16	Dual Presentation (No. 6)	U2011.061
	.16	Primary v. Fully Diluted EPS (No. 21)	U2011.095
	.16	Captions for Earnings per Share Presentations (No. 22)	U2011.097
	.17	Dilution Less Than 3% (No. 11)	U2011.073
	.17	Complex Capital Structure (No. 18)	U2011.088
	.17	Dual Presentation for Corporation with Simple Capital Structure (No. 20)	U2011.092
	.17	Captions in Comparative Statements (No. 23)	U2011.099
	.18	Restatement of Previously Reported Data	U2011.039
	.18	Required Disclosure (No. 100)	U2011.353
	.18	Investment Credit Is Prior Period Adjustment (No. 5)	U4094.021
	.19	Disclosure	U2011.045
	.19	Required Disclosure (No. 100)	U2011.353
	.20	Assumptions	U2011.011
	.20	Disclosure	U2011.045
	.20	Fair Value Used If No Market Price (No. 56)	U2011.190
	.20	Required Disclosure (No. 100)	U2011.353
	.21	Required Disclosure (No. 100)	U2011.353
	.22	Restatement of Previously Reported Data	U2011.039
	.22	Supplementary Data	U2011.046
	.22	Options and Warrants Outstanding Part of a Period (No. 57)	U2011.195

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Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
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	.23	Supplementary Data	U2011.046
	.23	Required Disclosure (No. 100)	U2011.353
	.23	Supplementary Data (No. 101)	U2011.354
	.24	Assumptions	U2011.011
	.24	Primary v. Fully Diluted EPS (No. 21)	U2011.095
	.25	Assumptions	U2011.011
	.25	Classification of Securities	U2011.013
	.25	Common Stock Equivalents (No. 2)	U2011.053
	.26	Assumptions	U2011.011
	.27	Assumptions	U2011.011
	.27	Primary Earnings per Share	U2011.017
	.27	Security (No. 1)	U2011.052
	.27	Common Stock Equivalents (No. 2)	U2011.053
	.27	Complex Capital Structure (No. 18)	U2011.088
	.27	Equivalents of Options and Warrants (No. 48)	U2011.162
	.27	Explanation of 20% Provision (No. 74)	U2011.255
	.27	Contingent Shares (No. 88)	U2011.308
	.28	Classification of Securities	U2011.013
	.28	Primary Earnings per Share	U2011.017
	.28	Classification and Assumed Conversion (No. 26)	U2011.111
	.28	Classification and Computation Not Always the Same (No. 28)	U2011.121
	.28	Change of Classification of Convertible Security (No. 29)	U2011.126
	.28	Change of Classification Is Mandatory (No. 30)	U2011.129
	.28	Definition of "Same Terms" (No. 31)	U2011.132
	.28	Issue Price Is Not a "Term" (No. 32)	U2011.133
	.28	Sale of Treasury Securities Is a New Issue (No. 33)	U2011.134
	.28	Effect of New Issue of Common Stock Equivalents (No. 96)	U2011.346
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	.28	Is Prior Period Restatement Permitted? (No. 99)	U2011.352
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	.29	Change of Classification of Convertible Security (No. 29)	U2011.126
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	.29	Time of Issuance for Contingent Issuances (No. 89)	U2011.313
	.29	Convertible Securities Contingently Issuable (No. 92)	U2011.330
	.30	Classification of Securities	U2011.013
	.30	Anti-Dilutive Securities	U2011.016
	.30	Convertible Securities	U2011.023
	.30	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
	.30	EPS for "Catch-up" Adjustment (No. 2)	U1051.010
	.30	Dilution—Dilutive Security (No. 4)	U2011.056
	.30	Anti-Dilution—Anti-Dilutive Security (No. 5)	U2011.058
	.30	EPS for Extraordinary Items (No. 16)	U2011.084

Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
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	.30	No Anti-Dilution From Convertible Preferred Stock (No. 41)	U2011.143
	.30	No Anti-Dilution From Convertible Debt (No. 42)	U2011.145
	.30	If Converted Method at Actual Conversion (No. 44)	U2011.151
