University of Mississippi

eGrove

Statements of Position

American Institute of Certified Public Accountants (AICPA) Historical Collection

1973

Accounting for companies in the development stage; Exposure draft (American Institute of Certified Public Accountants), 1973, May 1

American Institute of Certified Public Accountants. Committee on Companies in the Development Stage

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_sop

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

American Institute of Certified Public Accountants. Committee on Companies in the Development Stage, "Accounting for companies in the development stage; Exposure draft (American Institute of Certified Public Accountants), 1973, May 1" (1973). *Statements of Position*. 352.
https://egrove.olemiss.edu/aicpa_sop/352

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Statements of Position by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

EXPOSURE DRAFT
March 1973

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE

AUDIT GUIDE

Comments should be received by

MAY 1, 1973

Issued for comment from interested persons by the
AICPA Committee on Companies in
the Development Stage

Norman O. Olson, Chairman
Carl B. Burger
Ernest L. Hicks
Raymond C. Lauver
Edward J. McGowen

Comments should be addressed to:
John F. Mullarkey, Manager, Auditing Standards at
the Institute's offices, N.Y., N.Y. 10019

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE

TABLE OF CONTENTS

	Page
CHAPTER 1 - INTRODUCTION	1-6
Scope and Purpose of This Guide	1
Nature of the Problem	2-3
Identifying Companies in the Development Stage	3-6
CHAPTER 2 - BACKGROUND, HISTORY, AND CURRENT STATUS OF REPORTING BY COMPANIES IN THE DEVELOPMENT STAGE	7-13
Background Prior to 1948	7-8
1948--Article 5A	8-9
Use of Article 5A Statements	9-10
Unrecovered Research, Development, and Preoperating Costs	10-12
Auditors' Reporting Practices	12-13
CHAPTER 3 - PRESENTATION OF FINANCIAL INFORMATION	14-24
Purpose of Financial Statements	14
What Does the Company Own?	15
What Does the Company Owe?	16
How Was Capital Raised?	16-17
What Has the Company Done?	18-19
To What Is the Company Committed?	19
Financial Reporting Considerations	19-20
Financial Statements	20-22
Disclosures	22-24
CHAPTER 4 - ACCOUNTING FOR COSTS INCURRED	25-36
Introductory Comment	25
Cost Accumulation	25-26
Uncertainty and Recoverability	26-29
Abandoned Projects and Known Unrecoverable Costs	29-30
Other Theories	30-32
Shares Issued for Noncash Consideration	32-35
Categories of Accumulated Costs	36
CHAPTER 5 - AUDITORS' REPORTS	37-43
Introductory Comment	37-38
Illustrative Auditors' Report	38-43
CHAPTER 6 - TRANSITIONAL PROBLEMS AT CONCLUSION OF DEVELOPMENT STAGE	44-47
Introduction	44-45
Comparability and Consistency	45-47
Accounting for Income Tax Effects of a Loss Carryforward	47
Appendix	48-50
Notes to Financial Statements	51-53
An Alternative View by Norman O. Olson	54-55

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE[1]

CHAPTER 1 - INTRODUCTION

Scope and Purpose of This Guide

The dynamic nature of the economy with its burgeoning technology has created widespread interest in new and developing companies on the part of investors.[2] Managers and directors of companies in the development stage face some unique problems when they undertake to provide financial reports that are most useful to management and investors. Consequently, a somewhat specialized application of generally accepted accounting principles is needed.

A diversity of financial reporting practices exists for companies in the development stage and the type of auditors' report has varied widely for factual situations that appear to be comparable. This audit guide recommends practices which should result in the presentation of useful financial information by these companies with less variation in the form of the financial statements and in the accompanying auditors' reports.

The recommendations presented herein are applicable to any company, in any industry, which is in the development stage.

1/ Development stage, as used in this document, also includes the promotional stage and encompasses all aspects of the activities in which a business may be engaged in order to reach the operating stage, including organizational, start-up, capital raising, research, exploratory, administrative, and similar activity.

2/ The term "investor" is used in this audit guide in the broad sense and includes creditors as well as holders of equity interests.

Nature of the Problem 1

In making an investment decision, one generally con- 2
siders such factors as: quality of management; position of the 3
company in its industry; potential of the industry; nature of the 4
ownership interest; and the company's potential for innovation. 5
One also considers financial information such as earnings history, 6
funds flow, and financial position. However, a company in the 7
development stage does not have an earnings history nor does it 8
have a financial position comparable to that of an operating 9
company. Thus, the character of information available to inves- 10
tors and others for companies in the development stage necessarily 11
differs from that for more established companies. These circum- 12
stances create special reporting and auditing considerations which 13
are discussed in subsequent chapters of this guide. 14

A principal problem is accounting for costs incurred by 15
companies in the development stage, particularly costs of research 16
and development, exploration, and preoperating activity (the latter 17
category embraces such activities as start-up, promotional, personnel 18
recruiting and training, market planning, administrative, and financ- 19
ing). The guide deals with this problem and the related problem of 20
accounting for previously incurred costs after a company reaches the 21
operating stage. The guide does not deal with the question of how 22
a company which has emerged from the development stage should 23
account for costs which it incurs after it reaches the operating 24
stage nor with the question of how a long-established operating 25

company should account for exploration, promotion, and development costs.

Another problem often associated with companies in the development stage is the valuation of shares issued for property or services. The import of this problem depends on how much stock is thus issued, the extent to which shares are also issued for cash (which may provide a valuation guide for the non-cash issuances), the relationship of the parties involved to the corporation, and the availability of external indicators of fair value for the kinds of property and services exchanged for the company's stock.

These accounting problems introduce questions about the type of report that can be issued by the auditor.

Identifying Companies in the Development Stage

Whether a company is in the development stage and, consequently, whether the recommendations of this guide apply, should be determined by considering the purpose and activity of the company. A company in the development stage will be directing its efforts to establishing a business and laying a foundation for the generation of future earnings. To that end it will ordinarily be devoting a major part of its efforts to (or have under consideration) such start-up activity as research, development of a product or service, exploration for and development of natural

resources, financial planning, property acquisition, marketing 1
studies and personnel recruitment. Also, significant preoperating 2
costs will usually have been incurred (or can reasonably be expected) 3
relating to financing and to the day-to-day administrative function. 4
In particular, the description "company in the development stage" is 5
intended to be applicable to a company that has completed its 6
initial financing, but has not commenced its planned development 7
stage activity. Generally, a company in the development stage will 8
not have had significant revenues from its proposed endeavors. 9
However, the absence of revenues will not necessarily indicate a 10
development-stage company. 11

Other inappropriate criteria include lack of profitability, 12
uncertainty of cost recovery, difficulty of valuation of considera- 13
tion received for the sale of stock, or the inability of an auditor 14
to express an opinion on financial statements, if issued in con- 15
ventional form. These conditions often exist for companies in the 16
development stage, but they may also exist for companies in the 17
operating stage. 18

The duration of the development stage depends on a 19
variety of circumstances, including the nature of the company's 20
preoperating activities, the capability of its management and the 21
vagaries of fortune. For some companies, such as a franchised 22
sales business opening in facilities that are ready to operate, or 23

a company organized solely to hold investments, getting started may be so simple that a development stage, while it may in theory exist, will not as a practical matter be recognizable; such a company should not use development-stage accounting. For other companies, such as an industrial enterprise working to overcome complex technical problems in bringing its intended product to a marketable stage or a mining company attempting to locate mineral resources or preparing to exploit them, the development stage may extend for a number of years.

