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# APB accounting principles: volume 1: Current text as of June 30, 1973

American Institute of Certified Public Accountants. Accounting Principles Board

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APB

ACCOUNTING  
PRINCIPLES

• *Current Text*

AS OF JUNE 30, 1973

VOLUME ONE

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## HOW TO USE THIS REPORTER

### **Scope of the Reporter . . .**

This Reporter brings together for continuing reference the Opinions and Statements of the Accounting Principles Board, the Accounting Research Bulletins issued by the predecessor to the Accounting Principles Board, the Committee on Accounting Procedure, the Accounting Terminology Bulletins issued by the Committee on Terminology, excerpts from the AICPA Code of Professional Ethics and Accounting Interpretations issued by the American Institute of Certified Public Accountants.

Volume 1 contains the pronouncements which are currently effective. Changes in earlier pronouncements specified by later ones have been recognized by appropriate amendments and deletions in the textual material contained in Volume 1.

Volume 2 includes Accounting Research Bulletins 43 to 51, Accounting Terminology Bulletins 1 to 4, the Statements and Opinions of the Accounting Principles Board and the Accounting Interpretations as they were originally issued with no substantive amendments or changes.

### **How the Pronouncements Are Arranged . . .**

The contents of Volume 1 are arranged topically as follows:

- Preface, Introduction
- Financial Accounting—General
- Financial Statement Presentation
- Revenue and Expense
- Assets
- Liabilities and Deferred Credits
- Capital
- Special Industry Applications
- List of AICPA Industry Audit/Accounting Guides  
and Accounting Position Papers
- Accounting Interpretations

Volume 2 is arranged as follows:

- Accounting Research Bulletins 43 to 51
- Opinions of the Accounting Principles Board
- Statements of the Accounting Principles Board
- Accounting Terminology Bulletins 1 to 4
- Accounting Interpretations

### **Current Reports . . .**

New Opinions and Statements of the Accounting Principles Board and Accounting Interpretations will be issued periodically and will be accompanied by a "Report Letter." The Report Letter will describe the new pronouncements and will provide filing instructions for adding and deleting pages in Volumes 1 and 2.

New Opinions and Statements will be included in Volume 1 in the major sections pertinent to their subject matter and new Accounting Interpretations will be included in Volume 1 in a separate division. The same new material will also be provided in looseleaf form for addition to Volume 2 in its appropriate division. Changes in earlier pronouncements will be reflected in Volume 1 by the replacement of pages in the Reporter in order that its contents will be maintained up to date for current reference.

Report Letters will be numbered consecutively and filed in the section of Volume 2 indicated by the tab guide marked "Last Report Letter." Only the current Report Letter should be retained as a check on the receipt of the reports in the proper order.

### **How To Use Volume 1 . . .**

The arrangement of topics in Volume 1 is indicated in the general table of contents at the front of the volume. Tabs on the guide cards indicate the location of major sections. There is a detailed table of contents covering the material within each major section.

The major sections are broken down into subtopics, each with its own section number. Further, each paragraph within a section is decimally numbered. For example, the number 2021.05 refers to the fifth paragraph of section 2021, Reporting Changes in Financial Position.

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, section U2011 is the Accounting Interpretation of section 2011, *Earnings per Share*.

Section 6000, Special Industry Applications, includes an appendix which lists the American Institute of Certified Public Accountants Industry Audit/Accounting Guides and Accounting Position Papers. 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 topic, and refers the reader to section and paragraph numbers. The boldface numbers in the index refer to the section in which the topic is covered most comprehensively in Volume 1.

Appendix A is a cross-reference index which lists the Accounting Research Bulletins and Opinions and Statements of the Accounting Principles Board and which indicates the section number in the looseleaf edition 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 and which indicates the Accounting Research Bulletins and Opinions and Statements of the Accounting Principles Board 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 and in the Opinions and Statements of the Accounting Principles Board since June 1953 when ARB 43 was issued. The dates of change are also indicated. It is thus possible, by reference to this appendix, to determine the pronouncement which was in effect at any specified date.

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

**How To Use Volume 2 . . .**

Volume 2 is a reprinting, in looseleaf form, of Accounting Research Bulletins 43 through 51 (including the index), Opinions of the Accounting Principles Board and Statements of the Accounting Principles Board. Included also are the Accounting Terminology Bulletins 1 to 4 and the Accounting Interpretations. Basically, the material is arranged in chronological order within each division and tab guide cards are provided for the major divisions.

Volume 2 is included in the looseleaf edition primarily for historical purposes, although there may be occasions when reference to Volume 2 will be necessary to determine the status of a pronouncement at any specified date. It will be particularly useful when a new pronouncement has replaced one in the current volume (Volume 1), but the effective date of the new pronouncement indicates that it is not yet effective for a particular fiscal period. The reader is cautioned, however, that many changes have taken place in the material included in Volume 2, and he should consult Volume 1, Appendix C—Schedule of Changes, to ascertain if any change has taken place in any specified Bulletin, Opinion or Statement.

# Preface • Introduction

## FINANCIAL ACCOUNTING— GENERAL

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

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## 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

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. (For a detailed description of the Accounting Interpretation service, see Volume 2, page 9616.)

.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<sup>1</sup> 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

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<sup>1</sup> 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.

➤ *The next page is 31.* ←

## 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

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<sup>1</sup> 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

<sup>1</sup> 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<sup>2</sup> 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.

»»»→ *The next page is 51.* ←«««

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<sup>2</sup> See section 520, *Excerpts from the AICPA Code of Professional Ethics.*

**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.

➤→ *The next page is 101.* ←➤

**Section 1010****Fundamentals of Financial  
Accounting**

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.

»»»→ *The next page is 121.* ←«««

## Section 1021

# Purpose and Nature of the Statement

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.<sup>1</sup> This Statement of basic concepts<sup>2</sup> and accounting principles underlying financial statements of business enterprises<sup>3</sup> (sections 1021-1029) states the Board's views in response to that directive.<sup>4</sup>

.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

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<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> 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.

<sup>4</sup> 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

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.<sup>5</sup> 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.

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<sup>5</sup> 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. (See Volume 2, pages 9501-9524.)

**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:

	<i>Sections</i>
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 <i>presents fairly</i> ) in conformity with generally accepted account- ing 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

	<i>Sections</i>
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 131.* ← ➤➤➤

**Section 1022****Summary of  
the Statement**

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

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.

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<sup>1</sup> 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

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<sup>1</sup> See section 1026.01, footnote 1.

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

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-

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.

➤→ *The next page is 181.* ←➤

**Section 1023*****The Environment of  
Financial Accounting***

Issue date, unless  
otherwise indicated:  
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**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<sup>1</sup> 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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<sup>1</sup>The term *information* is sometimes applied only to relevant data. Sections 1021-1029 do not distinguish between the terms *information* and *data*.

**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.<sup>2</sup>

*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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<sup>2</sup> 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*.<sup>3</sup>

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<sup>3</sup> See paragraph .23 for further discussion of production.

*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 preferences 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-

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.<sup>4</sup>

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.

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<sup>4</sup>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.

**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<sup>5</sup>

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.

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<sup>5</sup> 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.<sup>6</sup> 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

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

nothing of value to itself in exchange for the resources it distributes.<sup>7</sup> 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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<sup>7</sup>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,<sup>8</sup> substantial, unanticipated reductions in enterprise resources not caused by other entities.<sup>9</sup> 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

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

<sup>9</sup>This definition of casualties differs from that in the Internal Revenue Code, which includes some external events as casualties.

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<sup>10</sup> 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-

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<sup>10</sup> 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

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.<sup>11</sup>

.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 221.* ←➤

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<sup>11</sup> *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.

**Section 1024****Objectives of  
Financial Accounting and  
Financial Statements**

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<sup>1</sup> (1) financial position, (2) results

<sup>1</sup> 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.<sup>2</sup>

#### **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.<sup>3</sup> 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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<sup>2</sup> See section 1025.17-.22.

<sup>3</sup> See section 1029.02-.03 for a discussion of the dynamic nature of financial accounting.

sources (resources less obligations) of an enterprise that result from its profit-directed activities.<sup>4</sup> 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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<sup>4</sup> 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.<sup>5</sup> 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.

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<sup>5</sup>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.)

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 information 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.<sup>6</sup> 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.

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<sup>6</sup> 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

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-

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.<sup>7</sup> 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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<sup>7</sup> Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, section 430.

### 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 251.* ←

**Section 1025****Basic Features and  
Basic Elements of  
Financial Accounting**

Issue date, unless  
otherwise indicated:  
October, 1970

**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.<sup>1</sup> (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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<sup>1</sup>The corollary observation is that if liquidation appears imminent, financial information may be prepared on the assumption that liquidation will occur.

- .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

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:

*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<sup>2</sup> but that are recognized and measured in conformity with generally accepted accounting principles.<sup>3</sup>

*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<sup>4</sup> but that are recognized and measured in conformity with generally accepted accounting principles.<sup>5</sup>

*Owners' equity*—the interest of owners in an enterprise, which is the excess of an enterprise's assets over its liabilities.<sup>6</sup>

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:

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}^7$$

.20 The *financial position* of an enterprise at a particular time comprises its assets, liabilities, and owners' equity and the relationship among them, plus those contingen-

<sup>2</sup> 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.

<sup>3</sup> This definition differs from that in Accounting Terminology Bulletin No. 1, paragraph 26 (see volume 2, page 9507), which defines assets as debit balances carried forward upon a closing of books of account that represent property values or rights acquired.

<sup>4</sup> 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.

<sup>5</sup> This definition differs from that in Accounting Terminology Bulletin No. 1, paragraph 27 (see Volume 2, page 9507), 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.

<sup>6</sup> 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 (see Volume 2, page 9507). Owners' equity is conventionally classified into several categories (see section 1027.24).

<sup>7</sup> 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.

cies, 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*<sup>8</sup> 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<sup>9</sup> of an enterprise that can change owners' equity.<sup>10</sup>

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.<sup>11</sup> 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-

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<sup>8</sup> The definition of balance sheet in this paragraph differs from that in Accounting Terminology Bulletin No. 1, paragraph 21, (see Volume 2, page 9506), 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.

<sup>9</sup> See section 1024.06, fn. 4, for the definition of profit-directed activities.

<sup>10</sup> The definition of revenue in this paragraph differs from that in Accounting Terminology Bulletin No. 2, paragraphs 5-7, (see Volume 2, page 9519), 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.

<sup>11</sup> 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.

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.<sup>12</sup>

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:

$$\text{Revenue} - \text{Expenses} = \text{Net Income (Net Loss)}^{13}$$

<sup>12</sup> This definition of expenses differs from that given in Accounting Terminology Bulletin No. 4, paragraphs 3-4, and 6 (see Volume 2, page 9523). 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*.

<sup>13</sup> 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.

➤➤➤ → *The next page is 281.* ← ➤➤➤

**Section 1026****Generally Accepted  
Accounting Principles—  
Pervasive Principles**

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October, 1970

**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<sup>1</sup> 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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<sup>1</sup> 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<sup>2</sup> of “generally accepted accounting principles” includes not only broad guidelines of general application, but also detailed practices and procedures.<sup>3</sup>

.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

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<sup>2</sup>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. . . .”

<sup>3</sup>“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.” Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, section 410.02.

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 prin-

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ciples 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.<sup>4</sup> The assets and liabilities are measured by the exchange prices<sup>5</sup> 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.

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<sup>4</sup>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.

<sup>5</sup>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.

.11 *Income Determination.*<sup>o</sup> Income determination in accounting is the process of identifying, measuring, and relating revenue and expenses of an enterprise for an

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<sup>o</sup>The term *matching* is often used in the accounting literature to describe the entire process of income determination. The term is also often 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.

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<sup>7</sup> 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 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,

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<sup>7</sup> 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.

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 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.<sup>8</sup> The assured price, the

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<sup>8</sup> This increase in assets is often reported in the income statement as a reduction of cost of goods sold rather than as sales revenue.

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 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.<sup>9</sup> 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.*<sup>10</sup> 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 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

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<sup>9</sup> See paragraph .38.

<sup>10</sup> The term *matching* is often applied to this process (see paragraph .11, footnote 6).

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 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.

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 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.<sup>11</sup> For example, most changes

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<sup>11</sup> Exceptions include the cost or market rule for inventories (see section 1027.09).

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).<sup>12</sup> 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 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.

.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

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<sup>12</sup> 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, (see Volume 2, page 9523) which defines only historical or acquisition cost.

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 experienced extreme inflation but are not now used in the basic financial statements in the United States.<sup>13</sup>

### **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 conven-

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

tions, 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.

.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 profession 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.

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**Section 1027****Generally Accepted  
Accounting Principles—  
Broad Operating Principles**

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

**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

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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-

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 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).

**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

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, acquisition 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.<sup>1</sup> 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.

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<sup>1</sup>The fair value of assets received is often measured by the fair value of the shares of stock issued.

*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 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.* 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 non-cash 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

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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.
- 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 condi-

tion 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.

**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 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

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.

**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.<sup>2</sup>

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

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<sup>2</sup> 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.

**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) non-reciprocal 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

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.

**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.

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- .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 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 finan-

cial 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)<sup>3</sup> is presumed to be useful in manufacturing, trading, and some service enterprises. Current assets and current liabilities are distinguished from other assets and liabilities.

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.<sup>4</sup>

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

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<sup>3</sup>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*.

<sup>4</sup>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.

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, receivables, and capitalized research and development costs, sizable gains and losses on sale of temporary investments, gains and losses recognized in non-monetary 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 transactions entered into after September 30, 1973, by APB Opinion No. 29.] (See section 1041.)

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 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 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.

➤→ *The next page is 391.* ←➤

**Section 1028****Generally Accepted  
Accounting Principles—  
Detailed Operating Principles**

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.<sup>1</sup> Opinions of the Accounting Principles Board and Accounting Research Bulletins deal with specific subjects

<sup>1</sup> 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.<sup>2</sup> [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 401. ←➤

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<sup>2</sup> 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.

**Section 1029*****Financial Accounting  
in the Future***

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.<sup>1</sup> 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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<sup>1</sup> Although consistency of principles is desirable, improving financial accounting may require changes that temporarily increase inconsistency among principles.

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. 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 the Special Bulletin, Disclosure of Departures from Opinions of Accounting Principles Board, October 1964.*

➤ *The next page is 501.* ←

**Section 1041****Accounting For  
Nonmonetary Transactions**

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<sup>1</sup> 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<sup>1</sup>) that involves principally nonmonetary assets or liabilities<sup>1</sup> or (b) a transfer of nonmonetary assets for which no assets are received or relinquished in exchange (nonreciprocal transfer<sup>1</sup>). 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:

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<sup>1</sup> 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.<sup>2</sup>
- 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.<sup>2</sup>
- 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.<sup>3</sup>
- d. *Nonreciprocal transfer*<sup>3</sup> 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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<sup>2</sup> 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.

<sup>3</sup> 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.

- 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,<sup>4</sup> 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

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<sup>4</sup>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

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 relevant 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-

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<sup>5</sup> 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

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<sup>5</sup> See paragraph .25 for determination of fair value.

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).<sup>6</sup>

.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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<sup>6</sup> 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

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.<sup>7</sup>

#### **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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<sup>7</sup> 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 601.* ←➤

**Section 1051****Accounting Changes**

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.<sup>1</sup> 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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<sup>1</sup> See Volume 1, page 5191-2, 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:<sup>2</sup>

- 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.”<sup>3</sup>

.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

<sup>2</sup> 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.

<sup>3</sup> Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, section 410.02.

(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; <sup>4</sup> a change in the method of accounting for long-term construction-type contracts, such as from the completed contract method to the percentage of completion method; and a change in accounting for research and development expenditures, such as from recording as expense when incurred to deferring and amortizing the costs. (Paragraph .11 covers a change in accounting principle to effect a change in estimate.)

#### **Change in Accounting Estimate**

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

.11 *Change in estimate effected by a change in accounting principle.* Distinguishing between a change in an accounting principle and a change in an accounting estimate is sometimes difficult. For example, a company may change

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<sup>4</sup>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.)

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.<sup>5</sup> 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.

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<sup>5</sup> Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, 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.

### **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.<sup>6</sup>

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<sup>6</sup>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).

**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<sup>7</sup> should be shown

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<sup>7</sup> 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.<sup>8</sup> 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.

<sup>8</sup> See footnote 7.

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 non-discretionary items,<sup>9</sup> computed on the assumption of retroactive application of the newly adopted method

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<sup>9</sup> 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

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.<sup>10</sup>

.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

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<sup>10</sup> 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 (section 2010.22).

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-

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.

## 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—

<u>Year</u>	<i>Excess of Accelerated Depreciation Over Straight Line Depreciation</i>	<i>Effects of Change Direct, Less Tax Effect</i>	<i>Pro forma (Note A)</i>
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
	<hr/>	<hr/>	<hr/>
Total at beginning of 1971 .....	\$250,000	\$125,000	\$112,500
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

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

	<u>1971</u>	<u>1970</u>
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	
	<u>          </u>	<u>          </u>
Net Income .....	<u>\$1,290,000</u>	<u>\$1,200,000</u>
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	-----
	<u>          </u>	<u>          </u>
Net income .....	<u>\$1.29</u>	<u>\$1.20</u>
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	-----
	<u>          </u>	<u>          </u>
Net income .....	<u>\$1.19</u>	<u>\$1.11</u>

	<u>1971</u>	<u>1970</u>
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

Earnings per common share—assuming full dilution:

	1971	1970	1969	1968	1967
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.

## 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—

Year	Pre-tax Income Reported by		Difference in Income	
	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—

<i>Income Statement:</i>	<u>1971</u>	<u>1970</u>
		<i>as adjusted (Note A)</i>
		<u>          </u>
Income before extraordinary item .....	\$ 550,000	\$ 500,000
Extraordinary item (description) .....		(80,000)
Net Income .....	<u>\$ 550,000</u>	<u>\$ 420,000</u>

Per share amounts:

Earnings per common share		
—assuming no dilution:		
Income before extraordinary item .....	\$0.55	\$0.50
Extraordinary item .....		(.08)
Net Income .....	<u>\$0.55</u>	<u>\$0.42</u>

Earnings per common share		
assuming full dilution:		
Income before extraordinary item .....	\$0.52	\$0.47
Extraordinary item .....		(.07)
Net Income .....	<u>\$0.52</u>	<u>\$0.40</u>

*Statement of Retained Earnings:*

	<u>1971</u>	<u>1970</u>
		<i>as adjusted (Note A)</i>
		<u>          </u>
Balance at beginning of year, as previously reported.....	\$17,800,000	\$17,330,000

	<u>1971</u>	<u>1970</u>
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.....	<u>\$18,550,000</u>	<u>\$18,000,000</u>

(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—

<i>Effect on—</i>	<i>Increase (Decrease)</i>	
	<u>1971</u>	<u>1970</u>
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.....	<u>\$420,000</u>	<u>\$400,000</u>	<u>\$350,000</u>	<u>\$450,000</u>
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.....	<u>\$0.42</u>	<u>\$0.40</u>	<u>\$0.35</u>	<u>\$0.45</u>
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.....	<u>\$0.40</u>	<u>\$0.39</u>	<u>\$0.34</u>	<u>\$0.43</u>

→ The next page is 701. ←

**Section 1071****Financial Statements  
Restated for General  
Price-Level Changes**

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.<sup>1</sup>

.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-

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<sup>1</sup> 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*. (See Volume 2, pages 6527-6531.) 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.)

.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

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

.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

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.<sup>2</sup> 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

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<sup>2</sup> See Paul Rosenfield, "Accounting for Inflation—A Field Test," *The Journal of Accountancy*, June 1969, pp. 45 to 50.

called a "general price-level loss."<sup>3</sup> 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.<sup>4</sup> 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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<sup>3</sup> 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.

<sup>4</sup> 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

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

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.<sup>5</sup> 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.<sup>6</sup>

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<sup>5</sup> 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.

<sup>6</sup> 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.

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*

*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.<sup>7</sup> 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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<sup>7</sup> 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.

**.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.<sup>8</sup> 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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<sup>8</sup> 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].

- 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
	<hr/>
Restated to general purchasing power at the end of the year.....	xxx
	<hr/> <hr/>

- 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.)*

**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**

<u>Year</u>	<u>Deflator</u> <u>(1958 = 100)</u>	<u>Percent Increase (Decrease) From Previous Year</u>
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**

<u>Year</u>	<u>Deflator</u> (1958 = 100)	<u>Percent Increase (Decrease) From Previous Year</u>
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**

<u>Year</u>	<u>Quarter</u>	<u>Deflator</u>
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

**Quarterly Averages—Continued**

<u>Year</u>	<u>Quarter</u>	<u>Deflator</u>
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

<u>Year</u>	<u>Quarter</u>	<u>Deflator</u>
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*.

**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.

	<u>Monetary</u>	<u>Non- monetary</u>
<b>.02 Assets</b>		
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.		

	<u>Monetary</u>	<u>Non- monetary</u>
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 .....	X	
Related to notes payable, a monetary item.		
Receivables under capitalized financing leases .....	X	
Long-term receivables .....	X	
Refundable deposits .....	X	
Advances to unconsolidated subsidiaries....	X	
If there is no expectation that the ad- vances will ever be collected, they are in effect additional investments and are nonmonetary.		
Investments in unconsolidated subsidiaries (see discussion)		
If an investment is carried at cost, it is nonmonetary. If an investment is car- ried on the equity basis, the statements of the subsidiary should be restated for general price-level changes (in accord- ance with section 1071.45 for foreign affiliates) and the equity method should then be applied.		
Pension, sinking, and other funds..... (see discussion)		
Depends on composition of the fund— bonds are generally monetary and stocks nonmonetary.		
Investments in convertible bonds..... (see discussion)		
If the bond is held for price specula- tion or with expectation of converting		

	<u>Monetary</u>	<u>Non- monetary</u>
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

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	

	<u>Monetary</u>	<u>Non- monetary</u>
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.		

	<u>Monetary</u>	<u>Non- monetary</u>
<b>.04 Owners' Equity</b>		
Minority interest .....		X
Preferred stock .....		X
<p>Classifying preferred stock as non-monetary 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.</p> <p>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.</p> <p>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.</p>		
Common stock .....		X
Additional paid-in capital .....		X
Retained earnings .....		(see discussion)
<p>Retained earnings is a residual and need not be classified as either monetary or nonmonetary.</p>		

**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.<sup>1</sup> This index is available on both

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<sup>1</sup> See section 1071.30.

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,<sup>2</sup> 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:

$$1957: 123.5 \div 97.5 = 1.267$$

$$1960: 123.5 \div 103.3 = 1.196$$

---

<sup>2</sup>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.

*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.

.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

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.

<i>1967 Restatement</i>	<i>1968 Restatement</i>
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.

<i>1967 Restatement</i>	<i>1968 Restatement</i>
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.

<i>1967 Restatement</i>	<i>1968 Restatement</i>
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.

<i>1967 Restatement</i>	<i>1968 Restatement</i>
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.