	.30	No Anti-Dilution from Options and Warrants (No. 47)	U2011.159
	.30	Grouping Options and Warrants (No. 49)	U2011.163
	.30	Market Prices Used for Treasury Stock Method (No. 52)	U2011.175
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	.30	Anti-Dilutive Exercise (No. 62)	U2011.217
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	.30	Debt Purchased Under Paragraph 38 (No. 77)	U2011.265
	.30	Computations May Differ for Primary and Fully Diluted When Paragraph 38 Applies (No. 81)	U2011.271
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	.30	Options or Warrants to Purchase Convertible Securities (No. 84)	U2011.290
	.30	Contingent Shares (No. 88)	U2011.308
	.31	Classification and Assumed Conversion (No. 26)	U2011.111
	.31	Conversion Assumed for Primary Only (No. 43)	U2011.147
	.33	Primary Earnings per Share	U2011.017
	.33	Common Stock Equivalents (No. 2)	U2011.053
	.33	Classification and Assumed Conversion (No. 26)	U2011.111
	.33	Change of Classification of Convertible Security (No. 29)	U2011.126
	.33	Determining a Convertible Security's Cash Yield (No. 34)	U2011.135
	.33	Computing a Convertible's Cash Yield (No. 35)	U2011.136
	.33	Cash Yield of Convertible Security in a "Package" (No. 36)	U2011.137
	.33	Property Included in Cash Yield (No. 37)	U2011.138
	.33	Fair Value Used If No Market Price (No. 56)	U2011.190
	.33	Explanation of 20% Provision (No. 74)	U2011.255
	.33	Options or Warrants to Purchase Convertible Securities (No. 84)	U2011.290
	.33	Convertible Securities Contingently Issuable (No. 92)	U2011.330
	.34	Assumptions	U2011.011
	.34	Prime Rate Used in Yield Test (No. 38)	U2011.140
	.34	Prior Period Prime Rates (No. 39)	U2011.141
	.35	Convertible Securities	U2011.023
	.35	Options and Warrants	U2011.026
	.35	Common Stock Equivalents (No. 2)	U2011.053
	.35	Classification and Assumed Conversion (No. 26)	U2011.111

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Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2011	.35	Classification of Options and Warrants (No. 46)	U2011.158
	.35	Equivalents of Options and Warrants (No. 48)	U2011.162
	.35	Grouping Options and Warrants (No. 49)	U2011.163
	.35	Methods Used for Options and Warrants (No. 50)	U2011.167
	.35	Securities Subject to Paragraph 37 Tests (No. 66)	U2011.231
	.35	Market Prices Used in Paragraph 37 Tests (No. 67)	U2011.236
	.35	Treasury Stock Method for Convertibles (No. 71)	U2011.249
	.35	Anti-Dilutive Options and Warrants Included (No. 72)	U2011.253
	.35	Explanation of 20% Provision (No. 74)	U2011.255
	.35	Deferred Compensation Stock Option (No. 82)	U2011.274
	.35	Stock Subscriptions Are Warrants (No. 83)	U2011.287
	.36	Assumptions	U2011.011
	.36	Options and Warrants	U2011.026
	.36	Restatement of Previously Reported Data	U2011.039
	.36	3% Test (No. 12)	U2011.076
	.36	No Anti-Dilution from Options and Warrants (No. 47)	U2011.159
	.36	Equivalents of Options and Warrants (No. 48)	U2011.162
	.36	Methods Used for Options and Warrants (No. 50)	U2011.167
	.36	Treasury Stock Method Reflects Dilution of Options and Warrants (No. 51)	U2011.171
	.36	Market Prices Used for Treasury Stock Method (No. 52)	U2011.175
	.36	How Many Market Prices? (No. 53)	U2011.181
	.36	What Market Price to Use? (No. 54)	U2011.184
	.36	Over-the-Counter and Listed Stocks Not Traded (No. 55)	U2011.187
	.36	Options and Warrants Outstanding Part of a Period (No. 57)	U2011.195
	.36	Anti-Dilutive Exercise (No. 62)	U2011.217
	.36	"Substantially All" of Three Months (No. 63)	U2011.223
	.36	Total of Quarters May Not Equal Annual EPS (No. 64)	U2011.228
	.36	Anti-Dilutive Options and Warrants Included (No. 72)	U2011.253