The end of the development stage will generally be indicated by the completion of identifiable development projects and the beginning of the intended business activities. For a company engaged in a number of such projects, completion of a major project and the generation of significant revenue from the fruits thereof will often indicate that the type of reporting appropriate for companies in the development stage should no longer be used, even though development activities continue. Another indication would be a representation by management and the board of directors that in their judgment the development stage had been concluded.[3]

3/ "...the answer to the question of when a company has begun operations is best left to management, subject to review by its independent auditors. Examples of some of the factors to be considered in answering this question are: the amount and trend of sales, sales backlog, the relationship of sales prices to related direct costs, the overall state of development of the company's production, marketing and administrative capabilities, and budgets and projections of future operating results." Wharton, Don, "Accounting and Reporting for Companies in the Development Stage," The Journal of Accountancy, July 1970.

The guide does not apply to established companies developing new products, services or markets, or to the development activities of their subsidiaries, even though the subsidiaries are in the development stage, when included in consolidated financial statements. It does, however, apply to separate financial statements of a subsidiary in the development stage and is applicable to consolidated financial information when the group as a whole is considered to be in the development stage.

The guide also does not ordinarily apply to companies which have previously issued conventional financial statements since these companies are presumed to have passed from the development to the operating stage. A dormant company which is activated or reactivated to undertake new ventures, or a company which discontinues its former business for a new line of business, may be an exception. Also, in rare cases, a company may have commenced operations, issued conventional financial statments and then returned to the development stage. Under these circumstances, previously issued conventional financial statements have little relevance and the reporting recommended in the guide should apply. However, reverting to development stage reporting is appropriate only if the company has clearly ceased being an operating company and if the change in circumstances is so substantial that conventional historical financial statements would be virtually useless.

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE

CHAPTER 2 - BACKGROUND, HISTORY, AND CURRENT STATUS OF REPORTING BY COMPANIES IN THE DEVELOPMENT STAGE

Background Prior to 1948

Only in rare instances does accounting literature give more than brief consideration to accounting for companies in the development stage, and even then the discussions provide no clear consensus about the most useful accounting and reporting methods.

The organization which has had the most influence on reporting practices for companies in the development stage is the Securities and Exchange Commission. Almost from the day it was organized, the Commission was troubled by what it considered questionable presentations by promotional and exploratory mining companies. In 1936 it adopted Form A-0-1 (under the Securities Act of 1933), which required special financial statements for certain corporations engaged in the exploitation of mineral deposits other than oil or gas. Form A-0-1 was superseded in 1941 by Forms S-2 and S-3. These forms provided for separate statements of: (1) assets and capitalized expenses, (2) liabilities, (3) capital shares, (4) other securities, and (5) cash receipts and disbursements. The 1936 pronouncement contained no reference to other types of development stage companies, but subsequent revisions extended coverage to almost all commercial, industrial, or mining companies meeting the Commission's definition of companies in the promotional, exploratory, or development stage. However, none of these provisions applied to financial statements included in

applications for registration or in annual reports (such as Forms 10, 10-K, or 1-MD) required to be filed under the Securities Exchange Act of 1934.

1948--Article 5A

In October 1948 the Commission made its second major pronouncement concerning development-stage companies by adding Article 5A to Regulation S-X, which governs the form and content of financial statements filed with the Commission. Article 5A extended the use of the segmented financial statements previously required only in Forms S-2 and S-3. It made these requirements applicable to financial statements of companies in the promotional, exploratory, or development stage when such statements are included in registration statements and annual reports required to be filed under the Securities Exchange Act of 1934 as well as when included in Forms S-2 and S-3 under the Securities Act of 1933.

The chairman of a subcommittee on mine accounting in a November 1948 report to the Committee on Accounting Procedure of the American Institute of Certified Public Accountants (AICPA) commented on this action as follows:

> "It has long been recognized by the Securities and Exchange Commission and the mining industry that the usual forms of financial statements were not satisfactory for enterprises in the development stage particularly those engaged in the mining of non-ferrous metals ... Many mining companies and some companies engaged in the exploitation of patents or similar enterprises may remain in the development stage for a long time. They may enter the production stage for a period and revert to the development stage or to a condition very similar to it. Until the issuance of this new rule companies of this type were required to present financial statements in the conventional form of balance sheets, income and surplus accounts. As use of such forms assumes the existence of a going concern, it is only natural that their use for an enterprise which has not yet started operations will raise many questions and will create serious problems."

Article 5A and Forms S-2 and S-3 define a company in the development stage indirectly, in specifying applicability. In general, they identify development-stage companies by reference to the nature and significance of revenues from the sale of products or services.

In the Article 5A statements, property, plant, equipment, and services acquired for securities, and capital shares issued in exchange for property and services, often are not extended in dollar amounts but rather in numbers of shares. The problem of valuation of these noncash transactions is thus deferred, to be faced later when the company prepares conventional statements and accordingly must assign dollar values to the transactions. There are no special guidelines as to when the dollar amounts should be recorded and how they should be classified. Furthermore, Article 5A statements may include material amounts of unrecovered promotional, exploratory, and development costs and may include other accumulated expenditures as well. The question of whether, and when, these costs should be amortized or written off is not dealt with in Article 5A.

Use of Article 5A Statements

A review of recent filings indicates that the Securities and Exchange Commission's current practice encourages submission of conventional balance sheets for registration statements of development stage companies if it is possible to assign dollar amounts to all significant noncash transactions. Otherwise, Article 5A statements are required.

1 In annual reports, both in published reports to stock-
2 holders and in reports filed with the Commission on Form 10-K,
3 use of Article 5A statements appears to be rare. Thus, state-
4 ments completely in accord with Article 5A apparently are used
5 primarily in registration statements filed on Forms S-2 and S-3
6 by companies that have had significant noncash transactions to
7 which dollar amounts have not been assigned. However, the
8 precise status of Article 5A statements is unclear. It seems fair
9 to conclude, at least, that the proliferation of companies in the
10 development stage, and their visibility in the capital markets
11 were not envisioned when the Article 5A statements were designed.