**1967 RESTATEMENT—XYZ COMPANY****EXHIBIT A**

.20

**XYZ Company**  
**General Price-Level Balance Sheet**  
**December 31, 1967**

ASSETS	<u>General Price-Level Basis</u> <u>(Restated to 12/31/67)</u>
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
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>	
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

.21

**EXHIBIT B**

**XYZ Company**  
**General Price-Level Statement**  
**of Income and Retained Earnings**  
**Year Ended December 31, 1967**

	<b>General Price-Level Basis (Restated to 12/31/67)</b>
Sales	\$( <sup>67</sup> )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	\$( <sup>67</sup> ) 7,099,000

.22

12/31/67

R-1

**XYZ COMPANY**  
**General Price-Level Restatement—1967**  
**Gross National Product Implicit Price Deflators and Conversion Factors**

<i>Year</i>	<i>Quarter</i>	<i>GNP deflators</i>	<i>Conversion factors 1967 (4th q.) = 1.000</i>
<b><u>Annual average</u></b>			
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)

**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		Notes
	Historical	Conversion factor or source	Historical	Conversion factor or source	
	Restated to 12/31/67 \$'s		Restated to 12/31/67 \$'s		
<b>Assets</b>					
Cash	810,000	(1) 1.031	835,110		
Marketable securities (at cost)	1,470,000	R-4	1,623,340		
Receivable—net	1,900,000	(1) 1.031	1,958,900		
Inventories					
Raw materials (FIFO)	2,680,000	(3) 1.044	2,797,920		(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.
Finished goods (FIFO)	2,450,000	(4) 1.031	2,525,950		
Parts and supplies (FIFO)	700,000	(3) 1.044	730,800		
Prepaid expenses	50,000	R-5	52,720		(2) 12/31/67 monetary items need no restatement because they are stated in 12/31/67 \$'s.
Total current assets	10,060,000		10,524,740		
Property, plant, and equipment (at cost)	25,400,000	R-6	29,154,200		(3) Year-end balance assumed acquired fairly evenly throughout the year.
Less: Accumulated depreciation	16,350,000	R-7	19,016,680		(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.
	9,050,000		10,137,520		
	19,110,000		20,662,260		
<b>Liabilities</b>					
Current liabilities	2,950,000	(1) 1.031	3,041,450		
Deferred income—payments received in advance	120,000	R-8	125,280		(5) 12/31/66 retained earnings restated in the amount which makes the balance sheet balance.
Long-term debt	5,300,000	(1) 1.031	5,464,300		
	8,370,000		8,631,030		
<b>Stockholders' Equity</b>					
Capital stock—common	1,760,000	R-4	2,109,120		
Additional paid-in capital	3,150,000	R-4	3,784,550		
Retained earnings	5,830,000	(5)	6,137,560		
	10,740,000		12,031,230		
	19,110,000		20,662,260		

.24

**XYZ COMPANY**  
**General Price-Level Restatement—1967**  
**Working Statement of Income and Retained Earnings**

12/31/67  
R-3

	<u>Historical</u>	<u>Conversion factor or source</u>	<u>Restated to 12/31/67 \$'s</u>
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
	<u>27,622,000</u>		<u>28,463,519</u>
Operating profit	<u>2,378,000</u>		<u>1,960,701</u>
Loss of sale of equipment	-0-	R-10	(11,730)
General price-level gain	-0-	R-11	137,715
	<u>-0-</u>		<u>125,985</u>
Income before federal income taxes	2,378,000		2,086,686
Federal income taxes	910,000	(1) 1.014	922,740
Net income	<u>1,468,000</u>		<u>1,163,946</u>
Retained earnings—12/31/66	5,830,000	R-2	6,137,560
	<u>7,298,000</u>		<u>7,301,506</u>
Dividends paid			
June 1967	100,000	1.020	102,000
December 1967	100,000	1.000	100,000
	<u>200,000</u>		<u>202,000</u>
Retained earnings—12/31/67	<u>7,098,000</u>		<u>7,099,506</u>

(1) Assumed accrued ratably throughout the year

.25

## 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

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			Restated to 12/31/67 \$'s				
		Balance 12/31/66	Additions	Amortization	Balance 12/31/67	Balance 12/31/66	Additions	Amortization	Balance 12/31/67
1964	1.092	5,000		5,000	5,460		5,460		
1965	1.072	10,000		7,000	10,720		7,504	3,216	
1966	1.044	35,000		25,000	36,540		26,100	10,440	
1967									
1st q.	1.025		25,000	8,000		25,625	8,200	17,425	
2nd q.	1.020								
3rd q.	1.010		20,000	2,000		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

.27

**XYZ COMPANY**  
**General Price-Level Restatement—1967**  
**Analysis of Property, Plant, and Equipment**

12/31/67  
 R-6

Year acquired	Factor to restate to 12/31/67 \$'s	Historical				Restated to 12/31/67 \$'s			
		Balance 12/31/66	Additions	Retirements	Balance 12/31/67	Balance 12/31/66	Additions	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	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

**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	Depreciation (1)	Retirements	Balance 12/31/67
1957	1.219	3,000,000		200,000	2,800,000		243,800	3,413,200
1958	1.189	2,700,000	290,000	90,000	2,900,000	344,810	107,010	3,448,100
1959	1.170	3,200,000	390,000	80,000	3,510,000	456,300	93,600	4,106,700
1960	1.151	2,520,000	360,000		2,880,000	414,360		3,314,880
1961	1.137	480,000	80,000		560,000	90,960		636,720
1962	1.125	2,500,000	500,000		3,000,000	562,300		3,375,000
1963	1.110	1,200,000	300,000		1,500,000	333,000		1,665,000
1964	1.092	600,000	190,000	30,000	760,000	207,480	32,760	829,920
1965	1.072	100,000	50,000		150,000	53,600		160,800
1966	1.044	50,000	50,000		100,000	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	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

.29

**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			Restated to 12/31/67 \$'s		
		Balance 12/31/66	Additions	Realized	Balance 12/31/66	Additions	Realized
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		51,000	30,600
3rd q.	1.010		50,000			50,500	50,500
4th q.	1.000		30,000			30,000	30,000
		120,000	170,000	190,000	125,280	172,500	196,380
				100,000			100,900

.30

**XYZ COMPANY**  
**General Price-Level Restatement—1967** 12/31/67  
**Analysis of Sales and Cost of Sales** R-9

	Historical	Conversion factor or source	Restated to 12/31/67 \$'s
<b>Sales</b>			
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
<b>Cost of sales (except depreciation)</b>			
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

.31

**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
<b>Selling and administrative expenses</b>			
Amortization of prepaid expenses	47,000	R-5	49,284
Other	2,530,000	(1) 1.014	2,565,420
	<u>2,577,000</u>		<u>2,614,704</u>
 (1) Spread fairly throughout the year			
<b>Loss on sale of equipment</b>			
Cost	500,000	R-6	588,900
Accumulated depreciation	400,000	R-7	477,170
	<u>100,000</u>		<u>111,730</u>
Proceeds, December, 1967	100,000	1.000	100,000
Loss	<u>-0-</u>		<u>11,730</u>

.32

**XYZ COMPANY**  
**General Price-Level Restatement—1967**  
**General Price-Level Gain or Loss**

12/31/67  
R-11

	Source	12/31/66		12/31/67
		Historical	Restated to 12/31/67 \$'s	Historical (stated in 12/31/67 \$'s)
<b>Net monetary items</b>				
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)
		<u>(5,540,000)</u>	<u>(5,711,740)</u>	<u>(3,020,000)</u>
		<b>Historical</b>	<b>Source</b>	<b>Restated to 12/31/67 \$'s</b>
<b>General price-level gain or loss</b>				
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
		<u>24,540,000</u>		<u>24,788,100</u>
Deduct:				
Purchases		22,845,000	R-9	23,164,830
Selling and administrative ex- penses—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
		<u>27,560,000</u>		<u>27,945,815</u>
Net monetary items—historical— 12/31/67 (as above)		<u>(3,020,000)</u>		
Net monetary items—restated— 12/31/67 (if there were no gain)				(3,157,715)
Net monetary items—12/31/67 (as above)				<u>(3,020,000)</u>
General price-level gain				<u>137,715</u>

**1968 RESTATEMENT—XYZ COMPANY**

.33

**EXHIBIT A**

**XYZ Company**  
**Comparative General Price-Level**  
**Balance Sheets**  
**December 31, 1968 and December 31, 1967**

ASSETS	General Price-Level Basis (Restated to 12/31/68)	
	Dec. 31, 1968	Dec. 31, 1967
Current assets:		
Cash .....	\$( <sup>68</sup> ) 2,120,000	\$( <sup>68</sup> ) 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
	\$( <sup>68</sup> )20,874,000	\$( <sup>68</sup> )23,756,000
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities .....	\$( <sup>68</sup> ) 2,521,000	\$( <sup>68</sup> ) 4,957,000
Deferred income — payments re- ceived 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
	\$( <sup>68</sup> )20,874,000	\$( <sup>68</sup> )23,756,000

**EXHIBIT B**

.34

**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 .....	\$( <sup>os</sup> )27,381,000	\$( <sup>os</sup> )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 ....	\$( <sup>os</sup> ) 7,479,000	\$( <sup>os</sup> ) 7,376,000

.35

12/31/68  
R-1

**XYZ COMPANY**  
**General Price-Level Restatement—1968**  
**Gross National Product Implicit Price Deflators and Conversion Factors**

<i>Year</i>	<i>Quarter</i>	<i>GNP deflators</i>	<i>Conversion factors 1968 (4th q.) = 1.000</i>
<b><u>Annual average</u></b>			
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
<b><u>Quarterly</u></b>			
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

12/31/68  
R-2

**XYZ COMPANY**  
**General Price-Level Restatement—1968**  
**Working Balance Sheets—12/31/67 and 12/31/68**

	12/31/68		Conversion factor or source	Restated to 12/31/68 \$'s
	Restated to 12/31/67 \$'s (1)	Historical (2)		
<b>Assets</b>				
Cash	1,700,000	1,766,300	(3)	2,120,000
Marketable securities (at cost)	1,654,090	1,718,600	(3)	6,170,000
Receivables—net	5,050,000	5,246,950	(3)	2,575,560
Inventories				2,390,000
Raw materials (FIFO)	2,849,340	2,960,464	(4) 1.014	612,000
Finished goods (FIFO)	2,560,000	2,659,840	(5) 1.000	42,000
Parts and supplies (FIFO)	577,980	600,521	(4) 1.014	13,874,000
Prepaid expenses	49,261	51,182	R-4	13,919,158
Total current assets	14,440,671	15,003,857		26,400,000
Property, plant, and equipment (at cost)	29,579,550	30,733,153	R-5	20,210,000
Less: Accumulated depreciation	21,156,145	21,981,235	R-6	6,190,000
	8,423,405	8,751,918		20,064,000
<b>Liabilities</b>				
Current liabilities	4,770,000	4,956,030	(3)	2,521,000
Deferred income—payments received in advance	100,900	104,835	R-7	50,490
Long-term debt	5,000,000	5,195,000	(3)	4,700,000
	9,870,900	10,255,865		7,271,490
<b>Stockholders' Equity</b>				
Capital stock—common	2,109,120	2,191,376	(6)	2,191,376
Additional paid-in capital	3,784,550	3,932,147	(6)	3,932,147
Retained earnings	7,099,506	7,376,387	R-3	7,479,401
	12,993,176	13,499,910		13,602,924
	22,864,076	23,755,775		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	2,407,987
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	—	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



**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		Restated to 12/31/68 \$'s	
		Balance 12/31/67	Balance 12/31/68	Balance 12/31/67 in (1)	Balance 12/31/67 (2)
1957		2,800,000	2,800,000	3,413,200	3,546,315
1958		2,900,000	2,900,000	3,448,100	3,582,576
1959		3,900,000	3,900,000	4,563,000	4,740,957
1960		3,600,000	3,600,000	4,143,600	4,305,200
1961		800,000	800,000	909,600	945,074
1962		5,000,000	5,000,000	5,625,000	5,844,375
1963		3,000,000	3,000,000	3,330,000	3,459,870
1964		1,900,000	300,000	2,074,800	2,155,717
1965		500,000	500,000	536,000	556,904
1966		500,000	500,000	522,000	542,358
1967					
1st q.		250,000	250,000	256,250	266,244
2nd q.		300,000	300,000	306,000	317,934
3rd q.		200,000	200,000	202,000	209,878
4th q.		250,000	250,000	250,000	259,751
1968					
1st q.	1.029		300,000		308,700
2nd q.	1.019		200,000		203,800
3rd q.	1.010		300,000		303,000
4th q.					
		25,900,000	800,000	300,000	26,400,000
				29,579,550	30,733,153
					340,376
					308,700
					203,800
					303,000
					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.

**XVZ 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		Restated to 12/31/68 \$'s		Balance 12/31/68
		Balance 12/31/67	Depreciation (1)	Balance 12/31/67 in 12/31/67 \$'s (2)	Depreciation (1)	
1957		2,800,000		3,413,200		3,546,316
1958		2,900,000		3,448,100		3,582,576
1959		3,510,000	390,000	4,106,700	474,096	4,740,957
1960		2,880,000	360,000	3,314,880	430,520	3,874,680
1961		560,000	80,000	636,720	94,507	756,059
1962		3,000,000	500,000	3,375,000	584,437	4,091,062
1963		1,500,000	300,000	1,865,000	345,987	2,075,922
1964		760,000	160,000	829,920	181,584	907,670
1965		150,000	50,000	160,800	167,071	222,761
1966		100,000	50,000	104,400	54,236	162,708
1967						
1st q.		25,000	25,000	25,625	26,624	53,248
2nd q.		30,000	30,000	30,600	31,793	63,586
3rd q.		20,000	20,000	20,200	20,988	41,976
4th q.		25,000	25,000	25,000	25,975	51,950
1968						
1st q.	1.029		30,000		30,870	30,870
2nd q.	1.019		20,000		20,380	20,380
3rd q.	1.010		30,000		30,300	30,300
4th q.						
		18,260,000	2,070,000	21,981,145	2,407,937	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.

12/31/68  
R-7

**XYZ COMPANY**  
**General Price-Level Restatement—1968**  
**Analysis of Deferred Income**

.41

Year acquired	Factor to restate to 12/31/68 \$'s	Historical		Restated to 12/31/68 \$'s			
		Balance 12/31/67	Additions Realized	Balance 12/31/67 in (1)	Balance 12/31/67 (2)	Additions	Realized
1967		20,000		20,400			
2nd q.		50,000	20,000	50,500	21,196	21,196	21,196
3rd q.		30,000	50,000	30,000	52,469	52,469	52,469
4th q.			30,000		31,170	31,170	31,170
1968							
1st q.	1.029		20,000		20,580	20,580	20,580
2nd q.	1.019		10,000		10,190	10,190	10,190
3rd q.	1.010		30,000		30,300	30,300	30,300
4th q.	1.000		10,000		10,000	10,000	10,000
		100,000	70,000	100,900	104,835	71,070	125,415
			120,000				50,490

(1) From R-8 of 12/31/67

(2) Each item restated by factor for 4th quarter 1967—1.039

.42

**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
<b>Sales</b>			
Current sales	26,880,000	(1) 1.014	27,256,320
Deferred sales realized	120,000	R-7	125,415
<b>Total sales</b>	<u>27,000,000</u>		<u>27,381,735</u>
<b>Cost of sales (except depreciation)</b>			
<b>Inventories 12/31/67</b>			
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
	<u>26,398,000</u>		<u>26,965,237</u>
<b>Inventories 12/31/68</b>			
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
	<u>5,542,000</u>		<u>5,586,128</u>
	<u>20,856,000</u>		<u>21,379,109</u>

(1) Spread fairly evenly throughout the year

.43

**XYZ COMPANY**  
**General Price-Level Restatement—1968**  
**Analysis of Expenses**

12/31/68  
R-9

	Historical	Conversion factor or source	Restated to 12/31/68 \$'s
<b>Selling and administrative expenses</b>			
Amortization of prepaid expenses	40,000	R-4	42,292
Other	2,580,000	(1) 1.014	2,616,120
	<u>2,620,000</u>		<u>2,658,412</u>
 (1) Spread fairly evenly throughout the year			
<b>Gain or (loss) on sale of equipment</b>			
Cost	300,000	R-5	340,376
Accumulated depreciation	120,000	R-6	136,151
	<u>180,000</u>		<u>204,225</u>
Proceeds, June 1968	241,000	1.019	245,579
	<u>61,000</u>		<u>41,354</u>
<b>Gain or (loss) on sale of marketable securities</b>			
Cost	1,500,000	R-2 (1967, 8)	1,718,600
Proceeds, December 1968	1,600,000	1.000	1,600,000
	<u>100,000</u>		<u>(118,600)</u>

.44

**XYZ COMPANY**  
**General Price-Level Restatement—1968**  
**General Price-Level Gain or Loss**

12/31/68  
R-10

Source	12/31/67		12/31/68	
	Historical	Restated to 12/31/68 \$'s	Historical (stated in 12/31/68 \$'s)	
<b>Net monetary items</b>				
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)
		<u>(3,020,000)</u>	<u>(3,137,780)</u>	<u>1,069,000</u>
<b>General price-level gain or loss</b>				
		<u>Historical</u>	<u>Source</u>	<u>Restated to 12/31/68 \$'s</u>
Net monetary items—12/31/67		(3,020,000)	as above	(3,137,780)
<b>Add:</b>				
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
		<u>25,771,000</u>		<u>26,035,189</u>
<b>Deduct:</b>				
Purchases		20,458,000	R-8	20,744,412
Selling and administrative ex- penses—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
		<u>24,702,000</u>		<u>25,050,892</u>
Net monetary items—historical— 12/31/68 (as above)		<u>1,069,000</u>		
Net monetary items—restated— 12/31/68 (if there were no gain)				984,297
Net monetary items—12/31/68 (as above)				<u>1,069,000</u>
General price-level gain				<u>84,703</u>

**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

	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	<u>\$20,000</u>	<u>\$24,000</u>	<u>\$34,000</u>	<u>\$34,000</u>
Income statement gains reported				
In year 1	\$—	\$—	\$—	\$—
In year 2	—	—	6,000	4,000(1)
In year 3	<u>14,000</u>	<u>10,000</u>	<u>8,000</u>	<u>5,640(2)</u>
Total gains for 3 years	<u>\$14,000</u>	<u>\$10,000</u>	<u>\$14,000</u>	<u>\$10,000(3)</u>
				(year 3 dollars)

*Notes*

(1) Market price, end of year 2 \$26,000

Restated market from year 1:  
 $20,000 \times 110/100 =$  22,000

Gain from appreciation \$ 4,000

(2) Selling price, year 3 \$34,000

Restated market from year 2:  
 $26,000 \times 120/110 =$  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.

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**Section 1081****Foreign Operations and  
Foreign Exchange**

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, and they should be reserved against to the extent that their realization in dollars appears to be doubtful.

**.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 Where more than one foreign exchange rate is in effect, care should be exercised to select the one most clearly realistic and appropriate in the circumstances.

#### **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 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.

#### **LOSSES AND GAINS ON FOREIGN EXCHANGE**

.10 Realized losses or gains on foreign exchange should be charged against or credited to operations.

.11 Provision should be made, ordinarily by a charge against operations, for declines in translation value of foreign net current and working assets (unrealized losses). Unrealized gains should preferably be carried to a suspense account, except to the extent that they offset prior provisions for unrealized losses, in which case they may be credited to the account previously charged.

#### **TRANSLATION OF ASSETS, LIABILITIES, LOSSES AND GAINS**

##### **Balance Sheet**

.12 Fixed assets and permanent investments should be translated into dollars at the rates prevailing when such assets were acquired or constructed. Long-term receivables may be similarly translated, although translation of such receivables at current exchange rates is appropriate in many circumstances. When large items are purchased for United States dollars (or from the proceeds of sale of such dollars), the United States dollar cost will, of course, be used. If, however, the purchase is made in some foreign currency (obtained from earnings or borrowings), then the cost of the assets should be the equivalent of the amount of foreign currency in the United States dollars, at the rate of exchange prevailing at the time payment is made. An exception to the foregoing general principles might be made where fixed assets, permanent investments, or long-term receivables were acquired shortly before a substantial and

presumably permanent change in the exchange rate with funds obtained in the country concerned, in which case it may be appropriate to restate the dollar equivalent of such assets to the extent of the change in the related debt. [As amended, effective for fiscal periods beginning after December 31, 1965, by APB Opinion No. 6.]

**.13** In consolidating or combining the accounts, depreciation should be computed on the amount of fixed assets as expressed in United States dollars, even though for purposes of local taxation it may be impossible to show the foreign currency equivalent of the full amount of depreciation on the foreign statements.

**.14** Cash, accounts receivable, and other current assets, unless covered by forward exchange contracts, should be translated at the rate of exchange prevailing on the date of the balance sheet.

**.15** Inventory should follow the standard rule of *cost or market, whichever is lower* in dollars. Where accounts are to be stated in which the question of foreign exchange enters and the inventory is not translated at the rate of exchange prevailing on the date of the balance sheet, as is usually done with current assets, the burden of proof is on those who wish to follow some other procedure.

**.16** There are, however, undoubtedly many cases where the cost or a portion of the cost of an article was incurred when the foreign currency was at a substantially higher rate of exchange than existed on the closing day of the financial period. In many cases such an asset could not be replaced for the amount in foreign currency at which it appears in the records of the branch or subsidiary company. In some cases the replacement price in foreign currency would undoubtedly have increased since the fall in exchange, and it would be inequitable to treat *the lower of cost or market* as a mere translation at the closing rate of the foreign currency cost price, where the article could now be replaced only at a much higher amount in foreign currency. Where the selling price obtainable in dollars, after deducting a reasonable percentage to cover selling and other local expenses, exceeds the cost of the article in dollars at the rate prevailing as of the date of purchase, such original

dollar equivalent may be considered as the cost for purposes of inventory.

.17 Current liabilities payable in foreign currency should be translated into dollars at the rate of exchange in force on the date of the balance sheet.

.18 Capital stock stated in foreign currency should not be translated at the closing rate, but at the rates of exchange prevailing when originally issued. Long-term liabilities payable in foreign currency may be similarly translated, although translation of such liabilities at current exchange rates is appropriate in many circumstances. These are general rules, but an exception may exist in respect to long-term debt incurred or capital stock issued in connection with the acquisition of fixed assets, permanent investments, or long-term receivables a short time before a substantial and presumably permanent change in the exchange rate. In such instances, it may be appropriate to state the long-term debt or the capital stock at the new rate and proper to deal with the exchange differences as an adjustment of the cost of the assets acquired. [As amended, effective for fiscal periods beginning after December 31, 1965, by APB Opinion No. 6.]

#### **Profit and Loss Statement**

.19 The operating statements of foreign branches or subsidiaries, or of domestic corporations conducting their business in foreign currencies (buying, selling, and manufacturing), should preferably, where there have been wide fluctuations in exchange, be translated at the average rate of exchange applicable to each month or, if this procedure would involve too much labor, on the basis of a carefully weighted average.

.20 Where a major change in an exchange rate takes place during a fiscal year, there may be situations in which more realistic results will be obtained if income computed in foreign currencies is translated for the entire fiscal year at the new rates in effect after such major fluctuation. This procedure would have the practical advantage of making unnecessary a cutoff at the date of the change in the exchange rate. Where dividends have been paid prior to a major change in the exchange rate, out of earnings of the

current fiscal year, that portion of the income for the year should be considered as having been earned at the rate at which such dividend was paid irrespective of the rates used in translating the remainder of the earnings.

.21 The possibility of gains and losses from foreign exchange rate changes may ordinarily be considered to be a risk inherent in the conduct of business in foreign countries, and the worldwide scope and unprecedented frequency of rate changes that have occurred in recent years are such that they can be regarded as recurrent hazards of business. Accordingly, foreign exchange gains and losses arising from such developments should be classified in the income statement in accordance with section 2012. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.]

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.22 The foregoing is no more than a brief résumé of the generally accepted principles pertaining to the treatment of foreign exchange as applied to the statements of accounts of American corporations. The practical problems which arise in their application should receive careful consideration in each case.

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## Section 1091

**Accounting for Business Combinations**

Effective to account for business combinations initiated after October 31, 1970, unless otherwise indicated <sup>1</sup>

**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.<sup>2</sup> 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

<sup>1</sup> See paragraphs .97—99.

<sup>2</sup> 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-

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**<sup>3</sup>

.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**<sup>4</sup>

.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.<sup>4</sup> The method was first applied in accounting for combinations of affiliated corporations and then extended to some combinations of unrelated corporate

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<sup>3</sup>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.

<sup>4</sup>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.

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.

**.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.

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

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

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

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.<sup>5</sup> 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.<sup>6</sup>

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<sup>5</sup> An exception for common stock held on October 31, 1970 is explained in paragraph .99.

<sup>6</sup> However, an adjustment after the effective date of this section in the terms of exchange in a plan of combination initiated before and consum-

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<sup>7</sup> 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,<sup>8</sup> (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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minated 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.)

<sup>7</sup>A class of stock that has voting control of a corporation is the majority class.

<sup>8</sup>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.

*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<sup>9</sup> 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-

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<sup>9</sup> Including (for this computation) stock of the issuing corporation held by the transferor combining company.

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

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

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-

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

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 inter-company 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<sup>10</sup>—that is, shares of stock issued are

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<sup>10</sup> An asset acquired may be an entire entity which may have intangible assets, including goodwill.

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."<sup>11</sup> "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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<sup>11</sup> ARB No. 24; the substance was retained in slightly different words in Chapter 5, ARB No. 43 (see Volume 2, page 6019) and ARB No. 48 (see Volume 2, page 6082).

**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.)

.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

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

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<sup>12</sup> 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.<sup>13</sup>
- 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,<sup>14</sup> 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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<sup>12</sup> 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.

<sup>13</sup> Fair values should be ascribed to specific assets; identifiable assets should not be included in goodwill.

<sup>14</sup> 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.

An acquiring 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

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<sup>15</sup> 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 is completed within five years after October 31, 1970 and

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,

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<sup>15</sup> Initiated is defined in paragraph .46-a whether the combination is accounted for by the pooling of interests method or by the purchase method.

1970 may exceed 10 percent of the outstanding voting common stock of the combining company (paragraph .46-b), and

- (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.

## Section 2000

# FINANCIAL STATEMENT PRESENTATION

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. . . reporting the results of operations . . .  
 earnings per share . . . statements of funds  
 . . . working capital . . . form of statements  
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## Section 2010

# Reporting the Results of Operations

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 (a) 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, and (b) specifies the criteria to be used in determining which items, if any, recognized during the current period are to be considered prior period adjustments and excluded from net income for the current period. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

.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 and establishes criteria which the Board feels are reasonable and practicable for the relatively few items which should be so recognized. [As amended, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

##### **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 embrace 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 recog-

nized 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: . . . ."<sup>1</sup> 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.

## OPINION

### Summary

.16 The Board has considered various methods of reporting the effects of extraordinary events and trans-

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<sup>1</sup> Accounting Research Bulletin No. 32, *Income and Earned Surplus*.

actions 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 With respect to *prior period adjustments*, the Board has concluded that those rare items which relate directly to the operations of a specific prior period or periods, which are material and which qualify under the criteria described in paragraph .22 below should, 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].

.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 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] [Superseded, effective for events and transactions occurring after September 30, 1973, by APB Opinion No. 30.] (See section 2012.)

[.20] [Superseded, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

[.21] [Superseded, effective for events and transactions occurring after September 30, 1973 by APB Opinion No. 30.] (See section 2012.)

#### **Criteria for Prior Period Adjustments**

.22 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 revenues under rate processes. Settlements of significant amounts resulting from litigation or similar claims may also constitute prior period adjustments.

.23 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 believes that prior period adjustments will be rare.

[.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.<sup>2</sup> When financial statements for a single period only are presented, this disclosure should indicate the ef-

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<sup>2</sup> 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,<sup>3</sup> 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,<sup>4</sup> (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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<sup>3</sup> See section 2041, *Comparative Financial Statements*.

<sup>4</sup> 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.)

➤ *The next page is 1035.* ←

## Section 2011

### *Earnings per Share*

Effective for fiscal periods  
beginning after December  
31, 1968, unless otherwise  
indicated <sup>1</sup>

#### 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*.<sup>2</sup>

.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

»»»→ *The next page is 1037.* ←«««

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<sup>1</sup> See paragraphs .45 and .46.

<sup>2</sup> See volume 2, pages 6563-6567.

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<sup>3</sup> 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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<sup>3</sup>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.

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 Opinion 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.