	.36	Redemption Premium or Discount (No. 76)	U2011.262
	.36	Computations May Differ for Primary and Fully Diluted when Paragraph 38 Applies (No. 81)	U2011.271
	.36	Deferred Compensation Stock Option (No. 82)	U2011.274
	.36	Options or Warrants to Purchase Convertible Securities (No. 84)	U2011.290
	.36	Is Prior Restatement Permitted? (No. 99)	U2011.352
	.37	Primary Earnings Per Share	U2011.017
	.37	Convertible Securities	U2011.023
	.37	Options and Warrants	U2011.026
	.37	Security (No. 1)	U2011.052
	.37	Classification and Assumed Conversion (No. 26)	U2011.111

Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2011	.37	No Anti-Dilution from Options and Warrants (No. 47)	U2011.159
	.37	Equivalents of Options and Warrants (No. 48)	U2011.162
	.37	Methods Used for Options and Warrants (No. 50)	U2011.167
	.37	Unusual Warrants and Their Equivalents (No. 65)	U2011.230
	.37	Securities Subject to Paragraph 37 Tests (No. 66)	U2011.231
	.37	Market Prices Used in Paragraph 37 Tests (No. 67)	U2011.236
	.37	Computations for Warrants Requiring the Tendering of Debt (No. 68)	U2011.240
	.37	Computations for Warrants Allowing the Tendering of Debt (No. 69)	U2011.241
	.37	Computations for Warrants Whose Proceeds are Applied to Retire Debt (No. 70)	U2011.246
	.37	Treasury Stock Method for Convertibles (No. 71)	U2011.249
	.37	Anti-Dilutive Options and Warrants Included (No. 72)	U2011.253
	.37	Explanation of 20% Provision (No. 74)	U2011.255
	.37	Original Issue Premium or Discount (No. 75)	U2011.261
	.37	Redemption Premium or Discount (No. 76)	U2011.262
	.38	Anti-Dilutive Securities	U2011.016
	.38	Options and Warrants	U2011.026
	.38	3% Test (No. 12)	U2011.076
	.38	Classification and Assumed Conversion (No. 26)	U2011.111
	.38	No Anti-Dilution from Options and Warrants (No. 47)	U2011.159
	38	Equivalents of Options and Warrants (No. 48)	U2011.162
	.38	Grouping Options and Warrants (No. 49)	U2011.163
	.38	Methods Used for Options and Warrants (No. 50)	U2011.167
	.38	Market Prices Used for Treasury Stock Method (No. 52)	U2011.175
	.38	Options and Warrants Outstanding Part of a Period (No. 57)	U2011.195
	.38	Securities Subject to Paragraph 37 Tests (No. 66)	U2011.231
	.38	Market Prices Used in Paragraph 37 Tests (No. 67)	U2011.236
	.38	Computations for Warrants Whose Proceeds Are Applied To Retire Debt (No. 70)	U2011.246
	.38	Treasury Stock Method for Convertibles (No. 71)	U2011.249
	.38	Anti-Dilutive Options and Warrants Included (No. 72)	U2011.253
	.38	No Order for Exercise (No. 73)	U2011.254
	.38	Explanation of 20% Provision (No. 74)	U2011.255
	.38	Original Issue Premium or Discount (No. 75)	U2011.261
	.38	Redemption Premium or Discount (No. 76)	U2011.262
	.38	Debt Purchased Under Paragraph 38 (No. 77)	U2011.265
	.38	Compensating Balances Excluded (No. 78)	U2011.267
	.38	Investments Under Paragraph 38 (No. 79)	U2011.268
	.38	Debt Eligible Only While Outstanding (No. 80)	U2011.270
	.38	Computations May Differ for Primary and Fully Diluted When Paragraph 38 Applies (No. 81)	U2011.271

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Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2011	.38	Two-Class Method for Warrants Issued by REITs (No. 102)	U2011.361
	.39	Classification of Securities	U2011.013
	.39	Earnings Applicable to Common Stock	U2011.020
	.39	Original Issue Premium or Discount on Convertible Securities (No. 40)	U2011.142
	.39	Deferred Compensation Stock Option (No. 82)	U2011.274
	.39	Securities Issued by Subsidiaries (No. 93)	U2011.334
	.40	Anti-Dilutive Securities	U2011.016
	.40	Fully Diluted Earnings Per Share	U2011.019
	.40	Convertible Securities	U2011.023