12 Unrecovered Research, Development,
13 and Preoperating Costs

14 Development stage companies record at cost, for both
15 conventional and Article 5A statements, the property and services
16 acquired in connection with research, development, and preoperating
17 activity when paid for with cash or other clearly measurable
18 consideration. When such items are acquired for capital shares,
19 it may be difficult to determine dollar amounts for the transactions.
20 The Article 5A statement form acknowledges this difficulty by
21 requiring both the items required and the capital stock issued to be
22 stated in numbers of shares only. However, a balance sheet may not
23 be prepared on this basis; dollar amounts must be assigned to all
24 transactions before a balance sheet can be prepared.

A review of conventional balance sheets submitted by development stage companies indicated a lack of uniformity as to what costs were carried forward. In some of these statements, all types of accumulated expenditures were carried forward. (However, the Commission staff has informally required charge-off of expenditures known to be unrecoverable; such expenditures would presumably include costs attributable to abandoned projects. Article 5A requires disclosure of the amount of the costs written off.) Some companies have charged off part or all of certain types of costs, such as those associated with general and administrative activity, so that only a portion of the accumulated expenditures were in the unrecovered category. Still other companies not filing a registration statement with the SEC have charged off all costs other than those identified with specific tangible and intangible assets.

When a company passes from the development stage to the operating stage, it faces the question of what to do with the costs incurred while it was still in the development stage and not charged off. While the current practices are anything but uniform, the most prevalent policy noted is to amortize such costs over a short period of time, usually not more than five years. However, other bases noted were: (1) lump sum write-off at the end of the development period, and (2) amortization over the first year of operations.

To summarize, concerning the broad question of accounting for costs incurred during the development stage, particularly those relating to research and development and preoperating activity, there is considerable variety of practice both during and after the development stage.

Auditors' Reporting Practices

Nowhere has the diversity in accounting for and reporting on companies in the development stage been more apparent than in the wide variety of auditors' reports on statements filed with the Commission as part of registration statements on Forms S-2 and S-3. The auditors' reports have referred to a wide range of bases of fair presentation for Article 5A statements. Some of the bases were: (1) generally accepted accounting principles, (2) generally accepted accounting principles for companies in the development stage, (3) requirements of the Securities and Exchange Commission, (4) the information stated therein, and (5) no stated basis (the most prevalent basis noted).

An American Institute subcommittee on mine accounting worked closely with the staff of the Securities and Exchange Commission at the time Accounting Series Release No. 66 was issued in 1948. This subcommittee recommended the following form of auditors' report:

> "We have examined the statements of assets and unrecovered promotional, exploratory and development costs, of liabilities and of capital share of ...... Company as of December 31, ... and the statements of cash receipts and disbursements for the fiscal year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

"In the accompanying statements of assets and unrecovered promotional, exploratory and development costs and of capital shares, the property acquired for capital shares and capital shares issued for services and property have been stated in numbers of capital shares rather than in dollars. This, in our opinion, represents an acceptable method of presenting the accounts of this company.

"In our opinion, the accompanying statements of assets and unrecovered promotional, exploratory and development costs, of liabilities, of capital shares and of cash receipts and disbursements present fairly the assets and unrecovered costs, liabilities and capital of the company at December 31, ... and its cash transactions for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

There have been numerous departures from this recommended opinion.

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE 1 2

CHAPTER 3 - PRESENTATION OF FINANCIAL INFORMATION 3

Purpose of Financial Statements 4

The financial statements of a company in the develop- 5
ment stage fulfill a somewhat different role than do the financial 6
statements of a company in the operating stage because: 7

a company in the development stage does not have the customary 8
operating activities and hence the usual revenue and expense 9
data to report, 10

its ultimate success depends upon concepts, rights, or 11
properties which are as yet unproven, 12

its capital needs are likely to be a more critical factor 13
than those of a company in the operating stage, 14

its ability to raise additional capital, if needed, is 15
subject to more than the usual uncertainty. 16

Factors such as these cause investments in such companies to be 17
classified as speculative, and such classification is widely known 18
and acknowledged. 19

It seems reasonable to believe that statement users are 20
interested in the following questions about a company in the 21
development stage and expect its financial statements to be of 22
some relevance thereto: 23

1. What does the company own? 24

2. What does the company owe? 25

3. How was capital raised? 26

4. What has the company done? 27

5. To what is the company committed? 28

These questions are discussed in the paragraphs which follow. 29

What Does the Company Own?

With respect to this question, the statement user's interest regarding a company in the development stage differs in some respects from that held in relation to an operating company. There is no difference in his interest about the earnings potential of the assets, but in the case of a company in the development stage, he looks to the assets to decide whether they are sufficient to complete the development program of the company. In this regard he is interested in those assets of a relatively liquid nature -- the cash, receivables, and investments -- and in any other assets that are unessential to the development activities and thus available as a source of cash. They represent the existing financial resources that are available to continue the development program.

Research, development and preoperating costs, intangibles and even essential plant and equipment may have little intrinsic value to an entity in the development stage, but the fruits of the activities that the costs represent may be highly valuable. They also interest the statement user because they indicate how much has been invested in the development process. In conventional parlance, items in both categories are assets. However, the attributes of the items are so different that it is essential to distinguish the categories carefully and to present them in such a way that a reader will not be misled as to their nature.

What Does the Company Owe?

An investor in any enterprise wants to know the degree to which it is obligated to those whose interests are prior to his or whose claims represent a threat to its continued existence. Accordingly, the financial statements for companies in the development stage should show the conventional information -- amount, interest rate, the due date, restrictions and collateral -- about all existing obligations.

Because the activities of a company in the development stage do not conform to the "operating cycle" concept customarily applied in the determination of working capital, current asset and current liability designations are generally not appropriate. Nevertheless, information about liabilities, cash, and near-cash assets should be presented in such a manner as to assist the reader in assessing the company's liquidity and ability to meet its obligations currently.

How Was Capital Raised?

This question, concerning the ownership of the enterprise, is also relevant for all businesses. A prospective investor wants to know how much has thus far been invested by organizers and other investors and how many ownership units they hold. Corollary questions are: "In what form was the capital contributed?" and "How many ownership units are contingently issuable and under what terms?" The former question may be

particularly pertinent for a company in the development stage. Some of the initial capital may have been invested in the form of services, of intangible assets or of tangible assets other than cash. The prospective investor should be interested in the nature of the consideration received and how the transaction, if not for cash, was valued.