➤→ *The next page is 1039-3.* ←➤

.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<sup>4</sup> 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<sup>4</sup> effect. The second is a pro-forma presentation which reflects the dilution<sup>4</sup> of 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

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<sup>4</sup> 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.

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,"<sup>5</sup> 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

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<sup>5</sup> APB Opinion No. 9 referred to the latter presentation as "supplementary pro forma earnings per share."

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 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.<sup>6</sup> 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.<sup>7</sup>

**.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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<sup>6</sup> 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.)

<sup>7</sup> See also section 2042 and section 2071.

periods presented.<sup>8</sup> 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.<sup>9</sup>

#### **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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<sup>8</sup> See sections 2011A.03-.04 and 2011A.17-.19 for exceptions to this general rule.

<sup>9</sup> 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

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.<sup>10</sup> 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

<sup>10</sup> 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 AIPB Opinion No. 30.] (See section 2012.)

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,<sup>11</sup> it has a cash yield of less than  $66\frac{2}{3}\%$  of the then current bank prime interest rate.<sup>12</sup> For any convertible security which

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<sup>11</sup> If no market price is available, this test should be based on the fair value of the security.

<sup>12</sup> 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<sup>13</sup> if its effect on earnings per share is anti-dilutive (see paragraph .30) except as indicated in paragraph .38.

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<sup>13</sup> Reasonable grouping of like securities may be appropriate.

.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.<sup>14</sup> 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.

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<sup>14</sup> 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:

- 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.<sup>15</sup>

<sup>15</sup> The following are examples of the application of Paragraph 38:

<i>Assumptions:</i>	<i>Case 1</i>	<i>Case 2</i>
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
<i>Computations:</i>		
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
	<u>\$15,000,000</u>	<u>\$15,000,000</u>
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) .....	<u>\$ 4,090,000</u>	<u>\$ 2,234,000</u>
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) .....	<u>3,400,000</u>	<u>3,400,000</u>
<i>Earnings per share:</i>		
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<sup>16</sup> 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

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<sup>16</sup> See footnote 10.

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.

**.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.

**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<sup>1</sup> 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

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<sup>1</sup> 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.<sup>2</sup> 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

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<sup>2</sup> The per share and aggregate amounts of cumulative preferred dividends in arrears should be disclosed.

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.<sup>3</sup> 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

<sup>3</sup> 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.)<sup>4</sup> 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

<sup>4</sup> An increasing conversion rate should not be accounted for as a stock dividend.

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.<sup>5</sup> 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

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<sup>5</sup> 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

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

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.

## Section 2011 B

### **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,

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

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

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

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.

## Section 2011 C

**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:

Common stock outstanding	<i>Number of Shares</i>	
	<u>1968</u>	<u>1967</u>
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**

<i>(Bottom of Income Statement)</i>	<i>Thousands</i>	
	<u>1968</u>	<u>1967</u>
Income before extraordinary item.....	\$ 9,150	\$7,650
Extraordinary item—gain on sale of property less applicable income taxes.....	900	.....
Net Income .....	<u>\$10,050</u>	<u>\$7,650</u>
Earnings per common share:		
Income before extraordinary item...	\$ 2.77	\$ 2.32
Extraordinary item .....	.28	.....
Net Income .....	<u>\$ 3.05</u>	<u>\$ 2.32</u>

**.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:

	<u>1968</u>	<u>1967</u>	<u>1966</u>
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 66 $\frac{2}{3}$ % 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-

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).

Holder 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 ( $\$60 \text{ exercise price} \times 500,000 \text{ warrants} = \$30,000,000$ ;  $\$30,000,000 \div \$70 \text{ share market price} = 428,572 \text{ shares}$ ;  $500,000 \text{ shares} - 428,572 \text{ shares} = 71,428 \text{ shares}$ ). 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:

	<u>1968</u>	<u>1967</u>
Beginning of year.....	3,300,000	3,300,000
Conversion of preferred stock...	500,000	.....
Conversion of debentures.....	200,000	.....
End of year.....	<u>4,000,000</u>	<u>3,300,000</u>

*Weighted average number of shares.* The weighted average number of shares of common stock and common stock equivalents was determined as follows:

	<u>1968</u>	<u>1967</u>
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	.....
	<u>3,650,000</u>	<u>3,300,000</u>
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 equivalents outstanding for third and fourth quarters of 1968, i. e., one-half year .....	35,714	.....
	<u>385,714</u>	<u>450,000</u>
Weighted average number of shares..	<u>4,035,714</u>	<u>3,750,000</u>

The weighted average number of shares would be adjusted to calculate fully diluted earnings per share as follows:

	<u>1968</u>	<u>1967</u>
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	.....
	<u>4,183,333</u>	<u>3,950,000</u>

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:

	<i>Thousands</i>		
	<i>Before Adjustment</i>	<i>Interest, net of tax effect</i>	<i>After Adjustment</i>
1967: Net income .....	\$10,300	\$208	\$10,508
1968:			
Income before extraordi- nary 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

<i>(Bottom of Income Statement)</i>	<i>Thousands Except per share data</i>	
	<u>1968</u>	<u>1967</u>
Income before extraordinary item.....	\$12,900	\$10,300
Extraordinary item—gain on sale of property less applicable income taxes.....	900	.....
Net Income .....	<u>\$13,800</u>	<u>\$10,300</u>
Earnings per common share and com- mon equivalent share (note x):		
Income before extraordinary item... \$	3.20	\$ 2.75
Extraordinary item .....	.22	.....
Net Income .....	<u>\$ 3.42</u>	<u>\$ 2.75</u>
Earnings per common share—assuming full dilution (note x):		
Income before extraordinary item... \$	3.11	\$ 2.66
Extraordinary item .....	.21	.....
Net Income .....	<u>\$ 3.32</u>	<u>\$ 2.66</u>

.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:

	<u>1968</u>	<u>1967</u>
Long-term debt:		
4% convertible debentures, due 1986. . . . .	—	\$10,000,000
	<u>          </u>	<u>          </u>
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
	<u>          </u>	<u>          </u>
	\$ xxx	\$ xxx
	<u>          </u>	<u>          </u>

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.

## Section 2011 D

### *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).

**.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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## Section 2012

# ***Reporting the Results of Operations— Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Frequently Occurring Events and Transactions***

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,<sup>1</sup> 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-

<sup>1</sup> See Volume 2, page 6561.

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.<sup>2</sup>

#### 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

<sup>2</sup> 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 <sup>3</sup> .....		\$xxxx
Provision for income taxes.....		xxx
		<hr/>
Income from continuing operations <sup>3</sup> .....		\$xxxx
Discontinued operations (Note .....):		
Income (loss) from operations of discontinued Division X (less applicable in come 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
	<hr/>	<hr/>
Net Income .....		<u>\$xxxx</u>

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

<sup>3</sup> 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.

statement.<sup>4</sup> 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 <sup>5</sup> .....	\$xxx
Extraordinary items (less applicable income taxes of \$.....) (Note .....)	xxx
	<hr/>
Net income .....	<u>\$xxx</u>

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-

<sup>4</sup> 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.

<sup>5</sup> 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

*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.<sup>6</sup> 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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<sup>6</sup> 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 Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, section 560.03.)

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.<sup>7</sup>

.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, deferred research and development costs, or other 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.

.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:

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<sup>7</sup> 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).

- (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,<sup>8</sup> 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-

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<sup>8</sup> 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

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, deferred research and development costs, or other 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.

**.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 not be reported as a prior period adjustment unless it meets the criteria for a prior period adjustment as defined in section 2010.22. An adjustment that does not meet such criteria 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.

***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-

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.<sup>9</sup>

#### 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 1201. ←➤

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<sup>9</sup> 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.

## Section 2021

# Reporting Changes in Financial Position

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.<sup>1</sup> 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

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<sup>1</sup> 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.)

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.<sup>2</sup> 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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<sup>2</sup> 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 Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, section 516.05-.06) and financial statements prepared for special purposes (see Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, section 620).

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.)

**.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.<sup>3</sup>

### 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;<sup>4</sup> both long-term borrowings

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<sup>3</sup> 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.

<sup>4</sup> 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<sup>6</sup> 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

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<sup>6</sup> 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*.

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 1251.* ←«««

## Section 2031

# Current Assets and Current Liabilities

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 generally to normal trade practices and terms within the business; (f) marketable securities representing the investment of cash available for current operations; and (g) pre-

paid 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*. 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<sup>1</sup> 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

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<sup>1</sup> 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.

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, costs of rearrangement of factory layout or removal to a new location, and certain types of research and development costs. [As amended, effective October 1, 1971, by APB Opinion No. 21.]

.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 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;<sup>2</sup> 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.<sup>3</sup>

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<sup>2</sup> 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.

<sup>3</sup> 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

.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 a contractual obligation falling due at an early date which is expected to be refunded,<sup>4</sup> or 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.

.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

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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.

<sup>4</sup>There should, however, be full disclosure that such obligation has been omitted from the current liabilities and a statement of the reason for such omission should be given. Cf. note 1.

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 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.]

**Section 2032****Offsetting Securities Against  
Taxes Payable**

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 1351.* ←➤

**Section 2041****Comparative Financial  
Statements**

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.

**Section 2042****Capital Changes**

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.

**Section 2043*****Disclosure of Depreciable  
Assets and Depreciation***

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.

**Section 2044*****Classification and Disclosure  
of Allowances***

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.

**Section 2045*****Disclosure of Accounting Policies***

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.<sup>1</sup> 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

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<sup>1</sup> See *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, sections 1026, 1027, and 1028.

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.<sup>2</sup>

.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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<sup>2</sup>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 Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, section 516.05-.06) and from certain special reports in which incomplete or no financial presentations are made (ibid section 620.09-.10).

.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, accounting for research and development costs (including basis for amortization), translation of foreign currencies, 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.

.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 1451.* ←➤

## Section 2051

# Consolidated Financial Statements

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.<sup>1</sup>

### 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

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<sup>1</sup>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.

.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 <sup>2</sup>**

.08 The earned surplus or deficit of a purchased <sup>3</sup> 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

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<sup>2</sup> As amended, effective for fiscal periods beginning after October 31, 1970, by APB Opinion No. 16.

<sup>3</sup> 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.

### 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-

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.

➤→ *The next page is 1551.* ←➤

**Section 2061****Disclosure of Supplemental  
Financial Information by  
Diversified Companies**

Issue date, unless  
otherwise indicated:  
September, 1967

**STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD****INTRODUCTION**

.01 Increasing attention is being given to the question of whether published reports of conglomerate companies should contain supplemental financial information concerning the activities of those segments of the business which are clearly separable into different industry lines. The term *conglomerate* is used popularly to describe a company that diversifies into distinctly different industries by acquisition or merger. The Board believes, however, that there is little distinction between industry diversification which arises by this method and industry diversification resulting from a company's own internal development and expansion efforts. All of these companies will be referred to in this statement by the more descriptive term *diversified companies*.

.02 Disclosure of financial data relating to separable industry activities of a diversified company has not been considered essential for fair presentation of financial position and results of operations in conformity with generally accepted accounting principles. The Board recognizes, however, that financial reporting practices are not static and should be responsive to changes in the business environment. The increase in industry diversification by business enterprises is one aspect of the changing business environment which indicates a need for reexamination of financial reporting practices.

.03 The Board believes it should consider financial reporting by diversified companies. Presently the Financial

Executives Research Foundation is conducting a comprehensive study on this subject, some interested organizations are releasing "position" papers and other organizations are publishing views of individual authors. Upon completion and evaluation of these research activities and further study as may be deemed appropriate, the Board intends to issue a definitive pronouncement on the subject.

#### **BACKGROUND**

.04 Unlike earlier merger movements, which were largely characterized as horizontal (companies joining with others in the same or related businesses) or vertical (companies joining with their suppliers or distributors into more integrated enterprises), the current merger activity has produced a significant number of business combinations which are neither horizontal nor vertical. Instead they represent the bringing together of companies in industries which are unrelated, or only slightly related.

.05 Many companies, also, have accomplished industry diversification through internally generated activities, including the acquisition in some cases of comparatively small companies in other industries as a means of obtaining specialized industry knowledge. Some companies have broken away from an industry pattern with which they were previously identified and have entered entirely different fields to reduce dependence on a single market.

#### **NEEDS OF THE INVESTOR AND HIS ADVISORS**

.06 Another major development has been the significant growth in the number of investors, as well as the growth in number of companies whose shares are publicly traded. Prominent in this growth has been the substantial increase in securities held by institutional investors (mutual funds, pension funds, insurance companies, foundations, etc.) with an increased emphasis on the role of the financial analyst. Analysts have frequently asserted the need for information concerning revenues and operating results of segments of diversified companies and have requested that it be furnished when it is not disclosed in published financial reports. These requests are a reaction by the analyst to the loss of corporate identification with a specific industry which has accompanied the development of complex diversified companies.

.07 The Board recognizes that such information may be useful for investors in appraising the past performance and future risks and prospects of diversified companies.

#### **REPORTING PROBLEMS**

.08 There appear to be few practical problems involved in determining sales or revenues for segments of a diversified company. However, determination of profitability by segments in a form suitable for reporting to investors raises many complex problems. Reporting profitability by segments may be practicable in those cases where the industry segments are relatively autonomous, rather than interdependent. There are many instances, however, where reporting on segments of a company's activities would require many estimates, assumptions, and arbitrary allocations and might result in information that would not be meaningful and could be misleading to investors. This is especially true where joint costs are involved or arbitrary transfer prices are used between major segments of a company.

#### **COMPETITIVE ASPECTS**

.09 Concern has been expressed that supplemental financial information as to segments of the business may reveal valuable information to competitors and could be harmful to the company.

#### **NEED FOR RESEARCH**

.10 Before a definitive pronouncement can be made, the Board believes that substantial research is necessary to provide practical guidelines for determining the extent to which such supplemental information is, in fact:

- (a) needed by investors;
- (b) reliable for investment decisions;
- (c) not harmful to the company (that is, its present shareholders); and
- (d) necessary for fair presentation of financial position and results of operations.

#### **INTERIM RECOMMENDATION FOR DISCLOSURE**

.11 For the present, the Board urges diversified companies to review their own circumstances carefully and objectively with a view toward disclosing voluntarily

supplemental financial information as to industry segments of the business.

.12 An increasing trend by diversified companies to disclose such information is now evident. Specific examples of supplemental disclosures that are being made by some companies at the present time are as follows:

- (a) Revenues by industry activity, or type of customer
- (b) Revenues and profits by separable industry segments
- (c) Separate financial statements of segments of the business which operate autonomously and employ distinctly different types of capital structure, such as insurance or bank subsidiaries of merchandising or manufacturing companies
- (d) Revenues by type of industry activity and type of customer, together with a general indication of the profitability of each category
- (e) Information that the operations of a segment of the enterprise are resulting in a loss, with or without disclosure of the amount of such loss.

#### CONCLUSION

.13 The Board believes that the experience derived from voluntary disclosure efforts, together with the conclusions to be derived from research activities and further study, should provide it with a sound basis for making a definitive pronouncement in the future on the need for, and extent of, disclosure of supplemental financial information by diversified companies.

#### NOTE

.14 *This Statement is not an "Opinion of the Accounting Principles Board" as contemplated in the Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, October 1964. It is being issued as a special report for the information and assistance of members of the Institute and others interested in the subject. The Board may issue similar Statements in the future when it appears that preliminary analyses or observations on accounting matters should be issued in advance of research and study by the Board.*

»»»→ The next page is 1601. ←«««

## Section 2071

### *Interim Financial Reporting*

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 for the balance of the annual period. Thus, an ex-

pense 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.<sup>1</sup> 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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<sup>1</sup> 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.

- 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

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

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.<sup>2</sup>

.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.<sup>3</sup> 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

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<sup>2</sup> 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).

<sup>3</sup> 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.<sup>4</sup> 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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<sup>4</sup>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.

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** 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.<sup>5</sup> The cumulative effect of a change in accounting practice or policy should be calculated in an interim period by determining the effect of the change on the amount of retained earnings at the beginning of the annual period in which the interim period falls. 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. When the previously reported interim information is subsequently presented, it should be restated to give effect to the accounting change.

**.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.

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<sup>5</sup> Section 1051.20-.22 provides guidance on the determination of the cumulative effect of an accounting change. The first two sentences of paragraph .27 above apply the guides of section 1051.20-.22 to interim data.

.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<sup>6</sup> report summarized financial information to 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:<sup>7</sup>

- 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).

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<sup>6</sup> See footnote 1.

<sup>7</sup> 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.

- 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 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) should be disclosed in the annual report in a note to the annual financial statements.

**.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.



SectionParagraph

<b>4050</b>	<b>Financial Statements of Lessors</b>	
<b>4051</b>	<b>Accounting for Leases in Financial Statements of Lessors</b>	
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»»»→ *The next page is 2011.* ←«««

**Section 4010*****Unrealized Profit***

Issue date, unless  
otherwise indicated:  
1934<sup>1</sup>

.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.)

➤➤➤ → *The next page is 2051.* ← ➤➤➤

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<sup>1</sup>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.

**Section 4020*****Installment Method  
of Accounting***

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<sup>1</sup> referred to above, the installment method of recognizing revenue is not acceptable.

➤➤➤ → *The next page is 2101.* ← ➤➤➤

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<sup>1</sup>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.)

**Section 4031****Long-Term Construction-Type  
Contracts**

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.

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.

➤➤➤ *The next page is 2151.* ←➤➤➤

## Section 4041

### ***Cost-Plus-Fixed-Fee Contracts***

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?

(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

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

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.

**Section 4042*****Renegotiation***

Issue date, unless  
otherwise indicated:  
June, 1953<sup>1</sup>

.01 This section<sup>2</sup> 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

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<sup>1</sup>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.

<sup>2</sup>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.<sup>3</sup> 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.

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<sup>3</sup> See section 4010.

**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, or as a prior period adjustment, as appropriate. (See sections 2010.22-.23, 2012.10-.12, and 2010.25.) [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.]

**Section 4043****Terminated War and  
Defense Contracts**

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

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-

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.<sup>1</sup> 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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<sup>1</sup> See section 4041.22.

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

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 2251.* ← ➤➤➤

**Section 4051*****Accounting for Leases in  
Financial Statements  
of Lessors***

**Effective for fiscal periods  
beginning after December  
31, 1966, unless otherwise  
indicated**

**INTRODUCTION**

**.01** This section sets forth the Board's views as to accounting for the revenue and expense related to, and the investment in, property leased to others. Because of the highly specialized problems involved, this section does not apply to lease agreements concerning natural resources such as oil, gas, timber and mineral rights.

**.02** The principal accounting problems of lessors concern the allocation of revenue and expense to the accounting periods covered by a lease. Although the lease typically establishes a schedule of rent to be received by the lessor, the treatment of this rent as revenue in the period of receipt does not necessarily result in a fair measurement of the lessor's periodic income during the term of the lease. The allocation to accounting periods of acquisition and operating costs of the leased property and of costs of negotiating and closing the lease needs to be systematic, rational and consistent with the method of recognizing revenue. The description and classification in the balance sheet of the investment in leasing activities is also of importance.

**DISCUSSION****Leasing Activities**

**.03** Lessors may engage in leasing activities to accomplish one or more objectives, such as: investing funds; facilitating the sale or use of the lessor's own manufactured product; retaining control of locations when it is desirable that the property be operated by others; and making available to others property operated by the lessor for profit. Some lessors engage in leasing primarily or solely as a

method of investing funds; some financing institutions specialize in leasing. On the other hand, some lessors engage in leasing as incidental to entirely different and relatively more significant business operations. Leasing activities of many lessors have both financing and operating characteristics to some degree, and some lessors have leasing activities of both types.<sup>1</sup>

#### **Accounting Methods**

**.04** There are two predominant methods in general use for allocating rental revenue and expenses over the accounting periods covered by a lease. These may be termed the "financing" and the "operating" methods.

**.05** *Financing method*—Under the financing method, the excess of aggregate rentals over the cost (reduced by estimated residual value at the termination of the lease) of the leased property is generally designed to compensate the lessor for the use of the funds invested. Since this excess is in the nature of interest, it is recognized as revenue during the term of the lease in decreasing amounts related to the declining balance of the unrecovered investment or, in other words, as an approximately level rate of return on funds not yet recovered. When rentals are level, this results in a decreasing percentage of each succeeding rental being accounted for as revenue and an increasing percentage as recovery of investment. This is comparable to the method followed by most lending institutions in accounting for level repayment plans.

**.06** *Operating method*—Under the operating method, aggregate rentals are reported as revenue over the life of the lease. The amount of revenue to be recognized in each accounting period will ordinarily be equivalent to the amount of rent receivable according to the provisions of the lease unless distortion of periodic revenue would result, e.g., when the rentals depart radically from a straight-line basis without relation to the economic usefulness of the leased property. The income statement reflects, as

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<sup>1</sup> A comprehensive discussion of leasing will be found in Accounting Research Study No. 4, *Reporting of Leases in Financial Statements* by John H. Myers, published by the American Institute of Certified Public Accountants in 1962. (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.)

expenses, depreciation of the leased property, maintenance and other related costs, as well as the cost of any other services rendered under the provisions of the lease. The amount of these expenses to be recognized in each accounting period should be determined by methods which are appropriate in the circumstances and which are conventionally used for such expenses when incurred in activities other than leasing.

**.07 Basis for selection**—The objective of fairly stating the lessor's net income during each of the periods covered by the leasing activities is the most important consideration in differentiating between the use of the financing or operating methods (see paragraphs .13-.15 for a description of balance sheet presentations consistent with the method used in determining income). Pertinent factors in making the choice, among others, are the following: the nature of the lessor's business activities; the specific objectives of its leasing activities, including the relationship to other business activities of the lessor, if any; the term of the lease in relation to the estimated useful life of the property; the existence of renewal or purchase options and the likelihood that the lessee will exercise them; provisions of the lease which indicate the extent to which the usual risks of ownership (e.g., obsolescence, unprofitable operation, unsatisfactory performance, idle capacity, dubious residual value) or rewards of ownership (e.g., profitable operation, gain from appreciation in value at end of lease) rest with the lessor or the lessee.

**.08** The financing method is generally appropriate for measuring periodic net income from leasing activities of entities engaged in, perhaps among other things, lending money at interest—e.g., lease-finance companies, banks, insurance companies or pension funds. Lease agreements of institutions of this kind typically are designed to pass all or most of the usual ownership risks or rewards to the lessee, and to assure the lessor of, and generally limit him to, a full recovery of his investment plus a reasonable return on the use of the funds invested, subject only to the credit risks generally associated with secured loans. Usually, the financing method is similar to the method of accounting for revenue already in use for other lending

activities of the institutions. [As amended, effective December 31, 1972, by APB Opinion No. 27.]

.09 On the other hand, there are companies (e.g., the owner-operator of an office building, the lessor of automotive equipment on short-term leases—daily, weekly or monthly) which retain the usual risks or rewards of ownership in connection with their leasing activity. They may also assume responsibilities for maintaining the leased property or furnishing certain related services which will give rise to costs to be incurred in the future. Rental revenues are designed to cover the costs of these services, depreciation and obsolescence, and to provide an adequate profit for assuming the risks involved. In these cases the operating method is appropriate for measuring periodic net income from leasing activities. The operating method is also appropriate if the leasing activity is an integral part of manufacturing, marketing or other operations of a business which generate revenues and costs which must be considered along with revenues and costs from the leasing activities in arriving at appropriate methods for measuring the overall periodic net income (examples are leases of retail outlets with lease provisions deliberately made favorable to induce lessee to handle lessor's product and leases which generate significant servicing revenues and costs). The operating method likewise is appropriate for leasing activities for an otherwise strictly financing institution if such activities are characterized as set forth in this paragraph.

#### OPINION

.10 The Board believes that the financing method of accounting, described in paragraph .05, should be used for lease financing activities of the type described in paragraph .08. The Board believes that the operating method, described in paragraph .06, should be used for leasing activities of the type described in paragraph .09. If a single company engages in separate leasing activities of the types described in both paragraphs .08 and .09, the appropriate accounting method should be used for each type of leasing activity. Where a single lease has both financing and operating characteristics to some degree, the determination of the appropriate accounting method should be made on the basis of which of the two methods described in paragraphs

.05 and .06 will fairly reflect net income. In rare cases, a single lease may require the use of both methods to reflect fairly lessor's net income; a condition precedent to this would be the ability initially to assign aggregate rentals to each of the financing and operating elements.

#### **Initial Direct Costs**

.11 When initial direct costs of negotiating and closing leases are reasonably expected to be recovered from revenues, these costs should preferably be deferred and allocated to future periods in which the related revenues are reported. In this context, "initial direct" costs are those costs which are directly associated with consummating the lease (e.g., commissions, legal fees, costs of investigating the lessee's financial status and of preparing and processing documents). The method of allocation to future periods should be consistent with that used to recognize revenue under the financing or operating methods. However, substantially the same net income would be reported under the financing method by expensing initial costs as incurred and recognizing as revenue in the same period, in addition to the normal revenue, a portion of the unearned revenue equal to the initial costs; this method is also acceptable. When initial direct costs of a lessor are reasonably constant in relation to revenues, no practical objection can be raised to a practice of consistently expensing these costs as incurred and recognizing revenue without compensating for initial costs.

[.12] [Superseded, effective for all lease transactions involving manufacturers or dealers with independent lessees after December 31, 1972, by APB Opinion No. 27.] (See section 4052.)

#### **Reporting in Balance Sheet**

.13 Amounts invested in leasing activities which are significant in relation to other resources or activities should be stated separately in a manner which best describes the nature of the investment. The investment in leasing activities is neither a conventional loan or receivable, nor in the same category as facilities employed in typical manufacturing or commercial operations. The classification and description of the investment should be appropriate in the

circumstances and should depend upon whether the financing or operating method of accounting is used.