	.40	Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1)	U1051.001
	.40	EPS for "Catch-up" Adjustment (No. 2)	U1051.010
	.40	Dilution—Dilutive Security (No. 4)	U2011.056
	.40	Anti-Dilution—Anti-Dilutive Security (No. 5)	U2011.058
	.40	Primary v. Fully Diluted ESP (No. 21)	U2011.095
	.40	Classification and Assumed Conversion (No. 26)	U2011.111
	.40	No Anti-Dilution From Convertible Preferred Stock (No. 41)	U2011.143
	.40	No Anti-Dilution From Convertible Debt (No. 42)	U2011.145
	.40	Conversion Assumed for Primary Only (No. 43)	U2011.147
	.40	No Anti-Dilution from Options and Warrants (No. 47)	U2011.159
	.40	Grouping Options and Warrants (No. 49)	U2011.163
	.40	Market Prices Used for Treasury Stock Method (No. 52)	U2011.175
	.40	Options and Warrants Outstanding Part of a Period (No. 57)	U2011.195
	.40	Computations for Warrants Whose Proceeds Are Applied To Retire Debt (No. 70)	U2011.246
	.40	Treasury Stock Method for Convertibles (No. 71)	U2011.249
	.40	Debt Purchased Under Paragraph 38 (No. 77)	U2011.265
	.40	Deferred Compensation Stock Option (No. 82)	U2011.274
	.40	Options or Warrants to Purchase Convertible Securities (No. 84)	U2011.290
	.40	Contingent Shares (No. 88)	U2011.308
	.41	Assumptions	U2011.011
	.41	Classification of Securities	U2011.013
	.41	Anti-Dilutive Securities	U2011.016
	.41	Restatement of Previously Reported Data	U2011.039
	.41	Other Potentially Dilutive Securities (No. 3)	U2011.054
	.41	Complex Capital Structure (No. 18)	U2011.088
	.41	Dual Presentation for Corporation with Simple Capital Structure (No. 20)	U2011.092
	.41	Primary v. Fully Diluted EPS (No. 21)	U2011.095
	.41	Classification and Assumed Conversion (No. 26)	U2011.111
	.41	If Converted Method at Actual Conversion (No. 44)	U2011.151

Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2011	.41	Options and Warrants Outstanding Part of a Period (No. 57)	U2011.195
	.41	Total of Quarters May Not Equal Annual EPS (No. 64)	U2011.228
	.42	Options and Warrants	U2011.026
	.42	Classification of Options and Warrants (No. 46)	U2011.158
	.42	No Anti-Dilution from Options and Warrants (No. 47)	U2011.159
	.42	Treasury Stock Method Reflects Dilution of Options and Warrants (No. 51)	U2011.171
	.42	Market Prices Used for Treasury Stock Method (No. 52)	U2011.175
	.42	Options and Warrants Outstanding Part of a Period (No. 57)	U2011.195
	.42	Applying Ending and Average Market Prices (No. 60)	U2011.207
	.42	Treasury Stock Method at Exercise (No. 61)	U2011.213
	.42	Anti-Dilutive Exercise (No. 62)	U2011.217
	.42	"Substantially All" of Three Months (No. 63)	U2011.223
	.42	Market Prices Used in Paragraph 37 Tests (No. 67)	U2011.236
	.42	Computations for Warrants Whose Proceeds Are Applied To Retire Debt (No. 70)	U2011.246
	.42	Redemption Premium or Discount (No. 76)	U2011.262
	.42	Computations May Differ for Primary and Fully Diluted When Paragraph 38 Applies (No. 81)	U2011.271
	.43	Other Securities	U2011.038
	.43	Securities Convertible Into Other Convertible Securities (No. 45)	U2011.154
	.45	Restatement of Previously Reported Data	U2011.039
	.45	Effective Date	U2011.048
	.45	Prior Period Restatement Recommended (No. 98)	U2011.349
	.46	Restatement of Previously Reported Data	U2011.039
	.46	Effective Date	U2011.048
	.46	Other Potentially Dilutive Securities (No. 3)	U2011.054
	.46	Classification and Assumed Conversion (No. 26)	U2011.111
	.46	Change of Classification Is Mandatory (No. 30)	U2011.129
	.46	Prior Period Prime Rates (No. 39)	U2011.141
	.46	Classification of Options and Warrants (No. 46)	U2011.158
	.46	Treasury Stock Method for Convertibles (No. 71)	U2011.249
	.46	Explanation of 20% Provision (No. 74)	U2011.255