The difficulty of ascribing value to noncash consideration for shares issued, such as highly speculative securities, unexplored mining properties, patents, licenses, and services, is widely appreciated. Nevertheless, a statement user, particularly a prospective investor, is interested in the dollar values attributed to such items. Overstatement, understatement, or complete omission of such values may give an erroneous impression of the position of the company. Further, these values may represent future charges to revenue which will be influential in determining the future operating earnings of the company if it is successful in its development. Attempting to cope with such transactions without expressing them in dollars is an inadequate solution. At best, the practice defers solution of the problem; further, if later information is used, the solution may be erroneous, since subsequent events are not relevant to the value at an earlier date. In most cases, the law requires directors to value the consideration received for securities issued, and thus the information necessary for the accounting ought to be available.

<u>What Has the Company Done?</u> 1

This query, if directed to an operating company, would 2
evidence interest in the results of operations or earnings by 3
period, including the trend of earnings. But by definition a 4
company in the development stage has no operating performance 5
record to present. It is engaged in the activities necessary to 6
establish a business. Therefore, performance by periods and 7
interperiod comparisons, of crucial concern to investors in 8
established companies, lack relevance during the development 9
stage. Instead, as discussed elsewhere, the focus of the in- 10
quiry is on the nature and cumulative cost of the development 11
activities to date and the results of these activities. Informa- 12
tion about costs can be presented in financial statements; the 13
emphasis should be on accountability for financial resources 14
received and expended rather than on periodic operating perform- 15
ance. However, information about the nature and results of 16
development activities cannot be communicated adequately by 17
financial statements; the investor must look to other manage- 18
ment communication devices for such information. 19

Another aspect of the question "What has the company 20
done?" relates to costs written off. A company in the develop- 21
ment stage is likely to make some false starts and go down some 22
blind alleys in the process of searching for a profitable product, 23
process, or service. Such setbacks are a part of development- 24
stage activity. They do not necessarily signal that a loss has 25

been incurred; conversely being in the development stage does 1
not justify postponing recognition of a known loss. Thus, 2
information about costs should include particulars concerning 3
costs that have been written off. 4

To What Is the Company Committed? 5

This question, with the same intent, is often asked 6
about companies in the operating stage. The statement user 7
wants to know the extent to which the future course of the enter- 8
prise and its resources have already been committed by contract 9
or other arrangement. 10

Financial Reporting Considerations 11

Much of what has been written here about the features 12
of companies in the development stage and the risks and uncertain- 13
ties they face also applies to operating companies, but usually 14
to a lesser degree. The fact remains that a company in the 15
development stage is different from an operating company. It 16
lacks an earnings history, a major factor in both managerial and 17
investment decisions relating to an operating business. It does 18
not have a financial position, as that term is commonly used for 19
companies in the operating stage. Many of its cost outlays are 20
speculative and result in rights or other things which may have 21
slight, if any, alternative useful value. For these reasons an 22

investor should consider the financial information differently than he would if the company were in the operating stage. To avoid misunderstandings, the financial statements of companies in the development stage should differ significantly in form from conventional financial statements of operating companies. Titles of the statements should identify the entity "as a company in the development stage."

Despite the distinctive format recommended, generally accepted accounting principles apply to companies in the development stage as they do to all business enterprises. However, the application of such principles differs in certain respects, particularly as related to the accumulation of costs as discussed further in Chapter 4.

Financial Statements

Illustrative statements for a hypothetical company, Acme Motorcycle Co., are shown in an Appendix. They place emphas on accountability for financial resources received and expended. Unlike conventional financial statements, they direct attention t accumulated costs rather than to measurement of performance. The statements include the following:

Preoperating Accountability Statement -- To show the assets and cumulative cost outlays, the liabilities and the proceeds of stockholders' investment

Suggested statement classifications are indicated in the illustrative statement. A basic objective of the classification is to show meaningful subtotals. For

instance, assets held in a form to provide short-term 1
debt-paying ability, such as cash or marketable securities, 2
should be shown under a common account classification. 3
Assets having some degree of alternative usefulness, which 4
might be sold to raise funds, should be separated from cost 5
outlays not having such alternative usefulness. Classifica- 6
tions within the Preoperating Accountability State- 7
ment that give recognition to the purpose for which 8
amounts are intended to be used will also be useful, e.g., 9
"held for development" or "held for future operations." 10
The Committee believes that the working capital concept 11
is not appropriate for companies in the development stage. 12

To call the reader's attention to the special nature of a 13
company in the development stage, some name other than 14
"balance sheet" should be given to the statement which 15
reports its assets, cumulative cost outlays, and liabil- 16
ities -- even though the column totals balance. Although 17
comparative data in this form are not useful generally, 18
there is no objection to presenting them. 19

Statement of Preoperating Financial Activities -- To show the 20
sources and uses of financial resources. Preferably, the 21
statement should present cumulative data since the company's 22
inception, along with data for the current period, as is 23
done in the illustrative statement for Acme Motorcycle Co. 24

A concept reflecting the changes in all financial resources 25
should ordinarily be used instead of the narrower concepts 26
of working capital (as noted, a company in the development 27
stage does not have an established operating cycle) or cash 28
receipts and disbursements. However, in some circumstances 29

a statement of cash receipts and disbursements (or an accrual-basis statement reconciled to cash receipts and disbursements) may provide an adequate reporting of the financial activities.

Statement of Investment by Stockholders -- To show the classes and numbers of shares authorized, issued, and outstanding and the types and amounts of consideration received for the shares issued. A valuation should be placed on all stock issuances for noncash consideration. The valuation bases used should be disclosed, where relevant, as illustrated in the notes accompanying the statements for Acme Motorcycle Co.

The statement is designed to show cumulative data since the company's inception, with considerable use of transaction detail to support the totals. Showing the data in comparative form is probably not useful, but the data can be presented by period and cumulatively if desired.

Revenue earned by a company during the development stage, which ordinarily will not be significant, should be deducted from the accumulated costs shown in the preoperating accountability statement. The financial statements should indicate the nature and amount of such deductions.

Disclosures

The financial statements with their accompanying notes should disclose that the company is in the development stage and has not demonstrated a capacity for successful operations. This disclosure should call attention to the uncertainties that surround such a company.

These uncertainties must be communicated without making use of an auditors' report; otherwise the statements are not fairly presented in conformity with generally accepted accounting principles. If the financial statements with their accompanying notes do not communicate the inherent uncertainties and limitations which are present, they are not made fair simply by association with an auditors' report.

Other disclosures similar to those of operating companies are appropriate. For example, information about the accounting policies in relation to research, development, and preoperating costs, about depreciation (whether or not recorded), and about the company's income tax status will need to be disclosed. The bases for carrying major items in the financial statements, including those items resulting from stock issuances for noncash consideration, and the company's intended accounting for the accumulated costs should be disclosed. Commitments affecting future cash requirements should be considered for disclosure in order to permit a comparison of resources with prospective outlays. In general, judgment about disclosure should be exercised in the same fashion as in the case of conventional financial statements, with the objective of meeting the established disclosure standards.