**.14** When the financing method is used, the aggregate rentals called for in the lease should be classified with or near receivables and a description used along the lines of "receivables under contracts for equipment rentals" or "contracts receivable for equipment rentals." When a company is predominantly engaged in leasing activities for which the financing method is appropriate, information should be disclosed regarding future maturities of the rentals receivable. Unearned finance charges or interest (as defined in paragraph .05) included in the aggregate rentals should be shown as a deduction therefrom.<sup>2</sup> Estimated residual value should be classified separately with or near property, plant and equipment unless the residual value represents an amount expected to be collected from the lessee (e.g., when a favorable purchase option exists), in which case it should be classified with or near notes and accounts receivable. Thus, the investment is represented by the net rentals receivable plus the residual value. Receivables under financing leases are subject to the same considerations as to current or noncurrent classification, where such segregation is appropriate in the balance sheet, as are assets resulting from other activities.<sup>3</sup>

**.15** When the operating method is used, the investment should be classified with or near property, plant and equipment and a description used along the lines of "investment in leased property," "property held for or under lease," or "property (equipment, buildings, machines, etc.) leased to others"; accumulated allowances for depreciation and obsolescence should be shown as a deduction from the investment.

#### **Disclosure**

**.16** In addition to an appropriate description in the balance sheet of the investment in property held for or under lease (see paragraphs .13-.15), the principal accounting methods used in accounting for leasing activities should be disclosed. Further, where leasing is a substantial portion of a nonfinancing institution's operations, the Board

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<sup>2</sup> See section 2031.10.

<sup>3</sup> See section 2031.10.

believes that financial statements should disclose sufficient information to enable readers to assess the significance of leasing activities to the company. Leases and leased property are also subject to the conventional disclosure requirements affecting financial statements as, for example, disclosure of pledges of leased property and leases as security for loans.

#### **Income Taxes**

.17 When lease revenues or expenses are recognized for tax purposes in a period other than the one in which they are recognized for financial reporting, appropriate consideration should be given to allocation of income taxes among accounting periods.<sup>4</sup>

#### **Relationship to Section 5351**

.18 The Board takes notice of a question that has been raised as to whether certain conclusions herein are inconsistent with conclusions in section 5351, *Reporting of Leases in Financial Statements of Lessee*—specifically, the question is whether leases accounted for on the financing method by lessors should be capitalized by lessees. As indicated in paragraphs .02 and .07, the Board considers the principal accounting problem of lessors to be the allocation of revenue and expense to accounting periods covered by the lease in a manner that meets the objective of fairly stating the lessor's net income; the Board believes that this objective can be met by application of the financing method when the circumstances are as described in this section. As to the lessee, however, capitalization of leases, other than those which are in substance installment purchases of property, may not be necessary in order to state net income fairly since the amount of the lease rentals may represent a proper charge to income. There continues to be a question as to whether assets and the related obligations should be reflected in the balance sheet for leases other than those that are in substance installment purchases. The Board will continue to give consideration to this question.

#### **Prior Lease Agreements**

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

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<sup>4</sup> See section 4091.

believes that the conclusions as to disclosure in paragraphs .13-.16 should apply to lease agreements made prior as well as subsequent to the issuance of this section (May 1966).

➤ *The next page is 2259.* ←

**Section 4052****Accounting for Lease Transactions  
by Manufacturer or  
Dealer Lessors**

Effective for all lease transactions involving manufacturers or dealers with independent lessees after Dec. 31, 1972, unless otherwise indicated

**INTRODUCTION**

.01 The accounting for leases entered into with independent lessees by manufacturers or dealers to assist in marketing their products or services is generally covered by section 4051, *Accounting for Leases in Financial Statements of Lessors*. However, the interpretation and application in practice of section 4051 have raised a number of questions since its issuance in May 1966.

**DISCUSSION**

.02 Questions have arisen about the circumstances under which it is appropriate to conclude that the manufacturer or dealer lessor has transferred the risks and rewards of ownership to the lessee thus allowing the lessor to record the lease transaction as if it were a sale of the leased property. In some cases, a sale has been recognized where a manufacturer or dealer lessor delivered property under a cancelable lease or under a noncancelable lease for only a portion of the economic life<sup>1</sup> of the property. Sometimes it was assumed that a cancelable lease would not be canceled or that a noncancelable lease for a period shorter than the economic life would be subsequently renewed. Determining these probabilities has proven to be extremely difficult in

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<sup>1</sup> The term *economic life*, as used in this section, refers to the period during which the property is generally expected to be used for the purpose for which it was designed. Economic life is usually shorter than the physical life of the property. Also, economic life can cover a period of use by more than one user and is therefore not dependent upon the operating policies of any particular user.

many cases. Assumptions that the lessee would continue to lease the property even though not legally obligated to do so sometimes were not realized in practice. Further, in some cases, a manufacturer or dealer sold or assigned a lease, or property subject to a lease, to an independent financing institution with certain guarantees by the manufacturer or dealer, raising questions as to the accounting for the sale or assignment. Likewise, a manufacturer or dealer sold property to an independent financing institution which leased the property to others with certain guarantees by the manufacturer or dealer, creating complications in accounting for the transaction. Additional problems arise if these transactions are with a related entity rather than with an independent entity.

.03 The Board has concluded that more specific criteria are needed to determine when a manufacturer or dealer lessor should recognize a lease transaction with an independent lessee as if it were a sale. This section supersedes the last sentence of section 4051.08 and all of section 4051.12. Except as stated in the preceding sentence, this section does not modify section 4051. Because of the highly specialized problems involved, this section does not apply to lease agreements concerning real estate and natural resources such as oil, gas, timber, and mineral rights. It also does not apply to the accounting for lease financing transactions by independent financing institutions and independent leasing companies. The section is, however, applicable to these organizations if they are acting as dealers.

## OPINION

### Two-party Lease Transactions

.04 *Leases equivalent to sales.* Some lease transactions with independent lessees are in substance equivalent to sales of the property with the sales price collectible over a period of time. A manufacturer or dealer lessor should account for a lease transaction with an independent lessee as a sale if at the time of entering into the transaction (a) collectibility of the payments required from the lessee is reasonably assured, (b) no important uncertainties, such as those described in paragraph .07, surround the amount of costs yet

to be incurred <sup>2</sup> under the lease, and (c) any one of the following conditions is present:

- (i) The lease transfers title to the property to the lessee by the end of its fixed, noncancelable term; or
- (ii) The lease gives the lessee the option to obtain title to the property without cost or at a nominal cost by the end of the fixed, noncancelable term of the lease; or
- (iii) The leased property, or like property, is available for sale, and the sum of (1) the present value <sup>3</sup> of the required rental payments <sup>4</sup> by the lessee under the lease during the fixed, noncancelable term of the lease (excluding any renewal or other option) and (2) any related investment tax credit retained by the lessor (if realization of such credit is assured beyond any reasonable doubt) is equal to or greater than the normal selling price or, in the absence thereof, the fair value (either of which may be less than cost) of the leased property or like property;<sup>5</sup> or
- (iv) The fixed, noncancelable term of the lease (excluding any renewal option) is substantially equal to the remaining economic life <sup>6</sup> of the property. (This test cannot be complied with (1) by estimating an economic life substantially equal to the noncancelable term if this is unrealistic or (2) if a material contingent residual interest is retained in the property.)

.05 A high credit risk frequently presents measurement problems (a) in determining the interest rate that is commensurate with the risk and should be applied in computing the present value of the rental payments or (b) in

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<sup>2</sup> Maintenance, management or service agreements, either separate from or as a part of the lease agreement, do not preclude recording the lease transaction as a sale if the agreements provide the manufacturer or dealer with a reasonable return on the services rendered under such agreements. If the revenues from such agreements are included as part of the lease payments, these revenues should not be considered as part of the sales price of the property.

<sup>3</sup> See section 4111.12-.13, *Interest on Receivables and Payables*.

<sup>4</sup> Maintenance, management and service charges should be excluded from rental payments for purposes of this computation. See footnote 2.

<sup>5</sup> In making the determination under (iii) no consideration should be given to the residual or salvage value. Residual or salvage value should be disregarded in determining whether a lease transaction should be treated as a sale because recognition of a sale implies that the revenue has been earned and all costs have been incurred or provided for at the time.

<sup>6</sup> See footnote 1.

determining an adequate provision for bad debts. When the credit risk is so high as to preclude reasonable assurance of collection the lease transaction should not be recorded as a sale.

.06 When a lease transaction by a manufacturer or dealer lessor is recorded as a sale, (a) revenue should be recognized in the period of the sale in an amount equal to the present value of the required rental payments<sup>7</sup> by the lessee under the lease during the fixed, noncancelable term (excluding any renewal or other option) of the lease and (b) the cost of the property (not reduced by salvage or residual value) and the estimated related future costs<sup>8</sup> (other than interest) should be charged against income in that period.<sup>9</sup> In some cases this may result in a loss on the transaction.

.07 *Operating leases.* Important uncertainties may still exist in some lease transactions that otherwise appear to meet the tests for recognition as a sale (see paragraph .04). For example, the lease may contain commitments by the lessor to guarantee performance in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence. The difficulties of evaluating the future costs, both individually and collectively, and thus the risks under such commitments may be so great that the lease transaction should be accounted for by the operating method.

.08 A manufacturer or dealer lessor should account for a two-party lease transaction that does not meet the criteria described in paragraph .04 for treatment as a sale by use of the operating method as set forth in section 4051.

.09 An implicit loss exists and should be recognized by the manufacturer or dealer whenever the rental payments expected to be received from independent lessees over the

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<sup>7</sup> See footnotes 2 and 4.

<sup>8</sup> In section 4111.04, *Interest on Receivables and Payables*, the Board stated that it was "not taking a position 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 service, for example, a warranty for product performance." Inasmuch as the revenue from a lease transaction recorded as a sale is measured by the present value of the required rental payments under the lease, the Board has concluded that estimates of future costs related to the lease may also be measured on the present value basis.

<sup>9</sup> In determining the amount of profit or loss to be recognized on the transaction consideration should be given to any related investment tax credits.

remaining economic life<sup>10</sup> of the leased property together with its estimated residual value are insufficient to recover the unrecovered costs pertaining to the property, estimated related future costs and any deferred costs relating to leases of the property.

#### **Participation by Third Parties**

.10 In some instances a manufacturer or dealer lessor sells or assigns a lease, or property subject to a lease, to independent financing institutions and independent leasing companies. In other instances, a manufacturer or dealer sells the property to the financing institutions and at that time a lease for the property is obtained for the benefit of the institutions. In these cases, a third party is participating in a lease transaction involving a manufacturer or dealer and the lessee. The terms of the underlying leases and the risks and rewards retained by the manufacturers or dealers should determine the accounting for such transactions by the manufacturers or dealers.

.11 *Leases equivalent to sales.* The sale or assignment by a manufacturer or dealer to an independent financing institution of a lease, or of property subject to a lease, that meets, insofar as the lease transaction is concerned, the conditions of paragraph .04 does not negate the original determination that the lease transaction should be accounted for as a sale. Profit or loss, if any, on the transaction with the financing institution should be recognized at the time of sale or assignment to the financing institution.

.12 *Operating leases.* The sale to an independent financing institution of property subject to an operating lease, or of property which is leased by or intended to be leased by the financing institution to an independent party, with the manufacturer or dealer effectively retaining any risks of ownership in the property, is not a sale in substance and, therefore, should not be accounted for as a sale. However, the sale to an independent financing institution of such property should be reflected as a sale if no important uncertainties such as those described in paragraph .07 exist and either (a) all risks and rewards of ownership in the property are transferred to the purchaser or (b) all risks are transferred but some of the rewards are retained by the

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<sup>10</sup> See footnote 1.

manufacturer or dealer and the sum of the present value of the required payments <sup>11</sup> by the purchaser and any related investment tax credit retained by the dealer (see paragraph .04(c)(iii)) is equal to or greater than the normal selling price or, in the absence thereof, the fair value of the property. When a sale is recorded, all costs should be charged against income in that period (see paragraph .06).

**.13** A manufacturer or dealer may by various arrangements assure recovery of the investment by the third-party financing institution in some operating lease transactions and thus retain substantial risks of ownership in 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 manufacturer or dealer (a) to acquire the lease or the property, (b) to substitute an existing lease, or (c) to secure a replacement lessee or a buyer for the property under a remarketing agreement. In these circumstances the manufacturer or dealer has not transferred all risks and should not reflect the transaction as a sale. However, a remarketing agreement by itself should not disqualify accounting for the transaction as a sale if the manufacturer or dealer (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 any priority to the re-leasing or disposition of the property owned by the third party over similar property owned or produced by the manufacturer or dealer. (For example, for this purpose, a "best efforts" or a first-in, first-out, remarketing arrangement is considered to be a priority.)

**.14** When the sale to an independent financing institution of property subject to an operating lease is not reflected as a sale, the transaction should be accounted for as a loan and revenue should be recognized under the operating method. Likewise, the sale or assignment by a manufacturer or dealer of lease payments due under an operating lease should continue to be accounted for under the operating method by the manufacturer or dealer and the proceeds should be recorded as a loan. (Transactions of these types are in effect collateralized loans from the financ-

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<sup>11</sup> See footnotes 2 and 4.

ing institution to the manufacturer or dealer.)<sup>12</sup> However, if all risks of ownership in the property are transferred but the transaction does not qualify as a sale because the sum of the present value of the required payments<sup>13</sup> by the purchaser and any related investment tax credit retained by the dealer (see paragraph .04(c)(iii)) is less than the normal selling price or, in the absence thereof, the fair value of the property (see paragraph .12), the proceeds should be classified as deferred revenue and taken into income under the operating method.<sup>12</sup>

### Transactions with Related Companies

**.15** *Leases equivalent to sales.* The sale or assignment by a manufacturer or dealer to a related company<sup>14</sup> of a lease, or property subject to a lease, that meets, insofar as the lease transaction is concerned, the conditions of paragraph .04 does not negate the original determination that the lease transaction should be accounted for as a sale. Profit or loss, if any, on the transaction with the related company should be recognized following the principles of section 2051, *Consolidated Financial Statements*, or section 5131, *The Equity Method of Accounting for Investments in Common Stock*, whichever is appropriate.

**.16** *Operating leases.* The sale to a related company of property (or an undivided interest in the property) subject to an operating lease, or of property (or an undivided interest in the property) which is leased by or intended to be leased by the related company to an independent party, is not a sale in substance if the manufacturer or dealer retains any risks of ownership in the property and, therefore, should not be accounted for as a sale. Likewise, the sale or assignment to a related company of lease payments due under an operating lease should continue to be accounted

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<sup>12</sup> Also see paragraph .09 of this section with regard to recognition of an implicit loss under an operating lease.

<sup>13</sup> See footnotes 2 and 4.

<sup>14</sup> For the purposes of this part (paragraphs .15 and .16) of this section a related company is considered to be a subsidiary, corporate joint venture, partnership, unincorporated joint venture or other investee in which the manufacturer or dealer has a financial interest. Financial interest refers to those situations in which the manufacturer or dealer directly or indirectly controls the related company or has the ability to exercise significant influence over operating and financial policies of the related company. (See section 5131.17.) Significant influence may be exercised through guarantees of indebtedness, extension of credit and other special arrangements, or ownership of warrants, debt obligations or other securities.

for under the operating method by the manufacturer or dealer. Further, the lease of property to a related company should not be considered a sale by the manufacturer or dealer unless the related company has leased the property to an independent lessee in a transaction that meets the conditions of paragraph .04 of this section and the manufacturer or dealer retains no risks of ownership in the property. When a sale is recorded by the manufacturer or dealer, all costs should be charged against income in that period (see paragraph .06). Profit or loss, if any, on the transaction with the related company should be recognized following the principles of section 2051 or section 5131, whichever is appropriate.<sup>15</sup>

.17 The sale by a manufacturer or dealer to an unrelated company of an undivided interest in property subject to an operating lease, or of an undivided interest in property which is leased by or intended to be leased by the unrelated company to an independent party, creates a situation similar to a joint venture and therefore should not be accounted for as a sale unless the transaction meets the conditions of paragraph .04 of this section and the manufacturer or dealer retains no risks of ownership in the property. When a sale of an undivided interest is recorded by the manufacturer or dealer, all costs pertaining to that undivided interest should be charged against income in that period (see paragraph .06).

#### EFFECTIVE DATE

.18 The provisions of this section shall be effective for all lease transactions involving manufacturers or dealers with independent lessees after December 31, 1972. However, the accounting for lease transactions that have previously been entered into in the fiscal year in which December 31, 1972 occurs may be adjusted to comply with the provisions of this section.

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<sup>15</sup> Also see paragraph .09 of this section with regard to recognition of an implicit loss under an operating lease.

**Section 4061*****Compensation Involved in  
Stock Option and Stock  
Purchase Plans***

Issue date, unless  
otherwise indicated:  
June, 1953<sup>1</sup>

.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.<sup>1</sup>

.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.

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<sup>1</sup> 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 <sup>2</sup>**

**.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

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<sup>2</sup> Four essential characteristics of a noncompensatory plan are described in section 4062.07.

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.<sup>3</sup>

.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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<sup>3</sup> 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

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.<sup>4</sup>

#### 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

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<sup>4</sup> 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.<sup>5</sup>

**.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.<sup>6</sup> Where significant market quotations cannot be obtained, other recognized methods of valuation have to be used. Furthermore, in determining the fair value<sup>7</sup> 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.<sup>8</sup>

#### 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.<sup>9</sup> Upon exer-

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<sup>5</sup> 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.]

<sup>6</sup> 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.)

<sup>7</sup> See section 4062.10 in which *quoted market price* is substituted for *fair value*.

<sup>8</sup> See section 4062.10a.

<sup>9</sup> See sections 4062.12-15.

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.

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**Section 4062****Accounting for Stock  
Issued to Employees**

Effective for all stock option, purchase, award, and bonus rights granted after December 31, 1972, unless otherwise indicated <sup>1</sup>

**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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<sup>1</sup> See paragraph .20.

.03 Accounting for employee services received as consideration for stock issued is included in an accounting research study<sup>2</sup> on stockholders' equity that is in process.

.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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<sup>2</sup> 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.

.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.<sup>3</sup>

*.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

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<sup>3</sup>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.

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(e) 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

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,<sup>4</sup> 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,<sup>5</sup> 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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<sup>4</sup> State law governs the issuance of a corporation's stock including the acceptability of issuing stock for future services.

<sup>5</sup> A corporation may be entitled to a deduction for income tax purposes even though it recognizes no compensation expense in measuring net income.

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.<sup>6</sup>

#### 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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<sup>6</sup>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.

**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-

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.

➤➤➤ → Section 4063 begins on page 2359. ← ➤➤➤

**Section 4061****Compensation Involved in  
Stock Option and Stock  
Purchase Plans**

Issue date, unless  
otherwise indicated:  
June, 1953<sup>1</sup>

.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.<sup>1</sup>

.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.

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<sup>1</sup> 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 is 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, the 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.

**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**

.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 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.<sup>2</sup>

.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 option 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.

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<sup>2</sup> This is the date on which income or gain taxable to the grantee may arise under Section 130A. Use of this date for tax purposes is doubtless based on considerations as to the ability of the optionee to pay taxes prior to sale of the shares.

.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 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.

#### 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 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.

.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.<sup>3</sup> Where significant market quotations cannot be obtained, other recognized methods of valuation have to be used. Furthermore, in determining the fair value 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.

#### 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. Upon exercise 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.

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<sup>3</sup> Whether treasury or unissued shares are to be used to fulfill the obligation is not material to a determination of value.

## Section 4062

### **Deferred Compensation Contracts**

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<sup>1</sup> 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<sup>1</sup> 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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<sup>1</sup> 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<sup>1</sup> 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.

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<sup>1</sup> 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.

**Section 4063****Accounting for the Cost  
of Pension Plans**

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 trustee 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

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

(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.

.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)<sup>1</sup> 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

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<sup>1</sup>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.

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.<sup>2</sup>

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

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<sup>2</sup> 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

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

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.<sup>3</sup> 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

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<sup>3</sup> See section 1091.88h.

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 re-deemed 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-

appropriate 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

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.

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.

**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.

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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.

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

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 trustee 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

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 trustee 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

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.)

**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.

**.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.)

**.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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**Section 4064****Deferred Compensation  
Contracts**

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<sup>1</sup> 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<sup>1</sup> 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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<sup>1</sup>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<sup>2</sup> 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.

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<sup>2</sup> See footnote 1.

**Section 4071****Depreciation and  
High Costs<sup>1</sup>**

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

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<sup>1</sup> 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:

.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."

**Section 4072*****Depreciation on  
Appreciation***

**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<sup>1</sup> 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.

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<sup>1</sup>See section 5581, Quasi-Reorganization or Corporate Readjustment.

**Section 4073****Emergency Facilities—  
Depreciation and  
Amortization**

Issue date, unless  
otherwise indicated:  
June, 1953 <sup>1</sup>

**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

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<sup>1</sup> 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

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.<sup>2</sup>

.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.

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<sup>2</sup> See section 4091.

**Section 4074****Declining-Balance  
Depreciation**

Issue date, unless  
otherwise indicated:  
July, 1958<sup>1</sup>

**.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."<sup>2</sup> 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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<sup>1</sup>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.

<sup>2</sup>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-

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 2551.* ←➤➤➤

**Section 4081*****Accounting for Real and Personal Property Taxes***

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<sup>1</sup> 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-

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<sup>1</sup> Magruder v. Supplee, 316 U. S. 394 (1942).

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.

.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 ordinarily be made through the income statement, either in combination with the current year's provision or as a separate item. Such adjustments should not be considered prior period adjustments unless they meet the criteria of sections 2010.22 and 2010.23. [As amended, effective for fiscal periods beginning after December 31, 1966, by APB Opinion No. 9.]

➤ *The next page is 2651.* ←

**Section 4091****Income Taxes**

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.<sup>1</sup> 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

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<sup>1</sup> 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<sup>2</sup> 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

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<sup>2</sup> 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.

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.<sup>3</sup>

.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,<sup>4</sup> 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 *carrybacks* should be allocated to the loss periods. The tax effects of operating loss *carryforwards*<sup>5</sup> 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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<sup>3</sup> See sections 2010 and 2012.

<sup>4</sup> See paragraph .18.

<sup>5</sup> The term "loss *carryforwards*" 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.<sup>6</sup>
- 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.<sup>7</sup>
- 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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<sup>6</sup> For the purposes of this definition "deductions" do not include reductions in taxable income arising from net operating loss carrybacks or carryforwards.

<sup>7</sup> See paragraph .32.

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.<sup>8</sup> 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.

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<sup>8</sup> Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes*, pages 2-3 and 8-10.

- 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.

**.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<sup>o</sup> 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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<sup>o</sup> 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-

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

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 pre-tax 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<sup>10</sup> 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

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<sup>10</sup> See paragraph .18.

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 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 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.

[.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 *carryback* or *carryforward*) 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 *carrybacks* 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 *carryforwards* 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 *carryforwards* would be recognized in the loss periods unless specific reasons exist to question their realization.

### Opinion

.43 The tax effects of any realizable loss *carrybacks* 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. Appropriate adjustments of existing net deferred tax credits may also be necessary in the loss period.

.44 The tax effects of loss *carryforwards* 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 *carryforwards*, since realization is dependent upon future taxable income. Accordingly, the Board has concluded that the tax benefits of loss *carryforwards* 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 *carryforwards* arise. When the tax benefits of loss *carryforwards* 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.<sup>11</sup>

.45 In those rare cases in which realization of the tax benefits of loss *carryforwards* 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<sup>12</sup> 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 next page is 2669. ←

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<sup>11</sup> See section 2012.07, *Reporting the Results of Operations*.

<sup>12</sup> 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.

the change as an adjustment of the asset account and of income tax expense.

**.46** 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.

**.47** Net deferred tax credits arising from timing differences may exist at the time loss carryforwards arise. In the usual case when the tax effect of a loss carryforward 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 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. In the unusual situation in which the tax effect of a loss carryforward is recognized as an asset in the loss year,<sup>13</sup> the deferred tax credit accounts would be amortized in future periods as indicated in paragraph .18.

**.48** The tax effects of loss carryforwards 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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<sup>13</sup> See paragraph .45.

corded as retroactive adjustments<sup>14</sup> of the purchase transactions and treated in accordance with the procedures described in section 1091.87. 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 carryforwards 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-

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<sup>14</sup> 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, non-current 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-

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 *carrybacks* and *carryforwards* 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 *carrybacks* or *carryforwards* 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

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<sup>15</sup> 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.<sup>15</sup>

#### *General*

**.62** Certain other disclosures should be made in addition to those set forth in paragraphs .55-.61:

- 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 pre-

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<sup>15</sup> 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.<sup>16</sup>

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<sup>16</sup> See section 2010, *Reporting the Results of Operations*.

**Section 4091A****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

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.

**Section 4092****Tax Allocation Accounts—  
Discounting**

Effective for fiscal periods  
beginning after December  
31, 1966, unless otherwise  
indicated

.01 Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes*,<sup>1</sup> 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.<sup>2</sup> 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.

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<sup>1</sup> 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.

<sup>2</sup> APB Opinion No. 11 was issued effective for fiscal periods beginning after December 31, 1967. See section 4091.

## Section 4093

### ***New Depreciation Guidelines and Rules***

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.

## Section 4094

# Accounting for the Investment Credit

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 realization of income. This is true for both regulated and non-regulated companies.

**.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-

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

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 *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. Either of two treatments is acceptable in the preparation of income statements for the year in which these *carrybacks* or *carryforwards* 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 2689.* ←«««

**Section 4095****Accounting for Income Taxes—  
Special Areas**

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 continues to defer conclusions on intangible development costs in the oil and gas industry pending the issuance of an Opinion on extractive industries. The Board also 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 investments in common stock accounted for by the equity method (other than subsidiaries and corporate joint ventures).