	.46	Computations May Differ for Primary and Fully Diluted When Paragraph 38 Applies (No. 81)	U2011.271
	.46	Deferred Compensation Stock Option (No. 82)	U2011.274
	.46	Stock Subscriptions Are Warrants (No. 83)	U2011.287
	.46	Contingent Shares (No. 88)	U2011.308
	.46	Convertible Securities Contingently Issuable (No. 92)	U2011.330
	.46	Securities Issued by Subsidiaries (No. 93)	U2011.334
	.46	Factors in Paragraph 46 Election (No. 95)	U2011.344

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Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2011	.46	Effect of New Issue of Common Stock Equivalents (No. 96)	U2011.346
	.46	No Change for Options and Warrants (No. 97)	U2011.347
	.46	Prior Period Restatement Recommended (No. 98)	U2011.349
2011A	.02	Presentation of Earnings per Share	U2011.010
	.02	Weighted Average of Shares Outstanding (No. 25)	U2011.105
	.02	If Converted Method at Actual Conversion (No. 44)	U2011.151
	.02	Options and Warrants Outstanding Part of a Period (No. 57)	U2011.195
	.02	Treasury Stock Method at Exercise (No. 61)	U2011.213
	.02	Anti-Dilutive Exercise (No. 62)	U2011.217
	.03	Restatement of Previously Reported Data	U2011.039
	.03	Required Disclosure (No. 100)	U2011.353
	.04	Restatement of Previously Reported Data	U2011.039
	.04	Business Combinations and Reorganization	U2011.042
	.04	Classification and Computation Not Always the Same (No. 28)	U2011.121
	.05	Earnings Applicable to Common Stock	U2011.020
	.05	Convertible Securities	U2011.023
	.05	Reporting Loss per Share (No. 15)	U2011.083
	.05	Earnings Applicable to Common Stock (No. 24)	U2011.101
	.05	Classification and Assumed Conversion (No. 26)	U2011.111
	.05	No Anti-Dilution from Convertible Preferred Stock (No. 41)	U2011.143
	.05	No Anti-Dilution from Convertible Debt (No. 42)	U2011.145
	.05	Required Disclosure (No. 100)	U2011.353
	.06	Earnings Applicable to Common Stock	U2011.020
	.06	Convertible Securities	U2011.023
	.06	Dilution—Dilutive Security (No. 4)	U2011.056
	.06	Earnings Applicable to Common Stock (No. 24)	U2011.101
	.06	Classification and Assumed Conversion (No. 26)	U2011.111
	.06	Classification and Computation Not Always the Same (No. 28)	U2011.121
	.06	Original Issue Premium or Discount on Convertible Securities (No. 40)	U2011.142
	.06	Explanation of 20% Provision (No. 74)	U2011.255
	.06	Original Issue Premium or Discount (No. 75)	U2011.261
	.06	Redemption Premium or Discount (No. 76)	U2011.262
	.06	Options or Warrants to Purchase Convertible Securities (No. 84)	U2011.290
	.06	Two-Class Method for Convertible Securities (No. 87)	U2011.304
	.06	Convertible Securities Contingently Issuable (No. 92)	U2011.330
	.07	Earnings Applicable to Common Stock	U2011.020
	.09	EPS Treatment of Two-Class and Participating Securities (No. 85)	U2011.295
	.09	Two-Class Method for Convertible Securities (No. 87)	U2011.304

Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2011A	.10	EPS Treatment of Two-Class and Participating Securities (No. 85)	U2011.295
	.10	Two-Class Method for Nonconvertible Securities (No. 86)	U2011.300
	.10	Two-Class Method for Convertible Securities (No. 87)	U2011.304
	.10	Two-Class Method for Warrants Issued by REITs (No. 102)	U2011.361
	.11	Delayed Effectiveness and Changing Rates or Prices	U2011.035
	.11	Securities Convertible Into Other Convertible Securities (No. 45)	U2011.154
	.12	Delayed Effectiveness and Changing Rates or Prices	U2011.035
	.12	Restatement of Previously Reported Data	U2011.039
	.12	Classification and Computation Not Always the Same (No. 28)	U2011.121
	.12	Deferred Compensation Stock Option (No. 82)	U2011.274