The financial circumstances of a company in the development stage can change dramatically in a relatively short period of time due, for example, to obtaining significant additional capital or expending a significant portion of the liquid assets in the research and development effort. When major changes take place after the end of the accounting period but before the issuance of the financial statements, disclosure may be necessary in order to keep the financial statements from being misleading.

Examples of disclosures accompany the illustrative statement 1
shown in the Appendix. 2

CHAPTER 4 - ACCOUNTING FOR COSTS INCURRED

Introductory Comment

The application of generally accepted accounting principles to companies in the development stage yields a different kind of financial information than in the case of companies in the operating stage. This condition is attributable primarily to the fact that the activities of a company in the development stage are devoted to establishing a business and do not include the kind of operations to which periodic income determinations apply. Closely related to this condition is the extensive uncertainty which usually surrounds the activities of a company in the development stage since it has not yet demonstrated a capacity for successful operating performance.

The emphasis on accountability that is warranted in the case of a company in the development stage gives added importance to the presentation of accumulated costs. By focusing on cost accumulation, the financial statements will portray the financial history resulting from development stage activities.

Cost Accumulation

A company in the development stage is engaged in building an enterprise, and the expenditures it makes are in the nature of investments for the future. Costs incurred during the development stage are accumulated because they have been incurred in the expectation that they will generate future revenues or otherwise benefit periods after the company reaches the operating stage. Accumulating costs is consistent with the business fact that for many companies

a development stage must precede the attainment of ordinary business 1
operations. 2

An analogy from accounting theory as applied to companies 3
in the operating stage is useful. When an operating company constructs 4
a plant or office building, the applicable costs are accumulated 5
during the construction period. In the case of a company in the 6
development stage, it is the enterprise that is being constructed and 7
the development stage is the construction period. 8

A company's development stage is essentially prologue, and 9
financial statements during the development period are preliminary 10
and more than ordinarily tentative. Under such conditions the 11
accumulation of costs (net of incidental revenues) conforms with 12
generally accepted accounting principles and results in information 13
that is useful to management and investors. 14

Although general and administrative expense is ordinarily 15
accounted for as a period cost by companies in the operating stage, 16
the reasoning which leads to the period cost classification does not 17
apply to a company in the development stage. The same result is 18
true of interest. Pending emergence from the development stage, 19
there is little conceptual justification for treating outlays for ad- 20
ministration or financing differently from other preoperating outlays. 21

[The only outlays that should not be carried as accumulated 22
costs during the preoperating period are those relating to known 23
losses] as discussed in a later paragraph. 24

Uncertainty and Recoverability 25

When an operating company's costs are accumulated and 26
carried forward they are subject to a recoverability test. Should 27

such a test be applied in the case of companies in the development stage?

A primary characteristic of a company in the development stage is uncertainty. There is uncertainty about the successful completion of the development of the company's intended products or services, the competition it will face, the abilities of its management, the effectiveness of its policies, its ability to raise the capital needed to continue in development and ultimately to begin operations and its ability to perform all of these in a way that will result in a financially successful enterprise.

The degree of uncertainty is ordinarily highest at the outset of the development period, but a great deal may persist throughout the period. Consequently, management will usually be unable, during much of the development stage, to make informed predictions about the enterprise with a satisfactory degree of certainty as to their accuracy; information on which to base useful predictions does not ordinarily become available until at or near the end of the development period.

In this context, being able to predict must be distinguished from having confidence. Most managements are optimistic and confident about the wisdom of their plans and decisions and the likelihood that their companies will succeed. Optimism and confidence, however, do not translate into reasonable certainty about the outcome of a complex development program in a competitive economic environment.

The question, for purposes of this discussion, is whether costs expended will ultimately be recovered through revenues. This determination involves estimates of both future revenues and future

costs. Revenues cannot be estimated with any degree of confidence until the estimator can foresee the market in which the intended product can be sold and the products with which it will compete. Estimates of manufacturing and selling costs are also dependent upon the market for the product. In a typical situation, a marketing organization competent to make reasonably dependable estimates about these matters may not come into being until a conclusion as to the technological success of the product or process being developed has been reached. Such a sequence of events exists to some degree in most enterprises in the development stage -- that is, the ability to make informed predictions is limited to the paucity of information available.

The inability to make informed predictions during the development stage is a natural result of the high degree of uncertainty that is a primary characteristic of a development-stage company and does not reflect discredit on the management of the company. This inability points the way to the resolution of the question of recoverability. For a company in the development stage there is from inception a presumption that uncertainty as to cost recovery will both exist and persist. (By contrast, the presumption for an operating company is that cost recoverability can be reasonably evaluated.) It would be unrealistic and arbitrary to write off immediately the costs incurred during the developement stage simply because of this predictable uncertainty. Further, the early write-offs would unrealistically improve the reported results of operations for periods after the development stage by failing to charge against the revenues of those periods the costs of the activities that made

the revenues possible. Consequently, except as discussed in the following section, a company in the development stage should present its accumulated costs without regard for their recoverability.

Abandoned Projects and Known Unrecoverable Costs

As noted earlier, a company in the development stage is likely to make false starts and go down some blind alleys. Some activities that seem unsuccessful in themselves are necessary steps in the research process and hence the costs are normal development costs. In some cases the work connected with an abandoned project may have opened up prospects along related lines, and the costs of the initial project, though it was abandoned as originally conceived, are properly carried forward.

In some instances, however, it becomes clear that certain costs will not be recovered. Such costs should be written off by reducing stockholders' investment. In one such instance a proposed development objective may prove to be feasible, and it will be abandoned; the remaining resources may then be devoted to a completely unrelated program of development or exploration. For example, a group, finding that it is not feasible to continue the development and marketing of a new type of machine tool, might abandon the project and devote the remaining resources to the development of a pharmaceutical product. Uncertainty about the future in relation to the costs involved in the machine tool project no longer exists; a loss has occurred. Although the company remains in the development stage, that status does not justify postponing recognition of the loss; the costs of the project should be written off.