.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

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.<sup>1</sup> 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

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<sup>1</sup>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<sup>2</sup> in the pretax accounting income

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<sup>2</sup>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.

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<sup>3</sup>) 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.<sup>4</sup> 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

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<sup>3</sup> Section 5131.14.

<sup>4</sup> 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<sup>5</sup> that any

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<sup>5</sup>The change in the status of an investment would not by itself mean that remittance of these undistributed earnings should be considered apparent.

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.<sup>6</sup>

### **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-

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<sup>6</sup> 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.<sup>7</sup>

.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<sup>8</sup> 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<sup>9</sup> 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.

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<sup>7</sup> 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.

<sup>8</sup> 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.

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<sup>9</sup> 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.<sup>10</sup>

**.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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<sup>9</sup> 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.

<sup>10</sup> Other disclosure requirements in sections 4091.55-.63 may also apply.

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.<sup>11</sup>

**.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

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<sup>11</sup> Other disclosure requirements in sections 4091.55-.63 may also apply.

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 2703.* ←

**Section 4096*****Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (other than Subsidiaries and Corporate Joint Ventures)***

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-

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-

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 2751.* ←➤

**Section 4111*****Interest on Receivables and Payables***

Effective for transactions entered into on or after October 1, 1971 unless otherwise indicated <sup>1</sup>

**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 <sup>2</sup> 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 "notes." Examples are secured and unsecured notes, de-

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<sup>1</sup> See Paragraph .16.

<sup>2</sup> *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.

ventures, 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.<sup>3</sup>

.04 This section is also not intended to apply to, and the Board is not presently taking a position<sup>4</sup> 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

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<sup>3</sup> 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.

<sup>4</sup> 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.

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.<sup>5</sup>

**.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-

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<sup>5</sup> 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<sup>a</sup> is re-

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<sup>a</sup> Paragraphs .02, .03 and .04 describe the applicability of this section.

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.<sup>7</sup>

.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<sup>8</sup> 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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<sup>7</sup> 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.

<sup>8</sup> 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*.

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.<sup>9</sup> 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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<sup>9</sup> Refer to section 4111A for illustrations of balance sheet presentation.

## 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:

	<i>Assume prevailing market rate of</i>		
	<u>10%</u>	<u>8%</u>	<u>12%</u>
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
	<hr/>	<hr/>	<hr/>
Present value and proceeds at date of issuance .....	<u>\$1,000</u>	<u>\$1,197</u>	<u>\$851</u>

.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
	<hr/>
Present value and proceeds at date of issuance .....	<u>\$149</u>

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.*

## December 31

*Example 1—Discount presented  
in caption*NOTE RECEIVABLE FROM  
SALE OF PROPERTY:

\$1,000,000 face amount, non-  
interest bearing, due De-  
cember 31, 1975 (less  
unamortized discount  
based on imputed interest  
rate of 8% — 1970,  
\$320,000; 1969, \$370,000)...

	1970	1969
	\$ 680,000	\$ 630,000

*Example 2—Discount presented  
separately*NOTE RECEIVABLE FROM  
SALE OF PROPERTY:

Noninterest bearing note  
due December 31, 1975.....  
Less unamortized discount  
based on imputed interest  
rate of 8%.....

	\$ 1,000,000	\$ 1,000,000
	320,000	370,000

Note receivable less un-  
amortized discount .....

	\$ 680,000	\$ 630,000
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*Example 3—Several notes  
involved*

## LONG-TERM DEBT (Note 1):

Principal amount .....  
Less unamortized discount ...  
Long-term debt less un-  
amortized discount .....

	\$24,000,000	\$24,000,000
	2,070,000	2,192,000
	\$21,930,00	\$21,808,000

*Note 1—Long-Term Debt*

Long-term debt at December 31, 1970 consisted of the  
following:

	<u>Principal</u>	<u>Unamortized Discount</u>
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
<b>Total</b> .....	<u>\$24,000,000</u>	<u>\$ 2,070,000</u>

**Section 5100****ASSETS**

... receivable accounts ... inventories ... inter-  
corporate investments ... intangible assets

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**Section 5111*****Receivables from Officers,  
Employees or Affiliated  
Companies***

Issue date, unless  
otherwise indicated:  
1934 <sup>1</sup>

.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.

»»»→ *The next page is 3051.* ←«««

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<sup>1</sup>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.

**Section 5121*****Inventory Pricing***

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.<sup>1</sup> 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

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<sup>1</sup> 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

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,<sup>2</sup> 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 re-handling 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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<sup>2</sup> 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.<sup>3</sup> 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

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<sup>3</sup>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."

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*<sup>4</sup> 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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<sup>4</sup> 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.

**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-

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.

➤ *The next page is 3101.* ←

**Section 5131*****The Equity Method of Accounting  
for Investments in Common Stock***

Effective for fiscal periods  
beginning after December  
31, 1971, unless otherwise  
indicated <sup>1</sup>

**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.<sup>2</sup>

.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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<sup>1</sup> See paragraph .21.

<sup>2</sup> 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.

### 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.<sup>3</sup>

.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-

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<sup>3</sup> See section 2051.03-.04 and section 1081.08.

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

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

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.<sup>4</sup>

.15 In APB Opinion No. 10, paragraph 4, the Board stated that the accounts of subsidiaries (regardless of when organized or acquired) whose principal business activity is leasing property or facilities to parent or other affiliated companies should be consolidated. The Board also concluded that the equity method is not adequate for the fair

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<sup>4</sup> Section 2051.03-.04 and section 1081.08 describe, 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.

presentation of those subsidiaries because their assets and liabilities are significant to the consolidated financial position of the enterprise. The Board reaffirms those conclusions.<sup>5</sup>

.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. 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.<sup>6</sup>

.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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<sup>5</sup> The Board is giving further consideration to the accounting treatment of lease transactions. In the meantime, it has deferred expressing an opinion on the inclusion in consolidated financial statements of leasing companies in which the equity interest, usually nominal at the time of organization, is held by third parties, but in which the principal lessee, through options or by similar devices, possesses or has the power to obtain the economic benefits of ownership from the lease arrangements. That deferral does not affect the applicability of section 5351.12.

<sup>6</sup> 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.

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.<sup>7</sup>

<sup>7</sup> .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.<sup>8</sup>

.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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<sup>7</sup> 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.

<sup>8</sup> 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.<sup>9</sup>
- 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.

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<sup>9</sup> 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.

- 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.<sup>10</sup> 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.]<sup>11</sup>
- 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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<sup>10</sup> 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.

<sup>11</sup> 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

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.<sup>12</sup>

**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,<sup>13</sup> and

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<sup>12</sup> 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.

<sup>13</sup> 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.<sup>14</sup>

#### **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

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<sup>14</sup> See footnote 8.

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.

➤ *The next page is 3201.* ←

**Section 5141****Accounting for  
Intangible Assets**

Effective to account for  
intangible assets acquired  
after October 31, 1970,  
unless otherwise indicated <sup>1</sup>

**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.

.03 The Director of Accounting Research of the American Institute of Certified Public Accountants has published Accounting Research Study No. 10, *Accounting*

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<sup>1</sup> See paragraphs .33-.35.

*for Goodwill*, by George R. Catlett and Norman O. Olson.<sup>2</sup> 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.

.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 costs, for example, research and development costs and preoperating costs, present problems which need to be studied separately. The question of deferral of those costs is beyond the scope of this section.

.07 This section applies to regulated companies in accordance with the provisions of section 6011, *Accounting Principles for Regulated Industries*.

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<sup>2</sup> 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.

.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

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 [see Volume 2, page 6018]).

#### **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

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 pre-paid 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.

**.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

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<sup>3</sup> may be accounted for in accordance with this section or Chapter 5 of ARB No. 43 (see Volume 2, page 6018) 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 (see Volume 2, page 6018) as modified by section 2010.

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<sup>3</sup>Section 1091.46a-.47a define date initiated and describe the effect of changes in terms of a plan of combination.

**Section 5151****Unamortized Discount, Issue Cost,  
and Redemption Premium on  
Bonds Refunded<sup>1</sup>**

Issue date, unless  
otherwise indicated:  
June, 1953

.01 Until the early days of the century, bond discount was commonly regarded as a capital charge. When the unsoundness of this treatment was recognized, alternative methods of treatment became accepted, under one of which the discount was distributed over the term of the issue, and under the other the discount was charged immediately against surplus, the latter being regarded generally as the preferable course.

.02 Present-day treatment recognizes that on an issue of bonds the amount agreed to be paid (whether nominally as interest or as principal) in excess of the net proceeds constitutes the compensation paid for the use of the money. Where bonds are issued at a discount it is customary to distribute the discount over the term of the bond issue and to charge both the coupon interest and the allocated discount directly to income.

.03 In the committee's opinion it is a sound accounting procedure to treat such discount as a part of the cost of borrowed money to be distributed systematically over the term of the issue and charged in successive annual income accounts of the company. The anticipation of this income charge by a debit to income of a previous year or to surplus has in principle no more justification than would a corresponding treatment of coupons due in future years.

.04 The argument advanced in favor of immediately writing off discount was that it extinguished an asset<sup>2</sup> that

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<sup>1</sup> See also section 5516, *Convertible Debt and Debt Issued with Stock Purchase Warrants.*

<sup>2</sup> 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. [As amended, effective October 1, 1971, by APB Opinion No. 21.]

was only nominal in character and that it resulted in a conservative balance sheet. The weight attached to this argument has steadily diminished, and increasing weight has been given to the arguments that all such charges should be reflected under the proper head in the income account, and that conservatism in the balance sheet is of dubious value if attained at the expense of a lack of conservatism in the income account, which is far more significant.

#### **TREATMENT OF UNAMORTIZED DISCOUNT, ISSUE COST, AND REDEMPTION PREMIUM ON BONDS REFUNDED**

.05 Discussion of the treatment of unamortized discount, issue cost, and redemption premium on bonds refunded (hereinafter referred to as unamortized discount) has revolved mainly about three methods of disposing of the unamortized balance:

- (a) A direct write-off to income or earned surplus,
- (b) Amortization over the remainder of the original life of the issue retired, or
- (c) Amortization over the life of the new issue.

Each of these methods has had support in court decisions, in determinations by regulatory agencies, and in accounting literature. The reasoning and conclusions reached by the committee in regard to them are given here.

#### **Direct Write-Off**

.06 It is acceptable accounting to write off unamortized discount in full in the year of refunding. This treatment is based on the view that the unamortized bond discount represents in effect the cost of the privilege of terminating a borrowing contract which has become disadvantageous and hence comes under the accounting doctrine that a loss or expense should be recognized as such not later than the time when the series of transactions giving rise to it is completed.

.07 Unamortized discount should not be written off against retained earnings. The decision as to whether a direct write-off of unamortized bond discount is to be classified as an extraordinary item should be governed by the criteria set forth in section 2010.20-.21. [As amended, ef-

fective for fiscal periods beginning after December 31, 1966, by APB Opinion No. 9.]

**Amortization over Remainder of Original Life of Retired Issue**

.08 The second alternative, distributing the charge over the remainder of the original life of the bonds re-

funded, has strong support in accounting theory. Its chief merit lies in the fact that it results in reflection of the refinancing expense as a direct charge under the appropriate head in a series of income accounts related to the term of the original borrowing contract.

.09 This method is based on the accounting doctrine that when a cost is incurred the benefits of which may reasonably be expected to be realized over a period in the future, it should be charged against income over such period. In behalf of this method, it is argued that the unamortized bond discount represents the cost of making a more advantageous arrangement for the unexpired term of the old agreement. In other words, such discount is regarded as the cost of an option included in the borrowing contract to enable a corporation to anticipate the maturity of its obligations if it finds it possible to refund them at a lower cost, either as the result of a favorable change in interest rates or as the result of its own improved credit. Continuing this line of reasoning, it is argued that the cost of money over the entire period of the original issue is affected by the terms of the original contract, and that if the cost of anticipating maturity is incurred, it is only because it is advantageous to do so; if the saving over the unexpired term of the old bonds will exceed the amount of unamortized discount to be disposed of, such discount should properly be spread over that unexpired term as a proper element of the cost of borrowed money.

.10 This method should be regarded as preferable. It conforms more closely than any other method to current accounting opinion.

.11 Where this method is adopted the reduction in current income tax resulting from the refunding should be apportioned over the future period in conformity with section 4091, *Income Taxes*. [As amended effective for fiscal periods beginning after December 31, 1967, by APB Opinion No. 11.]

#### **Amortization over Life of New Issue**

.12 The third method, amortization over the life of the new issue, is appropriate under circumstances where the refunding takes place because of currently lower interest rates or anticipation of higher interest rates in the

future. In such circumstances, the expected benefits justify spreading the costs over the life of the new issue, and this method is, therefore, acceptable. Paragraph .11 of this section is applicable when this method is adopted. [As amended, effective for fiscal periods beginning after December 31, 1965, by APB Opinion No. 6.]

#### OTHER CONSIDERATIONS

.13 If the unamortized discount is carried forward after refunding it is acceptable to accelerate the amortization over a shorter period than that mentioned in paragraph .09 as long as the charge is made against income and is not in any year so large as seriously to distort the income figure for that year. Such acceleration may be regarded as a middle course between two alternatives (immediate writing off and spreading over the life of the old issue), each of which is acceptable, and, therefore, as being itself acceptable.

.14 If the debt is to be paid off through a new issue with a term less than the remaining life of the old issue the amortization should be completed over the shorter period.

.15 The method employed should be clearly disclosed, and if the unamortized discount is carried forward the amount of the annual charge should, if significant in amount, be shown separately from other charges for amortization of bond discount and expense.

.16 The committee does not regard the charging of unamortized bond discount to capital surplus as an acceptable accounting treatment.

.17 If the debt is discharged—otherwise than by refunding—before the original maturity date of the issue, any balance of discount and other issue cost then remaining on the books, and any redemption premium, should be written off at the date of such retirement by a charge against income. (See section 2010.19-.21.) [As amended, effective for fiscal periods beginning after December 31, 1966, by APB Opinion No. 9.]

**Section 5152****Amortization of Debt  
Discount and Expense  
or Premium <sup>1</sup>**

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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<sup>1</sup> See section 4111, *Interest on Receivables and Payables*.



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**Section 5351****Reporting of Leases in  
Financial Statements  
of Lessee**

Issue date, unless  
otherwise indicated:  
September, 1964

**INTRODUCTION**

.01 This section sets forth the Board's views as to proper procedures or methods for implementing generally accepted accounting principles governing accounting for assets and liabilities and income and expense with respect to leases and sale and leasebacks. It supersedes Chapter 14 of Accounting Research Bulletin No. 43, *Disclosure of Long-Term Leases in Financial Statements of Lessees*. This section makes no distinction between leases of real property and leases of personal property. Because of the highly specialized problems involved, this section does not apply to agreements concerning natural resources such as oil, gas, timber and mineral rights.

.02 The two principal recommendations of Chapter 14 of Accounting Research Bulletin No. 43 were:

(1) . . . where the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that:

(a) disclosure should be made in financial statements or in notes thereto of:

(1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable and

(2) any other important obligation assumed or guarantee made in connection therewith;

(b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and

(c) in addition, in the year in which the transaction originates, there should be disclosure of the

principal details of any important sale-and-lease transaction.

- (2) . . . the committee is of the opinion that the facts relating to all such leases should be carefully considered and that, where it is clearly evident that the transaction involved is in substance a purchase, the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

**.03** In the period since the issuance of the Bulletin, the practice of obtaining by lease the right to use property has continued on an important scale. Although relatively more information about leases has been disclosed in financial statements of lessees in recent years, no consistent pattern has emerged, and the extent of disclosure of pertinent information has often been inadequate. In addition, there have been relatively few instances of capitalization of leased property and recognition of the related obligation, which suggests that the criteria for determining when a lease is in substance a purchase require clarification.

**.04** The situation described in the preceding paragraph caused the accounting research division of the American Institute of Certified Public Accountants to undertake a research study on reporting of leases in financial statements.<sup>1</sup> This study recommended, in part:

. . . To the extent then that leases give rise to property rights, those rights and related liabilities should be measured and incorporated in the balance sheet.

The major question then is what leases, or parts of leases, give rise to property rights. . . . (p. 4)

To the extent, then, that the rental payments represent a means of financing the acquisition of property rights which the lessee has in his possession and under his control, the transaction constitutes the acquisition of an asset with a related obligation to pay for it. To the extent, however, that the rental payments are for services such as maintenance, insurance, property taxes, heat, light, and elevator service, no asset has been acquired, and none should be recorded. . . .

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<sup>1</sup> Accounting Research Study No. 4, *Reporting of Leases in Financial Statements* by John H. Myers, published for its accounting research division by the American Institute of Certified Public Accountants in May, 1962. (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.)

The measurement of the asset value and the related liability involves two steps: (1) the determination of the part of the rentals which constitutes payment for property rights, and (2) the discounting of those rentals at an appropriate rate of interest. . . .

On the balance sheet the property rights acquired under lease should be grouped with the other property accounts, but probably separately classified in order to disclose the existence of the lease arrangement. The liability should be divided into its current and long-term portions and shown in the appropriate classification. . . . (p. 5)

In effect, the proposed balance-sheet treatment removes the charge for "rent" in the [income statement] accounts as an occupancy cost and instead treats it simply as a payment of an obligation and interest thereon. In its place is put "amortization of property right acquired under lease" (an occupancy cost) and "interest" (a financial expense). In the case of manufacturing concerns there probably would be a related effect on the valuation of work in process and of finished goods. (p. 6)

.05 The Accounting Principles Board has considered the recommendations and the supporting argument presented in Accounting Research Study No. 4. The Board agrees that the nature of some lease agreements is such that an asset and a related liability should be shown in the balance sheet, and that it is important to distinguish this type of lease from other leases. The Board believes, however, that the distinction depends on the issue of whether or not the lease is in substance a purchase of the property rather than on the issue of whether or not a property right exists. The Board believes that the disclosure requirements regarding leases contained in Accounting Research Bulletin No. 43, Chapter 14, should be extended, and the criteria for identification of lease agreements which are in effect installment purchases of property should be clarified. The Board also believes that accounting for gains and losses on sale-and-leaseback transactions should be specifically dealt with in this section.

#### DISCUSSION

.06 The central question is whether assets and liabilities are created by leases which convey the right to use property if no equity is accumulated in the property by the

lessee. Chapter 14 of Accounting Research Bulletin No. 43 and Accounting Research Study No. 4 agree that leases which are clearly in substance purchases result in assets and liabilities which should be recorded, and that to the extent rental payments are for services, such as property taxes, utilities, maintenance, and so forth, they should be charged to current operations. They disagree with regard to leases which convey merely the right to use property in consideration of specified rental payments over a definite future period.

.07 It seems clear that leases covering merely the right to use property in exchange for future rental payments do not create an equity in the property and are thus nothing more than executory contracts requiring continuing performance on the part of both the lessor and the lessee for the full period covered by the leases. The question of whether assets and liabilities should be recorded in connection with leases of this type is, therefore, part of the larger issue of whether the rights and obligations that exist under executory contracts in general (e.g., purchase commitments and employment contracts) give rise to assets and liabilities which should be recorded.

.08 The rights and obligations related to unperformed portions of executory contracts are not recognized as assets and liabilities in financial statements under generally accepted accounting principles as presently understood. Generally accepted accounting principles require the disclosure of the rights and obligations under executory contracts in separate schedules or notes to the financial statements if the omission of this information would tend to make the financial statements misleading. The rights and obligations under leases which convey merely the right to use property, without an equity in the property accruing to the lessee, fall into the category of pertinent information which should be disclosed in schedules or notes rather than by recording assets and liabilities in the financial statements.

.09 On the other hand, some lease agreements are essentially equivalent to installment purchases of property. In such cases, the substance of the arrangement, rather than its legal form, should determine the accounting treatment. The property and the related obligation should be

included in the balance sheet as an asset and a liability, respectively, at the discounted amount of the future lease rental payments, exclusive of payments to cover taxes and operating expenses other than depreciation. Further, in such cases, it is appropriate to depreciate the capitalized amount for property over its estimated useful life rather than over the initial period of the lease.

.10 The property and the related obligation should be included as an asset and a liability in the balance sheet if the terms of the lease result in the creation of a material equity in the property. It is unlikely that such an equity can be created under a lease which either party may cancel unilaterally for reasons other than the occurrence of some remote contingency. The presence, in a noncancelable lease or in a lease cancelable only upon the occurrence of some remote contingency, of either of the two following conditions will usually establish that a lease should be considered to be in substance a purchase:

- a. The initial term is materially less than the useful life of the property, and the lessee has the option to renew the lease for the remaining useful life of the property at substantially less than the fair rental value; or
- b. The lessee has the right, during or at the expiration of the lease, to acquire the property at a price which at the inception of the lease appears to be substantially less than the probable fair value of the property at the time or times of permitted acquisition by the lessee.

In these cases, the fact that the rental payments usually run well ahead of any reasonable measure of the expiration of the service value of the property, coupled with the options which permit either a bargain purchase by the lessee or the renewal of the lease during the anticipated useful life at bargain rentals, constitutes convincing evidence that an equity in the property is being built up as rental payments are made and that the transaction is essentially equivalent to a purchase.

.11 The determination that lease payments result in the creation of an equity in the property obviously requires a careful evaluation of the facts and probabilities surround-

ing a given case. Unless it is clear that no material equity in the property will result from the lease, the existence, in connection with a noncancelable lease or a lease cancelable only upon the occurrence of some remote contingency, of one or more circumstances such as those shown below tend to indicate that the lease arrangement is in substance a purchase and should be accounted for as such.

- a. The property was acquired by the lessor to meet the special needs of the lessee and will probably be usable only for that purpose and only by the lessee.
- b. The term of the lease corresponds substantially to the estimated useful life of the property, and the lessee is obligated to pay costs such as taxes, insurance, and maintenance, which are usually considered incidental to ownership.
- c. The lessee has guaranteed the obligations of the lessor with respect to the property leased.
- d. The lessee has treated the lease as a purchase for tax purposes.

**.12** In cases in which the lessee and the lessor are related, leases should often be treated as purchases even though they do not meet the criteria set forth in paragraphs .10 and .11, i.e., even though no direct equity is being built up by the lessee. In these cases, a lease should be recorded as a purchase if a primary purpose of ownership of the property by the lessor is to lease it to the lessee and (1) the lease payments are pledged to secure the debts of the lessor or (2) the lessee is able, directly or indirectly, to control or influence significantly the actions of the lessor with respect to the lease. The following illustrate situations in which these conditions are frequently present:

- a. The lessor is an unconsolidated subsidiary of the lessee, or the lessee and the lessor are subsidiaries of the same parent and either is unconsolidated.
- b. The lessee and the lessor have common officers, directors, or shareholders to a significant degree.
- c. The lessor has been created, directly or indirectly, by the lessee and is substantially dependent on the lessee for its operations.
- d. The lessee (or its parent) has the right, through options or otherwise, to acquire control of the lessor.

## OPINION

### Application of Opinion

.13 This section is concerned with accounting for non-cancelable leases (or leases cancelable only upon the occurrence of some remote contingency) which are material, either individually or as a group for similar types of property, or in the aggregate. The presumption is that if the rights and obligations under such leases are either material in relation to the lessee's net assets or reasonably expected to affect materially the results of operations of future periods, the leases are covered by the provisions of this section.

### Capitalization

.14 Except in cases of leases which come under paragraphs .09, .10, .11, and .12 of this section, the right to use property and a related obligation to pay specific rents over a definite future period are not considered by the Board to be assets and liabilities under present accounting concepts (see paragraphs .06, .07 and .08). Leases of this type involve future rights and obligations, however, and pertinent information should be disclosed as described in section 5352. In the opinion of the Board, disclosure rather than capitalization is the correct accounting treatment of these leases. [As amended, effective for fiscal periods ending on or after December 31, 1973 by APB Opinion No. 31.] (See section 5352.)

.15 Leases which are clearly in substance installment purchases of property (see paragraphs .09, .10, .11 and .12) 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. A note or schedule may be required to disclose significant provisions of the transaction. 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.

[.16] [Superseded, effective for fiscal periods ending on or after December 31, 1973 by APB Opinion No. 31.] (See section 5352.)

[.17] [Superseded, effective for fiscal periods ending on or after December 31, 1973 by APB Opinion No. 31.] (See section 5352.)

[.18] [Superseded, effective for fiscal periods ending on or after December 31, 1973 by APB Opinion No. 31.] (See section 5352.)

### **Sale and Leaseback**

.19 The principal details of any material sale-and-leaseback arrangement should be disclosed in the year in which the transaction originates.

.20 The conclusions in paragraphs .14, .15, and section 5352 apply to the agreement covering the leaseback as though no concurrent sale were involved. [As amended, effective for fiscal periods ending on or after December 31, 1973 by APB Opinion No. 31.]

.21 The Board is of the opinion that the sale and the leaseback usually cannot be accounted for as independent transactions. Neither the sale price nor the annual rental can be objectively evaluated independently of the other. Consequently, material gains or losses resulting from the sale of properties which are the subject of sale-and-leaseback transactions, should be amortized over the life of the lease as an adjustment of the rental cost (or, if the leased property is capitalized, as an adjustment of depreciation). The related tax effect should be amortized over the life of the lease in conformity with section 4091. [As amended, effective for fiscal periods beginning after December 31, 1967, by APB Opinion No. 11.]

.22 Exceptions to the rule in paragraph .21 are expected to be rare. If, however, the fair value of the property at the time of the sale and leaseback is less than the undepreciated cost, the loss should be reflected in income at the time of the sale to the extent that a write-down to recognize fair value could properly have been recorded in the absence of a sale. In other instances in which the use of the leased property changes with the sale and leaseback and in which the sale price falls within the limits which would reasonably be set by independent transactions (for example, companies engaged in both constructing and oper-

ating office buildings or other commercial investment properties may sell a property after construction and lease it back for operation), the exceptional circumstances surrounding a particular sale-and-leaseback transaction may clearly justify recognition of all or part of the gain or loss at the time of the sale.