	.12	Changing Exercise Prices and Conversion Rates (No. 94)	U2011.341
	.13	Delayed Effectiveness and Changing Rates or Prices	U2011.035
	.13	Classification and Computation Not Always the Same (No. 28)	U2011.121
	.13	Securities Convertible Into Other Convertible Securities (No. 45)	U2011.154
	.13	Computations for Warrants Allowing the Tendering of Debt (No. 69)	U2011.241
	.13	Treasury Stock Method for Convertibles (No. 71)	U2011.249
	.13	Deferred Compensation Stock Option (No. 82)	U2011.274
	.13	Changing Exercise Prices and Conversion Rates (No. 94)	U2011.341
	.14	Classification and Assumed Conversion (No. 26)	U2011.111
	.14	Property Included in Cash Yield (No. 37)	U2011.138
	.15	Property Included in Cash Yield (No. 37)	U2011.138
	.15	EPS Treatment of Two-Class and Participating Securities (No. 85)	U2011.295
	.16	Contingent Shares (No. 88)	U2011.308
	.16	Earnings Conditions (No. 91)	U2011.322
	.16	Convertible Securities Contingently Issuable (No. 92)	U2011.330
	.17	Restatement of Previously Reported Data	U2011.039
	.17	Time of Issuance (No. 27)	U2011.117
	.17	Contingent Shares (No. 88)	U2011.308
	.17	Market Price Conditions (No. 90)	U2011.314
	.17	Earnings Conditions (No. 91)	U2011.322
	.17	Convertible Securities Contingently Issuable (No. 92)	U2011.330
	.18	Restatement of Previously Reported Data	U2011.039
	.18	Contingent Shares (No. 88)	U2011.308
	.18	Market Price Conditions (No. 90)	U2011.314
	.18	Convertible Securities Contingently Issuable (No. 92)	U2011.330
	.19	Contingent Shares (No. 88)	U2011.308

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Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2011A	.19	Market Price Conditions (No. 90)	U2011.314
	.19	Earnings Conditions (No. 91)	U2011.322
	.19	Convertible Securities Contingently Issuable (No. 92)	U2011.330
	.20	Property Included in Cash Yield (No. 37)	U2011.138
	.20	Securities Issued by Subsidiaries (No. 93)	U2011.334
	.21	Property Included in Cash Yield (No. 37)	U2011.138
	.21	Securities Issued by Subsidiaries (No. 93)	U2011.334
	.22	Property Included in Cash Yield (No. 37)	U2011.138
	.22	Securities Issued by Subsidiaries (No. 93)	U2011.334
	.23	Property Included in Cash Yield (No. 37)	U2011.138
	.23	Securities Issued by Subsidiaries (No. 93)	U2011.334
	.24	Property Included in Cash Yield (No. 37)	U2011.138
	.24	Securities Issued by Subsidiaries (No. 93)	U2011.334
	.25	Required Disclosure (No. 100)	U2011.353
2011C	.03	EPS for Extraordinary Items (No. 16)	U2011.084
	.03	Market Prices Used for Treasury Stock Method (No. 52)	U2011.175
	.03	What Is a Period? (No. 58)	U2011.202
	.03	Share Averaging (No. 59)	U2011.205
	.03	Market Prices Used in Paragraph 37 Tests (No. 67)	U2011.236
	.03	Computations for Warrants Allowing the Tendering of Debt (No. 69)	U2011.241
	.03	Computations for Warrants Whose Proceeds Are Applied To Retire Debt (No. 70)	U2011.246
	.04	Fair Value Used If No Market Price (No. 56)	U2011.190
2012	.08	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
	.08	Illustration of the Application of Section 2012 (No. 1)	U2012.001
	.10	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
	.13	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
	.13	Illustration of the Application of Section 2012 (No. 1)	U2012.001
	.18	Illustration of the Application of Section 2012 (No. 1)	U2012.001
	.19	Illustration of the Application of Section 2012 (No. 1)	U2012.001
	.23	Illustration of the Application of Section 2012 (No. 1)	U2012.001
	.23	Losses Caused by Bankruptcies (No. 1)	U2010.001
	.26	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
	.26	Illustration of the Application of Section 2012 (No. 1)	U2012.001