At the end of the development stage, or as the end nears, 1
it may become apparent that the company will not achieve a degree of 2
success that will result in recovery of all the costs incurred during 3
the development stage. As to part of the costs, uncertainty as to 4
whether they will be recovered will have been replaced by reasonable 5
assurance that they will not be recovered. In that event, the portion 6
which demonstrably will not be recovered represents a loss that should 7
be written off. It is expected that write-offs of this type at any 8
time would be uncommon, and only in the rarest instances would 9
information providing this degree of certainty as to nonrecovery of 10
costs become available much before the end of the development stage. 11
Usually, the ability to reach a conclusion of nonrecovery would 12
signal the completion of the development stage. 13

Thus, applying the recoverability test to a development- 14
stage company leads to the write-off of accumulated costs only if 15
unrecoverability is a certainty. Briefly stated, a known loss 16
should be recognized. This contrasts with the application of the test 17
to operating companies, where merely a high degree of uncertainty 18
about recoverability can require such a write-off. 19

Other Theories 20

A number of other theories, relating primarily to costs 21
of an intangible nature, were considered in reaching the conclusions 22
on accounting for costs stated earlier in this chapter. The princi- 23
pal ones are discussed below. They are not mutually exclusive, 24
and still others could be created by combining elements of them. 25
In the following paragraphs, arguments for and against the princi- 26
pal other theories are mentioned. In addition, of course, the 27

reasoning underlying the conclusions stated earlier in this chapter, to the extent applicable, is pertinent to a discussion of theories not adopted.

Under one theory, a company would write off as incurred all costs for which there is no assurance of recovery from future revenues. Its supporters argue that this theory is equally applicable to operating companies and to companies in the development stage. They believe it is appropriate that companies in the development stage experience and report losses. They also believe that costs should be deferred only if they can be regarded as having an alternative value, as some assets of a tangible nature have. The proponents suggest that readers may misunderstand the significance of the accumulated amount, perhaps to the point of assuming that there is a corresponding resale value. Considering the disclosure recommended in this guide, however, this does not seem to be a serious possibility. More broadly, this theory would predictably result in losses prior to the operating stage and is not in accord with the rationale which causes enterpreneurs to undertake the risks of a new venture. Reported profits and losses represent the business world's way of assessing the success or failure of an enterprise; it is not realistic to report losses, indicating a lack of success, before it is possible to demonstrate success by engaging in transactions producing revenues.

Another approach would be to write off all costs during the development stage and reinstate some or all of them when the company reaches the operating stage. Such reinstatement could be based on assured recoverability, using the latest available informa-

tion, which would preclude inferences during the development stage that deferred costs have intrinsic value (see preceding paragraph); reinstatement could also be based on the accounting practice which the company will use during the operating stage, thereby emphasizing consistency of method. But, this theory has the same disadvantage of reporting losses before success can be judged. Further, it leaves the accounting for what is essentially an investment to be determined long after the investment cost has been incurred, and then on the basis of reasons unrelated to those which caused its incurrence.

Still another approach would permit companies in the development stage to choose from the same accounting practices which are available to companies in the operating stage. Accordingly, a company could accumulate or write off some or all costs incurred during the development stage depending upon management's wishes and the accounting alternatives available. Proponents argue that this would preclude a duplication of income charges during the operating stage resulting from expensing certain types of costs and at the same time amortizing similar costs incurred during the development stage. An objection is that this procedure ignores the fundamental differences between operating and development stage companies. In addition, it would permit write-off of development costs even when revenues were reasonably assured, with the result that earnings of the operating period would be overstated.

Shares Issued for Noncash Consideration

A cost measurement problem arises when shares of a company's capital stock are issued for property or services. The

problem results from a need to quantify the transaction and the absence of readily available information as to the appropriate amount. The significance of the problem depends on a number of factors, such as the relative magnitude of the exchanges, whether other shares are issued at the same time for cash (providing a valuation guide for the noncash issuances), the relationship of the recipients of the shares to the corporation and to each other, and the availability of indicators of fair value for the kinds of property and services exchanged for shares of stock. If there are not sufficient concurrent share issuances for cash to establish the fair value of the shares, the transaction is ordinarily recorded at the fair value (the cash equivalent) of the property or services received in the exchange. Measuring the transaction is a responsibility of the board of directors and requires the exercise of considerable judgment on their part.

The difficulty of ascribing value to highly speculative securities and to mining properties, patents, licenses and services is evident. This complex problem has frequently been avoided by issuing financial statements which report only the number of shares exchanged without attributing a dollar amount to them. Such reporting fails to recognize the importance of quantifying all transactions and the fact that estimates and judgments play an important role in many areas of accounting. Attempting to cope with exchanges of shares for assets or services without expressing them in dollars is, at best, a temporary solution. Ultimately, when the company becomes an operating company, amounts must be assigned retroactively to the transactions. However, no better information for making

the determination will be available then than was available when 1
the shares were issued. Events that may have taken place in the 2
meantime, such as later issuances of shares for cash, will be 3
irrelevant. 4

A number of valuation approaches may be available, such 5
as replacement cost, recent cash cost to a party other than the 6
person receiving the company's shares, recent transaction prices of 7
similar property or services, and outstanding bona fide offers. In 8
some cases it may be necessary for the directors to rely largely 9
on their best collective business judgment based on the considera- 10
tions weighed in reaching a decision to enter into the transaction. 11
When shares are issued to promoters, officers, directors, and 12
large stockholders for noncash consideration, the circumstances 13
surrounding the issuance should be fully disclosed. When assets 14
are involved, the disclosure should include such information as 15
the basis of valuation, the cost to the stockholder, and the length 16
of time the asset was owned by the stockholder. 17

"Predecessor cost" may be an appropriate indicator of 18
current value, depending on such circumstances as the length of time 19
since that cost was established and whether the cost arose in a 20
bargained exchange. Old costs resulting from bargained exchanges 21
are not automatically better than recent estimates of fair value. 22
When there has been a transaction not at arm's-length, such as when 23
a development-stage company acquires property rights from a sole 24
stockholder, use of predecessor cost will usually be preferable 25
because of the nature of the transaction (rather than because it is 26
an indicator of current value). 27

The significance of the use of fair value determinations in the establishment of initial cost measurement will, as previously noted, vary from case to case. Every effort should be exerted by management and directors to arrive at a fair valuation on a timely basis in order to discharge the fiduciary and legal responsibilities involved in issuing securities and to make the company's financial statements as meaningful as possible. In this connection, compliance with charters and State laws is no assurance that the resulting valuations are realistic or that they will be acceptable to the auditor who must be satisfied with the initial valuations or qualify his opinion.

(Auditors should be aware of the possibility that such transactions may be misstated as a result of tax or other legal motivations. Consequently, the considerations leading to the determination of amounts used should be carefully documented. In all cases, the standard for judging the value to be used should be the amount for which it is estimated the goods or services exchanged could have been acquired for cash.)

(It should be noted that if an auditor has reservations about initial cost measurements, mere passage of time will not remove the reservations. Thus, a qualification in an auditor's opinion relating to the value of consideration received for shares issued should be viewed by a company as an especially serious matter since such a qualification is apt to persist indefinitely or until the matter becomes immaterial due to the growth of the company.)