#### **Prior Lease Agreements**

.23 Unless otherwise stated, Opinions of the Board are not intended to be retroactive. However, the Board encourages the revision of past accounts in individual cases where the effect on current financial statements is material. In any event, the Board believes the conclusions as to disclosure stated in section 5352 should apply to lease agreements made prior to the issuance of that section. [As amended, effective for fiscal periods ending on or after December 31, 1973 by APB Opinion No. 31.] (See section 5352.)

➤→ *The next page is 3521.* ←➤

## Section 5352

### ***Disclosure of Lease Commitments by Lessees***

Effective for fiscal periods ending on or after December 31, 1973, unless otherwise indicated

#### **INTRODUCTION**

.01 Since the adoption of section 5351, *Reporting of Leases in Financial Statements of Lessee*, in September 1964, the Board has observed improvement in disclosures of lease commitments by lessees. However, some investors, credit grantors, credit rating services, and other users of financial statements have stated that the disclosures have not always provided all of the relevant information they believe to be important.

.02 These users of financial statements state that information with respect to expiration dates and minimum annual rentals under lease commitments is as essential as similar information with respect to long-term debt. Furthermore, they observe that comparisons of financial position, including capital structure and debt/equity ratios, of similar enterprises are impaired if the impact of lease commitments (and the major categories of leased properties) are not determinable from the financial statements of each company. Some have observed that, to make meaningful comparisons between enterprises that finance property acquisitions with long-term debt or equity capital and those that obtain the use of such properties under long-term noncancelable leases, it is necessary to calculate gross rental commitments and apply a "factor" to those amounts to estimate the present values of lease commitments. A "factor" must also be applied to rent expense in evaluating the ability of a lessee to meet fixed charges. These factors, generally arbitrary, have produced widely varying results in evaluating lease commitments in similar circumstances.

***Differing Views***

**.03** Some accountants believe that evaluation of lease commitments, as discussed in paragraph .02, would be aided by expanding disclosures to include (a) a description of the major categories of leased properties, (b) amounts of required lease payments due in future periods, (c) the present values of such payments after excluding the amounts applicable to taxes, insurance, maintenance, and other operating expenses (that is, on a net lease basis), and (d) interest rates used in computing the present values. Some accountants in this group believe that in view of the matters discussed in paragraph .05 it is acceptable to call attention to the possible utility of giving the information referred to in (c) and (d) but not to make the disclosure of such information mandatory at this time.

**.04** Other accountants believe that the disclosure of the aggregate gross commitments arising from leases by time intervals and type of property and services is adequate to assess the extent to which operations are dependent upon leased property and the credit of the company has been committed. They believe that disclosure of present values of lease commitments (net leases and, if practicable, gross leases reduced by estimation to a net lease basis) improperly implies that such lease commitments should have been recorded as debt and resulted in capitalization of the related assets. The subjective nature of the estimates necessary to reduce gross leases to a net lease basis, in their view, would result in many cases in the still more inappropriate alternative disclosure of the present values of the portions of gross leases which represent future services. Further, they believe that the disclosure of two substantially different amounts with respect to the same lease contract can only add complexity and cause confusion.

***Financial Accounting Standards Board***

**.05** The Board recognizes 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 also recognizes that the forthcoming report of the Study Group on 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 prejudice 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.

#### ***Applicability***

.06 This section supersedes sections 5351.16-18 and should be substituted for the references to them in sections 5351.14, 5351.20, and 5351.23. Except as stated in the preceding sentence, this section does not modify section 5351. This section applies to lease commitments for either personal property or real property, including leases of office space and special purpose facilities and of properties subleased to others. Because of the highly specialized problems involved, it does not apply to lease agreements concerning natural resources (such as oil, gas, timber, and mineral rights) other than land. Further, this section does not apply to lease commitments that have been capitalized in accordance with section 5351.

### **OPINION**

.07 The Board believes that financial statements of lessees should disclose sufficient information regarding non-capitalized lease commitments to enable users of the statements to assess the present and prospective effect of those commitments upon the financial position, results of operations, and changes in financial position of the lessees. Accordingly, the Board believes that the information specified in paragraphs .08-.10 should be disclosed as an integral part of the financial statements.

#### ***Total Rental Expense***

.08 Total rental expense (reduced by rentals from subleases, with disclosure of such amounts) entering into the determination of results of operations for each period for which an income statement is presented should be disclosed.

Rental payments under short-term leases for a month or less which are not expected to be renewed need not be included. Contingent rentals, such as those based upon usage or sales, should be reported separately from the basic or minimum rentals.

#### **Minimum Rental Commitments**

.09 The minimum rental commitments <sup>1</sup> under all non-cancelable leases <sup>2</sup> should be disclosed, as of the date of the latest balance sheet presented, in the aggregate for:

- a. Each of the five succeeding fiscal years,
- b. Each of the next three five-year periods, and
- c. The remainder as a single amount.

The amounts so determined should be reduced by rentals to be received from existing noncancelable subleases (with disclosure of the amounts of such rentals). The total of the amounts included in (a), (b), and (c) should also be classified by major categories of properties, such as real estate, aircraft, truck fleets, and other equipment.

#### **Additional Disclosures**

.10 Additional disclosures should be made to report in general terms:

- a. The basis for calculating rental payments if dependent upon factors other than the lapse of time.
- b. Existence and terms of renewal or purchase options, escalation clauses, etc.
- c. The nature and amount of related guarantees made or obligations assumed.
- d. Restrictions on paying dividends, incurring additional debt, further leasing, etc.
- e. Any other information necessary to assess the effect of lease commitments upon the financial position, results of operations, and changes in financial position of the lessee. (For example, in instances where significant changes in lease arrangements are likely

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<sup>1</sup> The minimum rental commitments are not necessarily indicative of the values of the property rights vested in the lessee.

<sup>2</sup> For purposes of this section a noncancelable lease is defined as one that has an initial or remaining term of more than one year and is noncancelable, or is cancelable only upon the occurrence of some remote contingency or upon the payment of a substantial penalty.

it may be desirable to state that the information given is for existing leases only and is not a forecast of future rental expense. A statement could also be made that the amounts given may not necessarily represent the amounts payable in the event of default.)

#### *Present Value of Commitments*

.11 The Board also believes that disclosure of the present value of the commitments reported in accordance with paragraph .09 may be helpful in evaluating the credit capacity of the lessee and in comparing the lessee's financial position with that of other entities using other means of financing to obtain the use of property. Such disclosure, if presented, may include, as of the date of the latest balance sheet presented:

- a. The present values of the net fixed minimum lease commitments<sup>3</sup> (based on the interest rates implicit in the terms of the leases at the times of entering into the leases<sup>4</sup>) in the aggregate and by major categories of properties, such as real estate, aircraft, truck fleets, and other equipment.
- b. Either the weighted average interest rate (based on the present values) and range of rates, or specific interest rates, for all lease commitments included in the amounts disclosed under (a) above.
- c. The present value of rentals to be received from existing noncancelable subleases of property included in (a) above (based on the interest rates implicit in the terms of the subleases at the times of entering into the subleases).

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<sup>3</sup>The net amounts disclosed should exclude the estimated or actual portions, if any, of the lease commitments applicable to taxes, insurance, maintenance, and other operating expenses. To the extent that such expenses cannot be reasonably estimated for some leases, it is acceptable to disclose the present value of the aggregate of those lease commitments computed without regard to such deductions (that is, on a gross basis). In the latter case separate amounts should be presented for lease commitments determined on a net basis and for those determined on a gross basis.

<sup>4</sup>In some cases, the pertinent lease documents may indicate the interest rates inherent in the lease terms. In other cases, interest rates applicable to the financing of purchases of similar types of properties by the lessee at the times of entering into the lease agreements may be indicative of the interest rates implicit in the terms of the leases. Also, see section 4111.12-13, *Interest on Receivables and Payables*.

**EFFECTIVE DATE**

.12 This section shall be effective for fiscal periods ending on or after December 31, 1973 and applies to all lease agreements, including those entered into prior to the issuance of this section. The Board, however, encourages earlier application of the provisions of this section.

➤→ *The next page is 3539.* ←➤

**Section 5361*****Amortization of Debt  
Discount and Expense  
or Premium***<sup>1</sup>

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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<sup>1</sup> See section 4111, *Interest on Receivables and Payables*.

➤➤➤ → *The next page is 3541.* ← ➤➤➤

**Section 5362****Early Extinguishment of Debt**

Effective for all extinguishments of debt occurring on or after January 1, 1973, unless otherwise indicated <sup>1</sup>

**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. 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.

.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.
- 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

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<sup>1</sup> See paragraph .22.

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 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 pre-

cedes 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 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 ex-

tinguishment 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.

.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.<sup>2</sup> The criteria in section 2012 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.)

.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.

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<sup>2</sup> 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.

**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.

## Section 5500

## CAPITAL

. . . stockholders' equity . . . treasury stock  
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➤→ The next page is 4011. ←➤

## Section 5511

### *Capital Surplus*

Issue date, unless otherwise indicated: 1934 <sup>1</sup>

.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.<sup>2</sup>

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<sup>1</sup>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.

<sup>2</sup>See also section 5581, *Quasi-Reorganization or Corporate Readjustment*.

**Section 5512*****Donated Stock***

Issue date, unless otherwise indicated: 1934<sup>1</sup>

.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.

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<sup>1</sup>The above rule was adopted by the membership of the Institute in 1934.

**Section 5513****Contingency Reserves**

Issue date, unless  
otherwise indicated:  
June, 1953

.01 The purpose of this section is to consider problems which arise in the accounting treatment of two types of reserves whose misuse may be the means of either arbitrarily reducing income or shifting income from one period to another:

(a) General contingency reserves whose purposes are not specific;

(b) Reserves designed to set aside a part of current profits to absorb losses feared or expected in connection with inventories on hand or future purchases of inventory.

.02 Charges to provide, either directly or by use of a reserve, for losses due to obsolescence or deterioration of inventory or for reducing an inventory to market, or for reducing an inventory to a recognized basis such as *last-in first-out* or its equivalent in accordance with an announced change in policy to be consistently followed thereafter, are not under consideration here.

.03 If a provision for a reserve, made against income, is not properly chargeable to current revenues, net income for the period is understated by the amount of the provision. If a reserve so created is used to relieve the income of subsequent periods of charges that would otherwise be made against it, the income of such subsequent periods is thereby overstated. By use of the reserve in this manner, profit for a given period may be significantly increased or decreased by mere whim. As a result of this practice the integrity of financial statements is impaired, and the statements tend to be misleading.

.04 The committee recognizes the character of the income statement as a tentative instalment in the record of long-time financial results, and is aware of the tendency to exaggerate the significance of the net income for a single

year. Nevertheless, there still exist the responsibility for determining net income as fairly as possible by sound methods consistently applied and the duty to show it clearly. In accomplishing these objectives, it is deemed desirable to provide, by charges in the current income statement, properly classified, for all foreseeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods with reasonable approximation.

.05 Accordingly, inventories on hand or contracted for should be priced in accordance with principles stated elsewhere by the committee.<sup>1</sup> When inventories which have been priced in accordance with those principles are further written down by a charge to income, either directly or through the use of a reserve, current revenues are not properly matched with applicable costs, and charges to future operations are correspondingly reduced. This process results in the shifting of profits from one period to another in violation of the principle that reserves should not be used for the purpose of equalizing reported income.

.06 It has been argued with respect to inventories that losses which will have to be taken in periods of receding price levels have their origins in periods of rising prices, and that therefore reserves to provide for future price declines should be created in periods of rising prices by charges against the operations of those periods. Reserves of this kind involve assumptions as to what future price levels will be, what inventory quantities will be on hand if and when a major price decline takes place, and finally whether loss to the business will be measured by the amount of the decline in prices. The bases for such assumptions are so uncertain that any conclusions drawn from them would generally seem to be speculative guesses rather than informed judgments. When estimates of this character are included in current costs, amounts representing mere conjecture are combined with others representing reasonable approximations.

.07 The committee is therefore of the opinion that reserves such as those created:

(a) for general undetermined contingencies, or

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<sup>1</sup> See section 5121.

(b) for any indefinite possible future losses, such as, for example, losses on inventories not on hand or contracted for, or

(c) for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles,<sup>2</sup> or

(d) without regard to any specific loss reasonably related to the operations of the current period, or

(e) in amounts not determined on the basis of any reasonable estimates of costs or losses

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income.

**.08** Accordingly, it is the opinion of the committee that if a reserve of the type described in paragraph .07 is set up:

(a) it should be created by a segregation or appropriation of earned surplus,

(b) no costs or losses should be charged to it and no part of it should be transferred to income or in any way used to affect the determination of net income for any year,<sup>3</sup>

(c) it should be restored to earned surplus directly when such a reserve or any part thereof is no longer considered necessary,<sup>3</sup> and

(d) it should preferably be classified in the balance sheet as a part of shareholders' equity.

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<sup>2</sup> See section 5121.

<sup>3</sup> Items (b) and (c) of paragraph .08 also apply to contingency reserves set up in prior years.

**Section 5514****Contingencies**

Issue date, unless  
otherwise indicated:  
October, 1958

.01 In the preparation of financial statements presenting financial position or operating results, or both, it is necessary to give consideration to contingencies. In accounting a contingency is an existing condition, situation or set of circumstances, involving a considerable degree of uncertainty, which may, through a related future event, result in the acquisition or loss of an asset, or the incurrance or avoidance of a liability, usually with the concurrence of a gain or loss. A commitment which is not dependent upon some significant intervening factor or decision should not be described as a contingency.

**DISCUSSION**

.02 The contingencies with which this section is primarily concerned are those in which the outcome is not sufficiently predictable to permit recording in the accounts, but in which there is a reasonable possibility of an outcome which might materially affect financial position or results of operations. Examples of contingencies which may result in the incurrance of liabilities, or in losses, are pending or threatened litigation, assessments or possible assessments of additional taxes, or other claims such as renegotiation refunds, that are being or would be contested, guarantees of indebtedness of others, and agreements to repurchase receivables which have been sold. Examples of contingencies which may result in the acquisition of assets, or in gains, are claims against others for patent infringement, price redetermination upward and claims for reimbursement under condemnation proceedings. Material contingencies of the types discussed in this paragraph should be disclosed.

.03 Other contingencies may exist where the outcome is reasonably foreseeable, such as probable tax assessments which will not be contested, or anticipated losses from uncollectible receivables. Contingencies of this type which are

expected to result in losses should be reflected in the accounts. However, contingencies which might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization;<sup>1</sup> but there should be adequate disclosure.

.04 There are also general risk contingencies that are inherent in business operations and which affect many if not all companies, such as the possibility of war, strike, losses from catastrophies not ordinarily insured against, or a business recession. Contingencies of this type need not be reflected in financial statements either by incorporation in the accounts or by other disclosure.<sup>2</sup>

#### DISCLOSURE

.05 Disclosure of contingencies referred to in paragraph .02 should be made in financial statements or in notes thereto. The disclosure should be based as to its extent on judgment in the light of the specific circumstances and should indicate the nature of the contingency, and should give an appraisal of the outlook. If a monetary estimate of the amount involved is not feasible, disclosure should be made in general terms describing the contingency and explaining that no estimated amount is determinable. When amounts are not otherwise determinable, it may be appropriate to indicate the opinion of management or counsel as to the amount which may be involved. In some cases, such as a law suit involving a substantial amount, management may reasonably expect to settle the matter without incurrence of any significant liability; however, consideration should be given to disclosing the existence of the litigation and the opinion of management or counsel with respect thereto. Although disclosures discussed here should be made with respect to those contingencies which may result in material gains or assets as well as with respect to those which may result in material losses or liabilities, care should be exercised in the case of gains or assets to avoid misleading implications as to the likelihood of realization. The discussion in this section does not deal with the question as to whether the existence of any of the contingencies discussed above is such as to require a qualified opinion

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<sup>1</sup> See section 4010.

<sup>2</sup> For the committee's position with respect to contingency reserves, see section 5513.

or a disclaimer of an opinion by the independent certified public accountant.

**.06** Certain other situations requiring disclosures have sometimes inappropriately been described as though they were contingencies, even though they are of a nature not possessing the degree of uncertainty usually associated with the concept of a contingency. Examples are 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. While some of these situations may develop into contingencies, they should not be described as contingencies prior to such eventuality.

**Section 5515****Liquidation Preference  
of Preferred Stock**

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.

**Section 5516****Convertible Debt and  
Debt Issued with  
Stock Purchase Warrants<sup>1</sup>**

Effective for fiscal periods  
beginning after December  
31, 1966, unless otherwise  
indicated <sup>2</sup>

**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 value of the stock does not increase sufficiently to result in

<sup>1</sup> As amended by APB Opinion No. 14, March, 1969.

<sup>2</sup> See paragraphs .17 and .18.

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-

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-

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.<sup>3</sup> Any resulting discount or premium on the debt securities should be accounted for as such.<sup>4</sup> 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.<sup>3</sup> 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.<sup>5</sup> However, if a portion of the proceeds of a convertible debt issue covered by paragraph .10

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<sup>3</sup> 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.

<sup>4</sup> See sections 5361 and 5362.

<sup>5</sup> 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.

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 (see section 2010.22).

➤→ *The next page is 4301.* ←➤

**Section 5541*****Accounting for  
Treasury Stock***

Issue date, unless  
otherwise indicated:  
1934 <sup>1</sup>

.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.

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<sup>1</sup>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.

## Section 5542

## ***Profits or Losses on Treasury Stock***

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:

- 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 APE 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 4501.* ←

## Section 5561

# Stock Dividends and Stock Split-Ups

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-

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.<sup>1</sup> 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-

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<sup>1</sup> 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*.

.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 4701.* ←➤➤➤

## Section 5581

# Quasi-Reorganization or Corporate Readjustment

(Amplification of Institute Rule No. 2 of 1934)

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.”<sup>1</sup>

.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-

<sup>1</sup> 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

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.<sup>2</sup>

.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.

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<sup>2</sup> See section 5582.

**Section 5582*****Discontinuance of Dating  
Earned Surplus***

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.

## Section 6000

# SPECIAL INDUSTRY APPLICATIONS

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. . . public utilities . . . industry audit guides . . .  
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➤→ *The next page is 5011.* ←➤

**Section 6011*****Accounting Principles for Regulated Industries***

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.

➤➤➤ The next page is 5191. ⚡

# APPENDIX

## AICPA Industry Audit/Accounting Guides and Accounting Position Papers

### Audit Guides Currently Available

- Audits of Banks, Including Supplement*, Committee on Bank Accounting and Auditing, 1969.
- Audits of Brokers and Dealers in Securities*, Committee on Stockbrokerage Auditing, 1973.
- Audits of Colleges and Universities*, Committee on College and University Accounting and Auditing, 1973.
- Audits of Construction Contractors*, Committee on Contractor Accounting and Auditing and the Committee on Cooperation With Surety Companies, 1965.
- Audits of Employee Health and Welfare Benefit Funds*, Committee on Health, Welfare and Pension Funds, 1972.
- Audits of Finance Companies*, Committee on Finance Companies, 1973.
- Audits of Fire and Casualty Insurance Companies*, Committee on Insurance Accounting and Auditing, 1966.
- Audits of Personal Financial Statements*, Committee on Personal Financial Statements, 1968.
- Audits of Stock Life Insurance Companies*, Committee on Insurance Accounting and Auditing, 1972.
- Audits of Savings and Loan Associations*, Committee on Savings and Loan Accounting and Auditing, 1973.
- Audits of Voluntary Health and Welfare Organizations\**, Committee on Relations with Nonprofit Organizations, 1968.
- Hospital Audit Guide*, Committee on Health Care Institutions, 1972.
- Medicare Audit Guide*, Committee on Health Care Institutions, 1969.

### Accounting Guides Currently Available

- Accounting for Motion Picture Films*, Committee on the Entertainment Industries, 1973.
- Accounting for Retail Land Sales*, Committee on Land Development Companies, 1973.
- Accounting for Franchise Fee Revenue*, Committee on Franchise Accounting and Auditing, 1973.
- Profit Recognition on Sales of Real Estate*, Committee on Accounting for Real Estate Transactions, 1973.

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\*Revision in Process.

**Audit Guides and Accounting Position Papers in Process**

*Companies in the Development Stage*

*Defense Contractors*

*Investment Companies*

*Pension Funds*

*Private Foundations*

*Service Center Produced Records*

*State and Local Governmental Units*

*Voluntary Health and Welfare Organizations* (Revision of 1968 Guide)

# ACCOUNTING INTERPRETATIONS

*The Institute staff has been authorized to issue interpretations of accounting questions having general interest to the profession. The purpose of the interpretations is 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 are reviewed with informed members of the profession, are not pronouncements of the Board. However, members should be aware that they may be called upon to justify departures from the interpretations. Responsibility for their preparation rests with RICHARD C. LYTLE, administrative director of the Accounting Principles Board. Unless otherwise stated, the interpretations are not intended to be retroactive.*

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**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

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, 2010.22, and 2010.23. 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.....	<u>\$ (90,000)</u>	<u>\$ 1,200,000</u>
Earnings per share amounts:		
As previously reported.....	\$ .20 <sup>a</sup>	\$ .75 <sup>c</sup>
Effect of retroactive change.....	(.30)	.45
As adjusted .....	<u>\$(.10)<sup>b</sup></u>	<u>\$1.20<sup>d</sup></u>

Computational Notes:

- (a)  $\$200,000 \div (900,000 + 100,000)$  shares
- (b)  $\$90,000 \div 900,000$  shares
- (c)  $(\$800,000 - \$200,000) \div 800,000$  shares
- (d)  $\$1,200,000 \div (800,000 + 200,000)$  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

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.] 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 either (a) income before extraordinary items (if any) and the cumulative effect of a change in accounting principle or (b) 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 before extraordinary items (if any) and cumulative effect of a change in accounting principle or (b) 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 either “a” or “b” but not on both. The per share amount of an extraordinary item or a “catch-up” adjustment is always computed by using the same denominator used to compute both the “a” and “b” earnings per share amounts.

**.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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**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.]

### 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.]

### 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

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-

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

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

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 business 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 and to business combinations completed within five years after that date. 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.**

.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 and consummated within five years 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 issu-

ing corporation which is owned by the other combining company on October 31, 1970?

**.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 and within five years after October 31, 1970. 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).

**.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-

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-

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 initiation 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”

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.

.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 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 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).

.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-

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.

.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.

.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?

**.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

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. (Contingencies of this type are described in section 5514.02.) 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, is reflected currently in net income or as a prior period adjustment in accordance with section 2010. 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.

[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]

**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 1091.47e 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 (see volume 2, page 6081) 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-

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 “piggy-back” (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

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.

**.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 5451.* ←

**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.]

➤➤➤ → *Section U 2011 begins on page 5501.* ← ➤➤➤

**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 prohibits including anti-dilutive<sup>1</sup> securities in earnings

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<sup>1</sup> See Interpretation 5 for the definition of an anti-dilutive security.

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

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<sup>2</sup> 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

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<sup>2</sup> 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.<sup>3</sup> [.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.<sup>4</sup> [.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

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<sup>3</sup> 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.

<sup>4</sup> Except as explained in Interpretations 29 and 30.

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<sup>5</sup> or (3) an aggregate computation is required which has a net dilutive effect but which may include anti-dilutive securities or anti-dilutive computations.<sup>6</sup> 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

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<sup>5</sup> Note that either primary earnings per share for net income or primary earnings per share for income before extraordinary items may be anti-dilutive when common stock equivalents are present together with extraordinary items. The common stock equivalents may have an anti-dilutive effect upon either of these amounts so long as the effect is dilutive upon the other amount. 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 extraordinary items. 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.)

<sup>6</sup> 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 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.)

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 preferred stock, for example, must deduct any preferred divi-

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 anti-dilution in earnings per share computations generally prohibits the assumption of exercise of any option or warrant or their equivalents when the assumed purchase 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]

.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]

**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,<sup>7</sup> (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 when the term of an agreement to issue additional shares

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<sup>7</sup> As defined in sections 2010.22 and 2010.23.

expires and the conditions have not been met.<sup>8</sup> [.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-

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<sup>8</sup> 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.)

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<sup>9</sup> 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:

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<sup>9</sup> 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<sup>10</sup> 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.<sup>11</sup> 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<sup>12</sup> 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

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<sup>10</sup> 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.

<sup>11</sup> See Interpretations 29 and 30 for exceptions.

<sup>12</sup> 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.

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  $66\frac{2}{3}\%$  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.<sup>13</sup> 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<sup>14</sup> 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

<sup>13</sup> 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.

<sup>14</sup> See Interpretation 46 for an explanation of why these options and warrants are not classified as common stock equivalents.

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 numerator 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.<sup>15</sup> 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

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<sup>15</sup> 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]

.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**

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**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.

.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 Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, section 620) 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

statement." Earnings per share must therefore be reported under section 2011.

#### **10. Closely Held Corporations**

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**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%**

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**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 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%<sup>16</sup> 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]

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<sup>16</sup> 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%.

.078 The following formula<sup>17</sup> 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<sup>18</sup> 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 = unknown

M = \$10

E = \$6

N = 10,000

Therefore:

$$I = \frac{\$10 - \$6}{\$10} (10,000)$$

I = .4(10,000)

I = 4,000

<sup>17</sup> 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.

<sup>18</sup> 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 Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, sections 516.05-.06 or 517.06 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

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.<sup>19</sup> 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 anti-dilutive but is dilutive on the other). [.30, *fn. 10*]

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<sup>19</sup> 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?