	.27	Illustration of the Application of Section 2012 (No. 1)	U2012.001
2021	.07	Number of Funds Statements Required (No. 1)	U2021.001
	.07	Funds Statements for Mutuals and Co-ops (No. 2)	U2021.005
	.10	Funds Statements for Mutual Funds and Real Estate Companies (No. 3)	U2021.007
	.12	Number of Funds Statements Required (No. 1)	U2021.001
	.16	Number of Funds Statements Required (No. 1)	U2021.001

Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2033	.01	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security (FASB Int. 8)	2033-1.01
	.02	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security (FASB Int. 8)	2033-1.01
	.09	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security (FASB Int. 8)	2033-1.01
	.10	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security (FASB Int. 8)	2033-1.01
	.11	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security (FASB Int. 8)	2033-1.01
	.16	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security (FASB Int. 8)	2033-1.01
	.20	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security (FASB Int. 8)	2033-1.01
	.40	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security (FASB Int. 8)	2033-1.01
2051	.02	Investment Credit in Consolidation (No. 6)	U4094.024
	.05	Consolidation of a Parent and Its Subsidiaries Having Different Balance Sheet Dates (FASB Int. 13)	5132-4.01
	.07	Intercompany Profit Eliminations under Equity Method (No. 1)	U5131.001
	.09	Goodwill in a Step Acquisition (No. 2)	U5141.003
	.13	Intercompany Profit Eliminations under Equity Method (No. 1)	U5131.001
	.16	Intercompany Profit Eliminations under Equity Method (No. 1)	U5131.001
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	.10	Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises (FASB Int. 7)	2062-1.01
	.14	Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises (FASB Int. 7)	2062-1.01
	.15	Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises (FASB Int. 7)	2062-1.01
	.16	Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises (FASB Int. 7)	2062-1.01

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Sec.		Interpretation Subject (Interpretation No.)	Interpretation Sec.
2071	.14	Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Int. 17)	1083-2.01
	.19	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
	.20	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
	.21	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
2072	.10	Accounting for Income Taxes in Interim Periods (FASB Int. 18)	2071-1.01
4053	.005	Lessee Guarantee of the Residual Value of Leased Property (FASB Int. 19)	4053-1.01
	.007	Lessee Guarantee of the Residual Value of Leased Property (FASB Int. 19)	4053-1.01
	.007	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
	.009	Lessee Guarantee of the Residual Value of Leased Property (FASB Int. 19)	4053-1.01
	.009	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
	.012	Lessee Guarantee of the Residual Value of Leased Property (FASB Int. 19)	4053-1.01
	.017	Lessee Guarantee of the Residual Value of Leased Property (FASB Int. 19)	4053-1.01
	.018	Lessee Guarantee of the Residual Value of Leased Property (FASB Int. 19)	4053-1.01
	.035	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
	.036	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
	.037	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
	.038	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
	.039	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
	.040	Accounting for Leases in a Business Combination (FASB Int. 21)	4053-2.01
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