Categories of Accumulated Costs 1

In accumulating costs, outlays for exploration or product- 2
oriented research and development should be separated from those 3
for other preoperating activities, such as marketing studies, per- 4
sonnel recruitment, administration and interest. These two general 5
categories of outlays differ as to purpose and character, and the 6
dollar totals of the separate categories are useful information. 7

Some preoperating costs are assignable to other statement 8
categories. For example, interest may be part of the cost of a 9
plant. The amounts to be carried as preoperating costs are those 10
remaining after appropriate allocations have been made to other 11
classifications. 12

Whether depreciation should be recorded depends on the 13
use to which an asset is put. If recorded, depreciation is ac- 14
cumulated along with other costs. Depreciation should be recorded, 15
for example, with respect to assets put to their intended long- 16
range use during the development stage; examples are research 17
laboratory equipment, equipment used in natural resource exploration, 18
and automobiles. On the other hand, a company in the development 19
stage may acquire plant and equipment for use during the operating 20
stage. Until the depreciable property is used in its intended way, 21
there is no reason to record depreciation unless holding the asset 22
reduces its potential usefulness. Except in the latter case, little 23
would be gained by reducing the carrying value of property and 24
correspondingly increasing the accumulated cost category. However, if 25
this matter is resolved in a given case, disclosure should be made. 26

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE

CHAPTER 5 - AUDITORS' REPORTS

Introductory Comment

Although it is widely understood that financial statements are independent of auditors' reports on them, the inherent limitations of the financial statements of companies in the development stage and the extensive uncertainty that surrounds them make it important that the auditor use his report to further reduce the possibility for misunderstanding. To this end, such limitations and uncertainties and the accounting followed should be mentioned by way of explanation in the auditors' report and reference should be made to the related financial statement disclosures. The auditor should use his judgment in each case as to the extent to which disclosure in the notes to financial statements should be repeated or summarized in his report. Explanatory disclosures in the auditors' report do not constitute a qualification of the auditors' opinion.

There has been confusion over the meaning and significance of the words "financial position" and "results of operations" with respect to companies in the development stage. These words have acquired their conventional meanings from association with the financial statements of operating companies and should not be used in association with financial statements of companies in the development stage. A company in the development stage has not engaged in activities for which meaningful results of operations can be reported and the pervasive uncertainties inherent in the development stage do not enable presentation of financial position as it is commonly

understood. Furthermore, the auditors' opinion should not refer to 1
financial position and results of operations because these words 2
are not applicable. Instead, it is appropriate for the auditors' 3
report to assert that the statements present fairly whatever they 4
are intended to present, e.g., the "cost of...the liabilities and the 5
stockholders' investment and the source and use of financial resources 6
in conformity with generally accepted accounting principles." 7

If the company has previously issued financial statements, 8
or if the statements cover a period longer than a year, the auditors' 9
report should include appropriate references to consistency. 10

Illustrative Auditors' Report 11

An illustrative report for a hypothetical company, where 12
there is no significant problem in valuing consideration for shares 13
issued, is as follows: 14

To the Shareholders of 15
Acme Motorcycle Co. 16

We have examined the accompanying preoperating ac- 17
countability statement of Acme Motorcycle Co. (a company in 18
the development stage) as of December 31, 1972, and the re- 19
lated statements of preoperating financial activities and 20
investment by stockholders for the period from April 1, 1971 21
(date of inception) to December 31, 1972. Our examination 22
was made in accordance with generally accepted auditing 23
standards and accordingly included such tests of the account- 24
ing records and such other auditing procedures as we con- 25
sidered necessary in the circumstances. 26

The Company is in the development stage and has no 27
operating history. Recovery of the accumulated net costs 28
(see Note 1) is dependent upon future events, the outcome of 29

which cannot be determined at this stage of the Company's development. The accompanying financial statements have been prepared to reflect these circumstances and do not present financial position or results of operations.

In our opinion, the acompanying financial statements present fairly the cost of the assets, the cost of research, development, and preoperating activities, the liabilities and the investment by the stockholders of Acme Motorcycle Co. as of December 31, 1972, and the source and use of its financial resources covering the period from April 1, 1971 (date of inception) to December 31, 1972, in conformity with generally accepted accounting principles applied on a consistent basis since inception.

The following is illustrative of the note, referred to in the auditors' report above, which would accompany the financial statements:

Note 1 - Basis of Financial Statements

The accompanying financial statements give recognition to the facts that the company is in the development stage and has no operating history. Except that costs associated with an abandoned project have been written off, all costs incurred, reduced by revenues, have been accumulated because they were incurred in the expectation that they would benefit future periods. It is not practicable, at this stage in the company's activities, to determine the extent of recoverability of the accumulated research, development or preoperating costs or of the costs incurred for property, plant, equipment

or patents. Recoverability is dependent on future events, 1
including the ability of the company to raise any needed 2
additional capital, to attain the goals of its development 3
program, to market its products successfully and to achieve a 4
satisfactory level of operations. The outcome of these matters 5
cannot be determined at this time. 6

The notes should disclose management's policy with regard to the 7
future disposition of accumulated costs. 8

If shares have been issued for property or services, the 9
auditor must consider the fairness of the values at which the trans- 10
actions have been stated. In many such instances, evidence of the 11
fair value of the kind of property or services acquired may be lack- 12
ing, and the values may have been determined by the board of directors, 13
relying largely on their collective business judgment. The auditor 14
is expected to ascertain the procedures used and to review the 15
supporting information, but he is not expected to act as an appraiser 16
or to substitute his judgment for that of the directors. 17

Even though the auditor believes that the valuation pro- 18
cedures were adequate and were carefully applied, he may be unable, 19
because of the uncertainties inherent in making valuations, to satis- 20
fy himself as to the fairness of the specific values used. In this 21
event, if he believes the values may be significantly overstated 22
or understated, he may have to qualify his opinion because of the 23
uncertainty. An example of a report that might be issued in these 24
circumstances is as follows: 25

We have examined the accompanying preoperating account- 26
ability statement of Acme Motorcycle Co. (a company in the 27

development stage) as of December 31, 1972, and the related 1
statements of preoperating financial activities and investment 2
by stockholders for the period from April 1, 1971 (date of 3
inception) to December 31, 1972. Our examination was made 4
in accordance with generally accepted auditing standards and 5
accordingly included such tests of the accounting records and 6
such other auditing procedures as we considered necessary in 7
the circumstances. 8

The Company is in the development stage and has no 9
operating history. Recovery of the accumulated net costs 10
(see Note 1) is dependent upon future events, the outcome of 11
which cannot be determined at this stage of the Company's 12
development. The accompanying financial statements have been 13
prepared to reflect these circumstances and do not present 14
financial position or results of operations. 15

As discussed in Note 1, shares of the Company's common 16
stock have been issued for property and services. The costs 17
ascribed to assets or services acquired and the amounts as- 18
signed to the capital stock issued have been the fair values 19
of the assets or services at the date of receipt as determined 20
by the board of directors. We have reviewed the valuation 21
procedures applied by the directors and have inspected under- 22
lying documentation; while the procedures appear to be 23
reasonable and the documentation appropriate, determination 24
of the values involves subjective judgment which is not 25
susceptible of substantiation by auditing procedures. 26

In our opinion, subject to the effects, if any, of the matter discussed in the preceding paragraph, the accompanying financial statements present fairly the cost of the assets, the cost of research, development, and preoperating activities, the liabilities and the investment by stockholders of Acme Motorcycle Co. as of December 31, 1972, and the source and use of its financial resources covering the period from April 1, 1971 (date of inception) to December 31, 1972, in conformity with generally accepted accounting principles applied on a consistent basis since inception.