**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. [.34, .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

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

Common Stock Equivalents Present	Other Potentially Dilutive Securities Present	Caption for Single Presentation	Dual Presentation	
			Primary Caption	Fully Diluted Caption
No <sup>a</sup>	No <sup>a</sup>	1		
No <sup>a</sup>	Dilutive		2	3
No <sup>a</sup>	Anti-dilutive	1 <sup>b</sup>		
Dilutive	No		4	3 <sup>c</sup>
Dilutive	Dilutive		4	3
Dilutive	Anti-dilutive		4	5 <sup>b, c</sup>
Anti-dilutive	No <sup>a</sup>	1 <sup>b</sup>		
Anti-dilutive	Dilutive		2 <sup>b</sup>	5 <sup>b</sup>
Anti-dilutive	Anti-dilutive	1 <sup>b</sup>		

Notes:

<sup>a</sup> Or dilution is less than 3% if such securities are present.

<sup>b</sup> In a note, disclose the existence of the anti-dilutive securities.

<sup>c</sup> 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

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:**

$$100,000 + \frac{1}{3} (6,000) = 102,000$$

$$100,000 + \frac{4}{6} (6,000) = 104,000$$

$$100,000 + \frac{10}{12} (6,000) = 105,000$$

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

months ending June 30 or 95,000 shares for the year ending December 31.

**COMPUTATIONAL NOTES:**

$$\begin{aligned} 100,000 - 6,000 &= 94,000 \\ 94,000 + \frac{2}{3} (6,000) &= 98,000 \\ 94,000 + \frac{2}{6} (6,000) &= 96,000 \\ 94,000 + \frac{2}{12} (6,000) &= 95,000 \end{aligned}$$

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.<sup>20</sup> 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 equivalent.

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<sup>20</sup> See paragraph .023 of this Interpretation and section 2011A.06 for a description of the if converted method.

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-

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 convertible 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.

**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.<sup>21</sup> However, if the dividends

<sup>21</sup> See Interpretation 26 for the amount to be used when a convertible security has a change of interest or dividends scheduled.

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
	<hr/>	<hr/>	<hr/>
Totals . . . . .	\$210.00	100.0%	\$200.00
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

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 non-convertible 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 non-recurring 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.

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<sup>22</sup> 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

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<sup>22</sup> 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<sup>23</sup> 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.

<sup>23</sup> See Interpretation 44 for an exception when actual conversion occurs.

**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<sup>24</sup> 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]

<sup>24</sup> 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 ( $\$9,500 \div 4,500$  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

is applied from the beginning of the period<sup>25</sup> 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<sup>25</sup> 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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<sup>25</sup> 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-

putations.<sup>26</sup> 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

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<sup>26</sup> 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 aggreg-

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 ( $\$125,000 \div 60,000$  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 ( $\$150,000 \div \$20$  per share average market price) of common stock in the market on the exercise date. Common stock would therefore increase 2,500 shares.<sup>27</sup> (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 ( $\$125,000 \div 62,500$  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<sup>28</sup> 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]

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<sup>27</sup> 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

<sup>28</sup> For fully diluted incremental shares, the computation would be  
 $\frac{\$25 - \$15}{\$25} \times 10,000 = 4,000$ .

**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?

**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

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 ( $16,667 \times 12/13$ ) in the fourth quarter of 1969. In the annual earnings per share computation for 1969, these warrants would represent 3,846 common shares ( $15,385 \div 4$ ).

.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:

$$\frac{\$12.50 - \$10}{\$12.50} \times 100,000 = 20,000$$

$$12/13 \times 20,000 = 18,462 \text{ shares.}$$

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

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,<sup>29</sup> 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.

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<sup>29</sup> 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 <sup>30</sup> 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 <sup>30</sup> 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 <sup>31</sup> 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

$$25,500 + 25,000 + 26,400 + 26,000 = 102,900$$

$$102,900 \div 4 = 25,725$$

or

$$\begin{array}{r} 500 \\ \hline 4 \end{array} + \begin{array}{r} 1,400 \\ \hline 4 \end{array} + \begin{array}{r} 1,000 \\ \hline 4 \end{array} = 725$$

$$725 + 25,000 = 25,725$$

<sup>30</sup> For example, see Interpretations 67, 70, 77 and 79.

<sup>31</sup> See Interpretation 25 and paragraph .359 for examples of computing a weighted average.

**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:

	<u>Average Market Price</u>	<u>Ending Market Price</u>
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:

	<u>Primary Incremental Shares</u>	
	<u>Quarterly EPS</u>	<u>Year-to-Date EPS</u>
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:

	<u>Fully Diluted Incremental Shares</u>	
	<u>Quarterly EPS (1)</u>	<u>Year-to-Date EPS</u>
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).

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:

	<u>Average Market Price</u>	<u>Ending Market Price</u>
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:

	<u>Primary Incremental Shares</u>	
	<u>Quarterly</u> EPS	<u>Year-to-Date</u> 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)  $\frac{1}{2}$  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  $\frac{1}{2}$  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:

	<u>Increase in Outstanding Shares</u>	
	<u>Quarterly</u> EPS	<u>Year-to-Date</u> 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)  $\frac{2}{3}$  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  $\frac{1}{3}$  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:

	<u>Fully Diluted Incremental Shares</u>	
	<u>Quarterly</u> EPS	<u>Year-to-Date</u> 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  $\frac{1}{3}$  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  $\frac{2}{3}$  (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.

	<u>Average Market Price</u>	<u>Ending Market Price</u>
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:

	<u>Primary Incremental Shares</u>	
	<u>Quarterly EPS</u>	<u>Year-to-Date EPS</u>
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)  $500 + 0 + 1,120 = 1,620$ .       $1,620 \div 3 = 540$
- (4)  $500 + 0 + 1,120 + 800 = 2,420$ .       $2,420 \div 4 = 605$

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)  $\frac{1}{3}$  of 1,000 shares issued June 1 and outstanding for one month.
- (2)  $0 + 333 = 333$ .       $333 \div 2 = 167$
- (3) 1,000 shares issued June 1.
- (4)  $0 + 333 + 1,000 = 1,333$ .       $1,333 \div 3 = 444$
- (5) 1,000 shares issued June 1.
- (6)  $0 + 333 + 1,000 + 1,000 = 2,333$ .       $2,333 \div 4 = 583$

.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  $\frac{2}{3}$  (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)  $(667 - 53) + (364 - 35) = 943$ .       $943 \div 2 = 472$ . 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)  $667 + 364 + 1,143 + 923 = 3,097$ .       $3,097 \div 4 = 774$  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<sup>32</sup> 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

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<sup>32</sup> 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.

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.

**.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 ( $2 \times \$48 = \$96$  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  $\frac{\$94 \text{ market price of debenture}}{\$100 \text{ tender value of debenture}} \times \$50 \text{ exercise price per share} = \$47$  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

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.<sup>33</sup> 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<sup>34</sup> common stock equivalents. [.37]

**.250** Convertible securities requiring the payment of cash are assumed to be converted at the beginning of the

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<sup>33</sup> Exercise may be assumed, however, if section 2011.38 applies. See Interpretations 72-74.

<sup>34</sup> Unless issued before June 1, 1969 and classified under election "b" of section 2011.46.

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.<sup>35</sup> [.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).<sup>35</sup> [.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-

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<sup>35</sup> 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<sup>88</sup> 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]

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<sup>88</sup> 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.

**.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<sup>37</sup> 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

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<sup>37</sup> 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.

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?

**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.<sup>38</sup> The exercise amount is divided by the market price<sup>39</sup> 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<sup>40</sup> 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<sup>41</sup>), the 6,000 shares have a market price of \$10 per share. Also assume

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<sup>38</sup> 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.

<sup>39</sup> 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.

<sup>40</sup> 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.

<sup>41</sup> 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.

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 ( $\$1.00 \times 6,000 = \$6,000$  increase in market multiplied by .50 tax rate). The total exercise price is \$12,000 ( $6,000 \times \$2$ ). 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:

$$\begin{aligned} \$44,000 + \$3,000 + \$12,000 &= \$59,000 \\ \$59,000 \div \$11 &= 5,364 \\ 6,000 - 5,364 &= 636 \end{aligned}$$

.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:

$$\begin{aligned} \$42,000 + \$4,500 + \$12,000 &= \$58,500 \\ \$58,500 \div \$11.50 &= 5,087 \\ 6,000 - 5,087 &= 913 \\ \$40,000 + \$6,000 + \$12,000 &= \$58,000 \\ \$58,000 \div \$12 &= 4,833 \\ 6,000 - 4,833 &= 1,167 \end{aligned}$$

.279 On July 1, 1973, 1,000 shares would be issued to the president and are outstanding shares thereafter.<sup>42</sup>

<sup>42</sup> 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:

$$\$38,000 + \$6,250 + \$10,000 = \$54,250$$

$$\$54,250 \div \$12.50 = 4,340$$

$$5,000 - 4,340 = 660$$

$$\$36,000 + \$7,500 + \$10,000 = \$53,500$$

$$\$53,500 \div \$13 = 4,115$$

$$5,000 - 4,115 = 885$$

.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:

$$\$34,000 + \$8,750 + \$10,000 = \$52,750$$

$$\$52,750 \div \$13.50 = 3,907$$

$$5,000 - 3,907 = 1,093$$

$$\$32,000 + \$10,000 + \$10,000 = \$52,000$$

$$\$52,000 \div \$14 = 3,714$$

$$5,000 - 3,714 = 1,286$$

.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:

	<u>Primary Computations</u>	<u>Fully Diluted Computations</u>
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 .....	<u>2,999</u>	<u>4,906</u>
Shares for weighted average (divide totals by 4) .....	750	1,227
Shares issued (1,000 ÷ 2) .....	500	500
Total shares .....	<u>1,250</u>	<u>1,727</u>

**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 anti-dilutive. 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<sup>43</sup>

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<sup>43</sup> Unless subscribed before June 1, 1969 and election "b" under section 2011.46 is made.

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 ( $2 \times \$46 = \$92$  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 ( $2 \times 526 = 1,052$ ) 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,  $2 \times \$42 = \$84$  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

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

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
		<hr/>
Undistributed 1969 earnings		\$12,000
		<hr/> <hr/>

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:

	<u>Preferred Stock</u>	<u>Common Stock</u>
Distributed earnings .....	\$5.40	\$2.60
Undistributed earnings .....	.60	.90
	<hr/>	<hr/>
Totals .....	\$6.00	\$3.50
	<hr/> <hr/>	<hr/> <hr/>

### 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 non-cumulative 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.

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
		<hr/>
Undistributed 1969 earnings.....		<u>\$12,000</u>

Allocation of undistributed earnings:

\$12,000

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= \$.60 per Class A share.

20,000 shares

2(.60) = \$1.20 per Class B share.

Earnings per share amounts:

	<u>Class A</u>	<u>Class B</u>
Distributed earnings .....	\$2.60	\$5.40
Undistributed earnings .....	.60	1.20
	<hr/>	<hr/>
Totals .....	<u>\$3.20</u>	<u>\$6.60</u>

.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 <sup>44</sup> 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

<sup>44</sup> 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-

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-

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?

**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<sup>45</sup> 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.<sup>46</sup> [.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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<sup>45</sup> 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.

<sup>46</sup> 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<sup>47</sup> 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.<sup>48</sup> [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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<sup>47</sup> Unless issued prior to June 1, 1969 and the parent company makes election "b" specified by section 2011.46.

<sup>48</sup> See Interpretation 45 for a description of the treatment of a subsidiary security convertible into a parent company's convertible security.

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:

$$\frac{\$3,600^a - \$300^b}{1,000^c + 100^d}$$

<sup>a</sup> Subsidiary's net income.

<sup>b</sup> Dividends paid by subsidiary on convertible preferred stock.

<sup>c</sup> Shares of subsidiary's common stock outstanding.

<sup>d</sup> 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:

$$\frac{\$3,600^e}{1,000 + 100 + 400^f}$$

<sup>e</sup> Subsidiary's earnings applicable to common stock applying the if converted method for convertible preferred stock.

<sup>f</sup> 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:

$$\frac{\$10,000^a + \$150^b + \$2,700^c + \$60^d}{10,000^e}$$

10,000<sup>e</sup>

<sup>a</sup> Parent's net income.

<sup>b</sup> Dividends received by parent on subsidiary's convertible preferred stock.

<sup>c</sup> Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed:  $\frac{900}{1,000}$  (1,000 shares × \$3 per share).

<sup>d</sup> Parent's proportionate interest in subsidiary's earnings attributable to warrants, computed:  $\frac{40}{200}$  (100 incremental shares × \$3 per share).

<sup>e</sup> Shares of parent's common stock outstanding.

Fully diluted earnings per share.....\$1.27

Computed:

$$\frac{\$10,000 + \$2,160^f + \$48^g + \$480^h}{10,000}$$

10,000

<sup>f</sup> Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed:  $\frac{900}{1,000}$  (1,000 shares × \$2.40 per share).

<sup>g</sup> Parent's proportionate interest in subsidiary's earnings attributable to warrants, computed:  $\frac{40}{200}$  (100 incremental shares × \$2.40 per share).

<sup>h</sup> 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 <sup>i</sup>		
	Common	330 <sup>j</sup>	480	3,120
Parent or consolidated net income				\$13,120

Computed:

<sup>1</sup> 50% (200 preferred shares × \$1.50 dividend per share).

<sup>2</sup> 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:

$\$3,600 - \$300$

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1,000

Fully diluted earnings per share..... \$3.30

Computed:

$\$3,600 - \$300$

---

1,000

**Parent or consolidated earnings per share**

Primary earnings per share..... \$1.28

Computed:

$\$10,000^a + \$2,970^b$

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10,000<sup>c</sup> + 100<sup>d</sup>

<sup>a</sup> Parent's net income.

<sup>b</sup> Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed:  $\frac{900}{1,000}$  (1,000 shares × \$3.30 per share).

<sup>c</sup> Shares of parent's common stock outstanding.

<sup>d</sup> 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  $\frac{\$20 - \$10}{\$20}$  × 200).



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

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-

mendment 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.

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]

.357

**EXHIBIT 1**  
**U. S. BANK PRIME INTEREST RATES**  
**(Source: Federal Reserve Bulletin)**

<u>Effective Date</u>	<u>Prime Rate (%)</u>	<u>66 2/3% of Prime Rate (%)</u>
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).

.358

**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:

	<u>Week</u>	<u>High</u>	<u>Low</u>	<u>Close</u>	<u>Shares Traded</u>
Month 1	1.....	21	19	20	300
	2.....	24	20	23	700
	3.....	24	22	22	500
	4.....	23	21	21	500
<hr/>					
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
<hr/>					
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

**Computing quarterly average from monthly averages based on weekly prices:**

Week	Simple Averages		Weighted Averages		
	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	<u>21.75</u>	<u>21.50</u>		<u>21.95</u>	<u>21.80</u>
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	<u>26.75</u>	<u>27.00</u>		<u>27.37</u>	<u>27.75</u>
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	<u>23.00</u>	<u>22.40</u>		<u>24.33</u>	<u>23.54</u>
Three month total	71.50	70.90		73.65	73.09
Divide by	3	3		3	3
Three month average	<u>23.83</u>	<u>23.63</u>		<u>24.55</u>	<u>24.36</u>

**Computing quarterly averages from monthly prices:**

	<u>Simple Averages</u>		<u>Shares</u>	<u>Weighted Averages</u>	
	<u>High-Low</u>	<u>Close</u>		<u>High-Low</u>	<u>Close</u>
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 .....	<u>72.00</u>	<u>72.00</u>	<u>14,000</u>	<u>345,250</u>	<u>344,700</u>
Divided by .....	<u>3</u>	<u>3</u>		<u>14,000</u>	<u>14,000</u>
Quarterly average ..	<u>24.00</u>	<u>24.00</u>		<u>24.66</u>	<u>24.62</u>

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:

	<u>Simple Averages</u>		<u>Weighted Averages</u>	
	<u>High-Low</u>	<u>Close</u>	<u>High-Low</u>	<u>Close</u>
Weekly prices .....	1,607	1,536	1,853	1,790
Monthly prices .....	1,667	1,667	1,890	1,877

Note: Computed

$$10,000 - \left( \frac{\$20 \times 10,000}{\text{average price}} \right) = \text{incremental shares}$$

**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:

<u>Market Prices Per Share of Common Stock</u>						
<u>Quarter</u>	<u>Year 1</u>		<u>Year 2</u>		<u>Year 3</u>	
	<u>Average</u>	<u>Ending</u>	<u>Average</u>	<u>Ending</u>	<u>Average</u>	<u>Ending</u>
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<sup>(1)</sup>**

<u>Quarter</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
1.....	—0—	1,667	—0—
2.....	—0—	909	—0—
3.....	909	—0—	1,667
4.....	1,667	—0—	909

**Fully Diluted Earnings Per Share**

<u>Quarter</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
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  $\left( \frac{\text{Market Price} - \text{Exercise Price}}{\text{Market Price}} \right) \times 10,000 =$  Incremental Shares

**Number of Incremental Shares Included in Year-to-Date  
Weighted Average**

**Primary Earnings Per Share<sup>(1)</sup>**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
First quarter .....	<u>—0—</u>	1,667	<u>—0—</u>
Six months .....	<u>—0—</u>	1,288	<u>—0—</u>
Nine months .....	303	859	556
Year .....	644	644	644

**Fully Diluted Earnings Per Share**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
First quarter .....	909(1)	2,000(1)	<u>—0—(1)</u>
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.

### EXHIBIT 4 DAYS BETWEEN TWO DATES

.360 The table on page 5619 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:

<u>Transaction Day</u>	<u>Number for Transaction Day</u>	<u>Number for Beginning Day</u>	<u>Days for Weighting</u>
September 18, 1969.....	261	182	79
April 8, 1970.....	463	261	202
End of year.....	547	463	84
			<hr style="width: 100%;"/>
Total days .....			365
			<hr style="width: 100%;"/>

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 <sup>49</sup>	Stock Split <sup>49</sup>	Days Outstanding	Weighted Shares
7/ 1/69	100,000	× 1.05 = 105,000	× 2 = 210,000	79	= 16,590,000
9/18/69	(525)		× 2 = (1,050)		
4/ 8/70	10,000		× 2 = 20,000	202	= 42,207,900
			228,950 ×	84	= 19,231,800
Totals				<u>365</u>	<u>78,029,700</u>

Weighted average number of shares outstanding:

$$\begin{array}{r} 78,029,700 \\ \hline 365 \\ \hline = 213,780 \end{array}$$

<sup>49</sup>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.

TABLE OF DAYS BETWEEN TWO DATES

Day in Month	January	February	March	April	May	June	July	August	September	October	November	December
1	1	31	1	1	1	1	1	1	1	1	1	1
2	2	28	2	2	2	2	2	2	2	2	2	2
3	3	27	3	3	3	3	3	3	3	3	3	3
4	4	26	4	4	4	4	4	4	4	4	4	4
5	5	25	5	5	5	5	5	5	5	5	5	5
6	6	24	6	6	6	6	6	6	6	6	6	6
7	7	23	7	7	7	7	7	7	7	7	7	7
8	8	22	8	8	8	8	8	8	8	8	8	8
9	9	21	9	9	9	9	9	9	9	9	9	9
10	10	20	10	10	10	10	10	10	10	10	10	10
11	11	19	11	11	11	11	11	11	11	11	11	11
12	12	18	12	12	12	12	12	12	12	12	12	12
13	13	17	13	13	13	13	13	13	13	13	13	13
14	14	16	14	14	14	14	14	14	14	14	14	14
15	15	15	15	15	15	15	15	15	15	15	15	15
16	16	14	16	16	16	16	16	16	16	16	16	16
17	17	13	17	17	17	17	17	17	17	17	17	17
18	18	12	18	18	18	18	18	18	18	18	18	18
19	19	11	19	19	19	19	19	19	19	19	19	19
20	20	10	20	20	20	20	20	20	20	20	20	20
21	21	9	21	21	21	21	21	21	21	21	21	21
22	22	8	22	22	22	22	22	22	22	22	22	22
23	23	7	23	23	23	23	23	23	23	23	23	23
24	24	6	24	24	24	24	24	24	24	24	24	24
25	25	5	25	25	25	25	25	25	25	25	25	25
26	26	4	26	26	26	26	26	26	26	26	26	26
27	27	3	27	27	27	27	27	27	27	27	27	27
28	28	2	28	28	28	28	28	28	28	28	28	28
29	29	1	29	29	29	29	29	29	29	29	29	29
30	30		30	30	30	30	30	30	30	30	30	30
31	31		31									

  

Day in Month	January	February	March	April	May	June	July	August	September	October	November	December
1	366	337	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	425	453	484	514	545	575	606	637	667	698	728
30	395	426	454	485	515	546	576	607	638	668	699	729
31	396	427	455	486	516	547	577	608	639	669	700	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:

Net income .....		\$1,000,000
Less dividends .....		900,000
		<hr/>
Undistributed earnings .....		\$ 100,000
Proceeds from the exercise of war- rants: 1,000,000 × \$5 .....	\$5,000,000	
Purchase of treasury stock under para- graph .38-a 200,000 shares × \$23 .....	4,600,000	
	<hr/>	
Balance to retire debt under para- graph .38-b .....	400,000	
Interest rate on debt retired .....	.03	
	<hr/>	
Interest adjustment .....		12,000
		<hr/>
Adjusted undistributed earnings .....		\$ 112,000
		<hr/> <hr/>
Common shares outstanding .....		1,000,000
Common shares assumed issued for warrants .....	1,000,000	
Less treasury stock purchased .....	200,000	
	<hr/>	
Incremental shares for warrants .....		800,000
		<hr/>
Common and common equivalent shares .....		1,800,000
		<hr/> <hr/>
Primary earnings per share:		
Distributed earnings ( $\$900,000 \div 1,000,000$ ) .....		\$ .90
Undistributed earnings ( $\$112,000 \div 1,800,000$ ) .....		.06
		<hr/>
Total earnings per common and common equivalent share .....		\$ .96
		<hr/> <hr/>

**.364** If the per share amount computed above had exceeded earnings per outstanding common share of \$1.00 (computed:  $\$1,000,000 \div 1,000,000$  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:  $\$1,012,000 \div 1,800,000$  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.]

**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.

(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

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

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 5631.* ←

## 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 5641.* ←

## Section U2045

### ***Disclosure of Accounting Policies: Accounting Interpretations of Section 2045***

#### **1. Disclosure of "Leveraged Lease" Transactions by Lessors**

.001 *Question*—In leasing arrangements generally referred to as "leveraged leases" the funds for the purchase of the leased property by the lessor (equity participant) are provided in part by one or more third parties (loan participants). Under such leases a major portion of the lease payments is typically assigned to the loan participants as repayment of their loans, together with interest thereon. In the event of default by the lessee, the loan participants usually have no rights of recovery against the equity participant; the loan participants look to the lessee and have a first lien on the property.

.002 In many of these leasing transactions the ownership of the property by the equity participant can give rise to income tax benefits (such as investment tax credits and the right to elect to use accelerated depreciation methods) that are considered an important part of the return on its investment.

.003 Another important element of return on investment of the equity participant can be the anticipated proceeds from sale or re-lease of the property during, or at end of, the original lease term. In many leasing transactions the residual value at the end of the original lease term is considered to be the last payment under the contract.

.004 The Accounting Principles Board terminated its study of accounting practices of equity participants in the determination of income from "leveraged leases," inasmuch as the Financial Accounting Standards Board has placed on its agenda the broad subject of accounting for leases by lessees and lessors. The APB's findings, however, reveal that various accounting practices are employed by equity participants under either the financing method or operating method (see section 4051, *Accounting for Leases in Finan-*

*cial Statements of Lessors*). Pending an FASB pronouncement on the matter, what types of financial statement disclosures are required of equity participants with respect to accounting for "leveraged leases" in order to fulfill the requirements of section 2045, *Disclosure of Accounting Policies*?

**.005 Interpretation**—The disclosure of the accounting followed for "leveraged leases" in financial statements issued by equity participants is called for by section 2045.12c. Accordingly, the financial statements should include as part of a summary of significant accounting policies or as a note to the financial statements:

1(A) *Financing Method*: A description of the manner in which the equity participant's unrecovered investment in the property (net receivable) is determined and reported in the balance sheet, together with disclosure of such amount and any related outstanding non-recourse debt.

(B) *Operating Method*: A description of the manner in which the equity participant's unrecovered cost is determined and reported in the balance sheet, together with disclosure of such amount and any related outstanding non-recourse debt.

2 A description of the manner in which the annual revenue from "leveraged leases" is determined and reported in the financial statements and the relationship of such revenue to the related (A) unrecovered investment (net receivable) or (B) unrecovered cost. The description should include the accounting treatment of (a) investment tax credits,<sup>1</sup> (b) current and cumulative tax timing differences,<sup>2</sup> (c) estimated recoveries of residual value (and related tax effects), and (d) leases under which the debt service payments (principal and interest) will exceed the aggregate collections to be received from lessees over the lease terms plus the estimated residual value.

[Issue Date: November, 1973]

➡ The next page is 5661. ←

<sup>1</sup> See Accounting Interpretation No. 3, *Acceptable Methods of Accounting for Investment Credits under 1971 Act* (March 1972), section U4094.005, *Accounting for the "Investment Credit"*.

<sup>2</sup> See Accounting Interpretation No. 25, *"Leveraged" Lease Accounting* (March 1972), section U4091.141, *Accounting for Income Taxes*.

## 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 non-compensatory 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.).

[Issue Date: June, 1973]

➤➤➤→ *The next page is 5681.* ←➤➤➤

**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

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.<sup>1</sup> 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.<sup>2</sup> 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-

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<sup>1</sup> See Volume 2, page 6052.

<sup>2</sup> See Volume 2, page 6077.

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<sup>3</sup> 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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<sup>3</sup> 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,

(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

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

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

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-

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.

.059

**EXHIBIT A**  
**Illustration of Defined-Maximum Method**

	Year					
	1	2	3	4	5	
<b>Prior Service Cost (Same as Exhibit B):</b>						
Beginning	\$88,000	\$ 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	<u>\$90,000</u>	<u>\$100,000</u>	<u>\$110,000</u>	<u>\$164,000</u>	<u>\$178,060</u>	
<b>Pension Fund:</b>						
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	<u>\$14,800</u>	<u>\$ 25,792</u>	<u>\$ 36,824</u>	<u>\$ 74,797</u>	<u>\$ 98,789</u>	
<b>Balance Sheet:</b>						
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	<u>\$—0—</u>	<u>\$ 4,000</u>	<u>\$ 8,160</u>	<u>\$ (8,014)</u>	<u>\$ (9,835)</u>	
<b>Pension-Cost Provision for the Year:</b>						
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	<u>\$16,000</u>	<u>\$ 16,000</u>	<u>\$ 16,160</u>	<u>\$ 23,826</u>	<u>\$ 23,179</u>	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	
<b>Prior Service Cost</b> (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	
<b>Pension Fund:</b>						
Beginning	\$ —	\$ 10,000	\$ 20,000	\$ 30,200	\$ 44,628	E
Earnings	—	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
<b>Unfunded Prior Service Cost:</b>						
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
<b>Balance Sheet:</b>						
Beginning	\$ —	\$ —	\$ 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	\$ —	\$ 200	\$ 428	\$ 469	\$ 1,306	K
<b>Actuarially Computed Value of Vested Benefits:</b>						
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
<b>Excess of Vested Benefits Over Pension Fund and Balance Sheet Accrual:</b>						
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

**EXHIBIT B (continued)**  
**Illustration of Defined-Minimum Method**

	Year					
	1	2	3	4	5	
<b>Calculation of Additional Provision for Vested Benefits:</b>						
Test 1: 5% of beginning excess	\$ 500	\$ 450	\$ 428	\$ 469	\$ 1,495	(1) = 5% of 0
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
<b>Pension-Cost Provision for Year:</b>						
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

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.

**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

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

	<u>Past Service Cost</u>	
	<u>Separate Amount</u>	<u>Included in Normal Cost</u>
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.

.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-

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:**

<i>Gain (Loss)</i>				
<u>Year</u>	<u>Actual</u>		<u>Applied to Reduce Provision</u>	<u>Deferred to Future Years</u>
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:**

<i>Gain (Loss)</i>				
<u>Year</u>	<u>Actual</u>	<u>5-Year Total</u>	<u>Applied to Reduce Provision</u>	<u>Deferred to Future Years</u>
-4	\$ 1,000			
-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

or 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.

.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.<sup>4</sup> 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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<sup>4</sup>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.]

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.<sup>5</sup> 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

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<sup>5</sup> 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.

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.

## 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.

**.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 ( $10 \times \$200 \times 25\%$ ). 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

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?*

.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<sup>1</sup> 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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<sup>1</sup>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.

*.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?*

.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 reprogramming 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-

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?*

»»»→ The next page is 5729-5. ←«««

.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.

**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.]

**Section U4091*****Accounting for Income Taxes:  
Accounting Interpretations  
of Section 4091*****1. Accounting for Income Tax Surcharge Rate Changes**

[.001] (Section U 4091.001-.005 deleted from Volume 1.  
See Volume 2, page 9637.)

➤ *The next page is 5733.* ←

# Accounting Interpretations of Section 4091

By Donald J. Bevis and Raymond E. Perry

## 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.<sup>1</sup>

.013 The major subjects covered by section 4091 are (1) interperiod allocation of income tax expense because of

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<sup>1</sup> 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.

timing differences, (2) accounting for operating loss carrybacks and carryforwards, and (3) financial statement presentation of income taxes, including allocation within a period (intraproduct 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

➤→ *The next page is 5735-3.* ←➤

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 Two specialized industry situations having tax consequences somewhat similar to those for timing differences have been excluded pending further study. Each these situations has certain unique aspects which create problems in the measurement and recognition of their tax consequences. The exclusions are—(1) intangible development costs in the oil and gas industry, and (2) deposits in statutory reserve funds by United States steamship companies. Section 4091 is, however, applicable to these industries in all other respects including timing differences. [As amended by APB Opinion No. 23, December, 1971.]

## 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, interperiod allocation was required for nonrecurring differences and for some but not all recurring differences.<sup>2</sup> Practice had been mixed with regard to types of recurring differences where allocation was not specifically required under prior pronouncements.

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<sup>2</sup> 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.<sup>3</sup> 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<sup>4</sup> 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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<sup>3</sup> 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).

<sup>4</sup> 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.)

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"

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
	<hr/>
Taxable income . . . . .	\$ 800,000
	<hr/> <hr/>
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
	<hr/>
Income tax expenses as shown in income statement . . . . .	\$ 473,500
	<hr/> <hr/>

.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:

## Year 2

Pretax accounting income .....	\$1,000,000
Gross margin on prior year's sales collected during the current year .....	200,000
	<hr/>
Taxable income .....	\$1,200,000
	<hr/> <hr/>
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)
	<hr/>
Income tax expenses as shown in income statement .....	\$ 530,450
	<hr/> <hr/>

.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 warranted 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 warranted 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.

## 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

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.<sup>6</sup> Under either

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<sup>6</sup> 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

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 research and development 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.

.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 rather to illustrate some of the complications that may be

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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.

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

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

	<i>Gross Change Method</i>	<i>Net Change Method</i>
	<i>(thousands of dollars)</i>	
<b>Computation of taxable income</b>		
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 .....	<u>\$200</u>	<u>\$200</u>
<b>Computation of tax estimated to be currently payable</b>		
48% rate .....	\$ 96	\$ 96
Surtax exemption .....	( 6)	( 6)
10% surcharge .....	9	9
	<u>\$ 99</u>	<u>\$ 99</u>

	<i>Gross Change Method</i>	<i>Net Change Method</i>
	<i>(thousands of dollars)</i>	
<b>Computation of deferred tax on depreciation timing difference</b>		
Taxable income .....	\$200	\$200
Originating or net change in depreciation timing differences ....	500	400
Adjusted taxable income—"without" timing differences .....	<u>\$700</u>	<u>\$600</u>
Tax on adjusted taxable income .....	\$363 (a)	\$310 (a)
Tax currently payable .....	<u>99</u>	<u>99</u>
Differential equivalent to tax effects of timing differences to be added to deferred tax credit .....	<u>\$264</u>	<u>\$211</u>
<b>Computation of deferred tax on deferred gross margin timing differences</b>		
Taxable income .....	\$200	\$200
Originating or net change in gross margin timing differences ....	300	(100)
Adjusted taxable income—"without" timing differences .....	<u>\$500</u>	<u>\$100</u>
Tax on adjusted taxable income .....	\$257 (a)	\$ 46 (a)
Tax currently payable .....	<u>99</u>	<u>99</u>
Differential equivalent to tax effects of timing differences to be added to (or deducted from) deferred tax credit .....	<u>\$158</u>	<u>\$( 53)</u>
<b>Summary of changes in deferred tax credit balance</b>		
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 .....	<u>\$182 (b)</u>	<u>\$158 (b)</u>

**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.

	<i>Gross Change Method</i>	<i>Net Change Method</i>
	<i>(thousands of dollars)</i>	
<b>Computation of taxable income</b>		
Same as Exhibit I		
 <b>Computation of tax estimated to be currently payable</b>		
48% rate .....	\$ 96	\$ 96
Surtax exemption .....	( 6)	( 6)
10% surcharge .....	9	9
Allowable investment credit .....	( 50)	( 50)
	\$ 49	\$ 49
 <b>Computation of deferred tax on depreciation timing difference</b>		
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

	<u>Gross Change Method</u>	<u>Net Change Method</u>
	<i>(thousands of dollars)</i>	
<b>Computation of deferred tax on deferred gross margin timing differences</b>		
Taxable income .....	\$200	\$200
Originating or net change in gross margin timing differences ....	300	(100)
Adjusted taxable income—"without" timing differences .....	<u>\$500</u>	<u>\$100</u>
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 .....	<u>158</u>	<u>\$( 39)</u>
<b>Summary of changes in deferred tax credit balance</b>		
Additions to deferred credits arising from originating differences:		
Depreciation .....	\$264	
Deferred gross margin .....	158	
Arising from increase in cumulative depreciation differ- ences .....		\$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 de- ferred gross margin .....		( 39)
Net increase .....	<u>\$182</u>	<u>\$172 (c)</u>

**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.<sup>7</sup> 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-

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<sup>7</sup> 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).

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**

Year	Income (Loss) Before Income Taxes		Income Tax Expense (Credit)			Cumulative Net Deferred Tax Credits
	Account- ing	Taxable	Current	Deferred	Total	
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.

## 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 2010, *Reporting the Results of Operations*, greatly restrict prior period adjustments. One criterion essential to a prior period adjustment is that such adjustment not be “attributable to economic events occurring subsequent to the date of the financial statements for the prior period.” Since the realization of the tax benefit from the operating loss results from subsequent profitable operations, it is clear that it does not meet this test. Therefore, it is not appropriate to adjust the loss period retroactively.

.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.]

.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

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.

**EXHIBIT IV**  
**EXAMPLE OF LOSS CARRYFORWARD RECOGNIZED AS OFFSET TO NET DEFERRED TAX CREDITS**  
 (All amounts in thousands of dollars)

Year	Income before income taxes		Depreciation		Income tax expense (1)		Cumulative net deferred tax credits
	Accounting	Taxable	Accounting	Tax	Current (2)	Deferred (F)	
1	\$ 15,000	\$ 5,000	\$ 10,000	\$ 20,000	\$ 2,500	\$ 5,000	\$ 5,000
2	15,000	5,000	10,000	20,000	2,500	5,000	10,000
3	15,000	5,000	10,000	20,000	2,500	5,000	15,000
4	15,000	5,000	10,000	20,000	2,500	5,000	20,000
5	(54,000) (3)	(64,000) (3)	10,000	20,000	(7,500) (A)	(15,000) (B) (2,000) (C)	3,000
6	2,000	6,000	10,000	6,000	—	(2,000) 3,000	4,000
7	2,000	6,000	10,000	6,000	—	(2,000) 3,000	5,000
8	2,000	6,000	10,000	6,000	—	(2,000) 3,000	6,000
9	2,000	6,000	10,000	6,000	—	(2,000) 3,000	7,000
10	5,000	9,000	10,000	6,000	—	(2,000) 4,500	9,500
11	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	7,000
12	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	5,700
13	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	3,800
14	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	1,900
15	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	—
	<u>\$ 69,000</u>	<u>\$ 69,000</u>	<u>\$ 150,000</u>	<u>\$ 150,000</u>	<u>\$ 42,500</u>	<u>\$ —</u>	<u>\$ —</u>
							<u>\$ 42,500</u>

.094

**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

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
		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
		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.

**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

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)

<b>Assumed Facts</b>	
Pretax accounting income .....	\$500
Additional depreciation for tax purposes .....	500
Taxable income .....	<u>\$ -0-</u>
Available investment credits .....	<u>\$100</u>
Tax rate .....	52.8% (less surtax exemption)
<b>Deferred tax computation</b>	
Tax on taxable income .....	<u>\$ -0-</u>
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
	<u>\$157</u>
Differential equal to deferred tax credit .....	<u>\$157</u>
<b>Financial statement presentation</b>	
Income before income taxes .....	\$500
Income tax expense:	
Currently payable .....	\$ -0-
Deferred .....	157
	<u>157</u>
Net income .....	<u>\$343</u>

(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)**

<b>Assumptions:</b>	
Pretax accounting income .....	\$1,000
Excess depreciation (assuming no cumulative timing differences from prior years exist) .....	500
Taxable income .....	<u>\$ 500</u>
Available investment credits .....	<u>\$ 400</u>
<b>Deferred taxes:</b>	
Taxable income with timing difference .....	<u>\$ 500</u>
Tax thereon:	
52.8% less surtax exemption .....	\$ 257
Investment credits (\$25 plus 50% of tax in excess of \$25) .....	141
Tax payable .....	<u>\$ 116</u>
Taxable income without timing difference .....	<u>\$1,000</u>
Tax thereon:	
52.8% less surtax exemption .....	\$ 521
Investment credits (\$25 plus 50% of tax in excess of \$25) .....	\$ 273
Tax .....	<u>\$ 248</u>
Differential equal to deferred tax credits .....	<u>\$ 132</u>
<b>Investment credits:</b>	
Available .....	\$ 400
Realized .....	141
Carryforward .....	<u>\$ 259</u>
Investment credit benefit received in computation of deferred taxes:	
Deferred taxes without considering investment credits (\$521 less \$257) .....	<u>\$264</u>
Deferred taxes as computed above .....	<u>132</u> \$ 132
Investment credit carryforward to future years .....	<u>\$ 127</u>
<b>Summary:</b>	
Income before income taxes .....	\$1,000
Income tax expense:	
Currently payable (after giving effect to investment credits realized of \$141) .....	\$116
Deferred taxes .....	<u>132</u> 248
Net income .....	<u>\$ 752</u>

## 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
	<hr/>
Loss before extraordinary credit .....	\$ (100,000)
Extraordinary long-term capital gain of \$600,000, less applicable income tax of \$250,000 <sup>8</sup> .....	350,000
	<hr/>
Net income .....	<u>\$ 250,000</u>

.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

<sup>8</sup> 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.

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 . . . . .	<u>\$500,000</u>	<u>\$350,000</u>

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 warranted 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:

	<u>1968</u>	<u>1967</u>
Currently payable before giving effect to investment credits .....	\$550	\$350
Investment credits realized .....	(175)	(50)
Deferred—net .....	( 75)	50
	<u>\$300</u>	<u>\$350</u>

## 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

deferred tax charges from noncurrent 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 non-current 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.]

**.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?

**.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 Question**—Financing institutions enter into "leveraged" leases by which they rapidly recover their equity in leased property and the yield thereon on a cash-flow basis (subject to income tax payments in later years) although the lease may provide only a low rate of return on total investment over the life of the lease. In recognizing income from a "leveraged" lease, is it acceptable to discount deferred income taxes, i. e., compute taxes payable in the future on a present-value basis?

**.142 Interpretation**—Section 4091.34 specifies that the deferred method should be followed for interperiod tax allocation. This method does not permit the discounting of income taxes directly or indirectly.

[Issue Date: March, 1972]

**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: March, 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

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: March, 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<sup>1</sup> 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

<sup>1</sup> 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

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<sup>2</sup> 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

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<sup>2</sup> 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: March, 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 Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, section 560).

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<sup>2</sup> 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

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<sup>2</sup> See sections U4091.106-114, "Investment Credit Carrybacks and Carryforwards" and sections 4091.44-47 for rationale.

December 10, 1971 even though the credits may be carried 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: March, 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 Statement on Auditing Procedure, No. 47).

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: March, 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: March, 1972]

➤→ Section U 4095 begins on page 5779-9. ←➤

## 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.]

## 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 5783.* ←➤

## 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

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: November, 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: November, 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 5791. ←➤

## 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, Volume 2, page 6018). 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.<sup>1</sup>

**.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 5795.* ←➤

<sup>1</sup>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.

## 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.]

# CROSS-REFERENCE TABLES

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## APPENDIX A

### Finding List of Pronouncements

Accounting Research Bulletins 43 through 51 and Accounting Principles Board Opinions and Statements are cross-referenced to sections of the current text.

ARB	Chap.	Par.		Vol. 1 Sec.
43	1A	1	Unrealized Profit .....	4010
43	1A	2	Capital Surplus .....	5511
43	1A	3	Consolidated Financial Statements.....	2051
43	1A	4	Accounting for Treasury Stock.....	5541
43	1A	5	Receivables from Officers, Employees or Affiliated Companies .....	5111
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43	2B		(Superseded by APB Opinion 9)	
43	3A		Current Assets and Current Liabilities....	2031
43	3B		(Withdrawn by APB Opinion 10)	
43	4		Inventory Pricing .....	5121
43	5		(Superseded by APB Opinions 16, 17)	
43	6		Contingency Reserves .....	5513
43	7A		Quasi-Reorganization or Corporate Readjustment .....	5581
43	7B		Stock Dividends and Stock Split-Ups.....	5561
43	7C		(Superseded by ARB 48)	
43	8		(Superseded by APB Opinion 9)	
43	9A		Depreciation and High Costs.....	4071
43	9B		(Superseded by APB Opinion 6)	
43	9C		Emergency Facilities—Depreciation, Amor- tization and Income Taxes.....	4073
43	10A		Accounting for Real and Personal Prop- erty Taxes .....	4081
43	10B		(Superseded by APB Opinion 11)	
43	11A		Cost-Plus-Fixed-Fee Contracts .....	4041
43	11B		Renegotiation .....	4042
43	11C		Terminated War and Defense Contracts...	4043
43	12		Foreign Operations and Foreign Exchange	1081

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43	13A		(Superseded by APB Opinion 8)
43	13B		Compensation Involved in Stock Option and Stock Purchase Plans..... 4061
43	14		(Superseded by APB Opinion 5)
43	15		(Superseded by APB Opinion 26)
44			(Superseded by ARB 44 Revised)
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45			Long-Term Construction-Type Contracts 4031
46			Discontinuance of Dating Earned Surplus 5582
47			(Superseded by APB Opinion 8)
48			(Superseded by APB Opinion 16)
49			(Superseded by APB Opinion 9)
50			Contingencies ..... 5514
51			Consolidated Financial Statements ..... 2051
51		7, 8	(Superseded by APB Opinion 16)
51		16	(Superseded by APB Opinion 23)
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Opinion 2			Accounting for the "Investment Credit" (Except Addendum) ..... 4094
Addendum to Opinion 2			Accounting Principles for Regulated In- dustries ..... 6011
Opinion 3			(Superseded by APB Opinion 19)
Opinion 4			Accounting for the "Investment Credit".. 4094
Opinion 5			Reporting of Leases in Financial State- ments of Lessee..... 5351
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Opinion 9	Reporting the Results of Operations . . . 2010-2010A
Opinion 9, Par. 20, 21, 22	(Superseded by APB Opinion 30)
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Opinion 9, Exh. A-D	(Superseded by APB Opinion 30)
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Opinion 19	Reporting Changes in Financial Position	2021
Opinion 20	Accounting Changes	1051-1051B
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Opinion 22	Disclosure of Accounting Policies	2045
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# APPENDIX B

## Sources of Sections in Current Text

Sections in Volume 1 are cross-referenced to Accounting Research Bulletins and Accounting Principles Board Opinions and Statements.

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100	Preface
500	Introduction
510	General
520	Excerpts from the AICPA Code of Professional Ethics
1000	Financial Accounting—General
1010	Fundamentals of Financial Accounting . . . APB Stmt. 1
1020-	Basic Concepts and Accounting Principles
1029	Underlying Financial Statements of Business Enterprises . . . . . APB Stmt. 4
1040	Nonmonetary Transactions
1041	Accounting for Nonmonetary Transac- tions . . . . . APB 29
1050	Changes in Accounting Principles and Estimates
1051-	
1051B	Accounting Changes . . . . . APB 20
1070	Price-Level Changes
1071-	Financial Statements Restated for
1071D	General Price-Level Changes . . . . . APB Stmt. 3
1080	Foreign Operations
1081	Foreign Operations and Foreign Ex- change . . . . . ARB 43, Ch. 12; APB 6
1090	Business Combinations
1091	Accounting for Business Combina- tions . . . . . APB 16
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2012	Reporting the Results of Operations . . . . . APB 9; APB 13; APB 15
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2012	Reporting the Results of Operations . . . . . APB 30
2020	Statements of Funds
2021	Reporting Changes in Financial Posi- tion . . . . . APB 19

Sec.	Source
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2030	Working Capital
2031	Current Assets and Current Liabilities . . . . . ARB 43, Ch. 3A; APB 6
2032	Offsetting Securities Against Taxes Payable . . . . . APB 10
2040	Form of Statements
2041	Comparative Financial Statements . . . . . ARB 43, Ch. 2A
2042	Capital Changes . . . . . APB 12
2043	Disclosure of Depreciable Assets and Depreciation . . . . . APB 12
2044	Classification and Disclosure of Allowances . . . . . APB 12
2045	Disclosure of Accounting Policies . . . . . APB 22
2050	Consolidation of Financial Statements
2051	Consolidated Financial Statements . . . . . ARB 51; ARB 43, Ch. 1A, Par. 3
2060	Statements of Diversified Companies
2061	Disclosure of Supplemental Financial Information by Diversified Companies . . . . . APB Stmt. 2
2070	Interim Financial Statements
2071	Interim Financial Reporting . . . . . APB 28
4000	Revenue and Expense
4010	Unrealized Profit . . . . . ARB 43, Ch. 1A, Par. 1
4020	Installment Method of Accounting . . . . . APB 10
4030	Construction-Type Contracts
4031	Long-Term Construction-Type Contracts . . . . . ARB 45
4040	Government Contracts
4041	Cost-Plus-Fixed-Fee Contracts . . . . . ARB 43, Ch. 11A
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4043	Terminated War and Defense Contracts . . . . . ARB 43, Ch. 11C
4050	Financial Statements of Lessors
4051	Accounting for Leases in Financial Statements of Lessors . . . . . APB 7
4052	Accounting for Lease Transactions by Manufacturer or Dealer Lessors . . . . . APB 27
4060	Compensation
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4072	Depreciation on Appreciation.....ARB 43, Ch. 9B; APB 6
4073	Emergency Facilities—Depreciation and Amortization .....ARB 43, Ch. 9C
4074	Declining-Balance Depreciation.....ARB 44 (Rev.); APB 6
4080	Real and Personal Property Taxes
4081	Accounting for Real and Personal Property Taxes .....ARB 43, Ch. 10A
4090	Accounting for Income Taxes
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4094	Accounting for the Investment Credit..APB 2; APB 4
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5352	Disclosure of Lease Commitments by Lessees .....APB 31
5360	Premium and Discount on Debt
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5516	Convertible Debt and Debt Issued with Stock Purchase Warrants.....	APB 14
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## APPENDIX C

### Schedule of Changes in Accounting Pronouncements

The current text (section 100 and following) reflects the changes that have been made in Accounting Research Bulletins 43 through 51 and the Opinions and Statements of the Accounting Principles Board. The following schedule lists the changes made and the date of each change.

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	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	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	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	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
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

ARB	Chap.	Par.		Date of Change
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
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
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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
6		12c	Superseded by APB 16	10/31/70
6		15	Superseded by APB 17	10/31/70
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
9		3	Amended by APB 30	9/30/73
9		6	Amended by APB 13	12/31/68
9		8	Amended by APB 30	9/30/73
9		17	Amended by APB 30	9/30/73
9		18	Amended by APB 20	7/31/71
9		20	Amended by APB 20	7/31/71
9		20-22	Superseded by APB 30	9/30/73
9		25	Superseded by APB 20	7/31/71

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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
11	6	Amended by APB 28	12/31/73
11	38, 39, 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
17	31	Amended by APB 30	9/30/73
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
26	20	Amended by APB 30	9/30/73
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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
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4	145, 181	Amended by APB 21	10/1/71
4	10, 81, 191, 199	Amended by APB 22	12/31/71
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# APPENDIX D

## Finding List of Accounting Interpretations

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	.19 Changing EPS Denominator for Retroactive Ad- justment to Prior Period (No. 1).....	U1051.001
	.19 EPS for "Catch-up" Adjustment (No. 2).....	U1051.010
	.20 EPS for "Catch-up" Adjustment (No. 2).....	U1051.010
	.21 Changing EPS Denominator for Retroactive Ad- justment 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 Ad- justment to Prior Period (No. 1).....	U1051.001
	.28 Changing EPS Denominator for Retroactive Ad- justment to Prior Period (No. 1).....	U1051.001
	.29 Changing EPS Denominator for Retroactive Ad- justment to Prior Period (No. 1).....	U1051.001
	.34 Changing EPS Denominator for Retroactive Ad- justment to Prior Period (No. 1).....	U1051.001
	.36 Changing EPS Denominator for Retroactive Ad- justment to Prior Period (No. 1).....	U1051.001
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 Com- bination (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
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	.43 Acquisition of Minority Interest (No. 26).....	U1091.099
	.43 Entities under Common Control in a Business Com- bination (No. 27).....	U1091.103
	.43 Several Companies in a Single Business Combina- tion (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 Com- bination (No. 11).....	U1091.036
	.45 All Shares Must Be Exchanged to Pool (No. 25)....	U1091.090
	.46 Ratio of Exchange (No. 1).....	U1091.001

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	.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 Com- bination (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 Com- bination (No. 27) .....	U1091.103
	.46 Pooling by Subsidiary of Personal Holding Com- pany (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 Combina- tion (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
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	.47 Effect of Termination (No. 10) .....	U1091.034
	.47 Use of Restricted Stock To Effect a Business Com- bination (No. 11) .....	U1091.036
	.47 Warrants May Defeat Pooling (No. 12) .....	U1091.040
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	.47 All Shares Must Be Exchanged to Pool (No. 25) ...	U1091.090
	.47 Entities under Common Control in a Business Com- bination (No. 27) .....	U1091.103
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	.47 Representations in a Pooling (No. 30) .....	U1091.119
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	.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
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	.55 Paragraph .99 Is Not Mandatory (No. 15) .....	U1091.050
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	.58 Costs of Maintaining an "Acquisitions" Department (No. 33) .....	U1091.133
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	.94 Goodwill in a Step Acquisition (No. 2) .....	U5141.003
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	.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
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	.17 Investment Credit Is Prior Period Adjustment (No. 5) .....	U4094.021
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	.23 Changing EPS Denominator for Retroactive Adjustment to Prior Period (No. 1) .....	U1051.001
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