The note illustrated on page 40 would be expanded to include a discussion of the transactions referred to in the third paragraph of the auditor's report. The note would include general statements of the consideration received and the valuation techniques used; specific details would be given for significant transactions. In addition, the relationship to the corporation of the parties who received shares in exchange transactions, e.g. employee, officer, director, shareholder, also would be disclosed. For an example of such a note, see the Appendix.

If the possible misstatement is extremely significant, the auditor must consider whether the type of qualification illustrated above adequately expresses his reservations. If it does not, he may decide to disclaim an opinion.

If the auditor believes that the valuation procedures used were not adequate and were not carefully applied, or if the valuations are clearly contradicted by the available information, it may be necessary for the auditor to issue an opinion which is qualified as to fair presentation or is adverse.

In addition to the complexities already mentioned, a company in the development stage may be engaged in litigation (patent infringement, for example) or face still other contingencies. The auditor may be unable to evaluate the effects of such contingencies on the financial statements, and if the possible effects are material, he may find it necessary because of the uncertainty to qualify his opinion or to disclaim an opinion. Assuming that the auditor found it necessary to qualify his opinion for such reasons, the opinion paragraph might read as follows:

> In our opinion, subject to such adjustments, if any, as may result from the outcome of the litigation described in Note A, the accompanying financial statements...

The related note might read as follows:

> Note A - The company is defendant in a lawsuit filed by XYZ Corporation alleging infringement of patents and asking for damages of $__________. The company is contesting the suit, but in the opinion of counsel no determination of the outcome of the litigation can be made at this time. No provision has been made in the financial statements for this contingent liability.

In summary, when preparing his report the auditor must take into consideration the factors discussed in the earlier chapters. He should also give particular attention to any special circumstances not related to the fact that the client is in the development stage and modify his reporting accordingly if circumstances require. Regardless of the extent of disclosure in the auditors' report, notes to the financial statements must contain all of the information that is necessary for fair presentation.

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE

CHAPTER 6 - TRANSITIONAL PROBLEMS AT CONCLUSION OF DEVELOPMENT STAGE

Introduction

When a company emerges from the development stage and turns to conventional financial statements, it must adopt accounting practices conventionally used by operating companies. It was indicated earlier that disclosure should be made during the development stage of the more important practices as to disposition of accumulated costs that the company intends to follow during the operating stage. Continued disclosure should be made of the more important practices, particularly those relating to depreciation of plant and equipment and amortization of research, development and preoperating costs.

Research, development and preoperating costs, accumulated during the development stage in the expectation that they will benefit future periods, should be amortized against revenues earned during the operating period. The amortization periods for research and development costs and for preoperating costs need not be identical. In selecting the periods, the objective should be to effect an appropriate matching of the costs with revenues. In any event the periods should be reasonable and because of the uncertainties, should err in the direction of too short a life rather than too long a life.

With regard to costs incurred after the conclusion of the development stage, the company faces a new set of conditions.

The fact that research and development costs were accumulated during the development stage and are to be amortized during the operating stage does not commit the company to adopt the deferral-amortization practice for research and development costs incurred after operations have begun. Ordinarily, costs of the type accumulated during the development stage as preoperating costs (for example, costs of administrative, marketing and organizational activites, and interest cost) will be charged to expense as incurred once a company reaches the operating stage.

After a business becomes operational and its financial statements include a balance sheet, the recoverability tests appropriate for operating companies must be applied to the assets and accumulated costs carried forward from the development stage. If they are written down as a result of these tests, the adjustments should be treated as ordinary charges in the income statement. However, it would be improper to make write-offs for no reason except that the development stage has ended.

Comparability and Consistency

At the conclusion of the first period of operations, no attempt should be made to present the conventional financial statements in comparative form. It would be inappropriate to modify data presented in the preoperating statements in an effort to make such data comparable with those shown in the conventional financial statements.

In the first period following the end of the development stage, when conventional financial statements are used for the first time, a question may arise about the application of the

consistency standard, since there will have been changes in the application of generally accepted accounting principles related to the change in circumstances. The financial statements appropriate for a company in the development stage and the conventional financial statements appropriate for a company that has emerged from that stage do not purport to convey the same kind of information or report the same kinds of measurements. Thus, in describing the changes in accounting, notes to financial statements would relate them to the changes in facts.

Because the accounting change merely gave effect to a fact change, the auditors' report would not make any reference to a departure from consistency. However, the fact that a company has passed from the development stage to the operating stage and consequently has changed the character of its financial reporting is highly significant to an understanding of the financial statements and of the auditors' report. Therefore, disclosure of this change should appear in the auditors' report, either in the scope paragraph or in a separate paragraph. The following wording is illustrative:

> As described in Note___, the company was in the development stage prior to July 1, 197__ when it began operations. Accordingly, the accompanying Statement of Income presents the results of the company's operations after that date.

If the auditor has qualified his report with regard to the initial valuation basis of an issuance of capital stock other than for cash, the qualification will be continued into the

operating period, ordinarily until the amounts involved become immaterial as a result of company growth.

Accounting for Income Tax Effects of a Loss Carryforward

A company in the development stage may elect for income tax purposes to deduct research, development and preoperating costs as incurred; companies that do this emerge from the development stage with a tax loss carryforward. Since the company will have carried these costs forward in its financial statements, timing differences, as defined in Opinion No. 11 of the Accounting Principles Board, will have arisen. The effects of these timing differences should be accounted for in accordance with the provisions of that Opinion.

To the extent that loss carryforwards are not attributable to timing differences but to losses accounted for as such in the financial statements during the development stage, any tax benefit realized during the operating stage should be excluded from net income and be credited to whatever stockholders' equity account was charged with the loss.

ACME MOTORCYCLE CO.
(A Company in the Development Stage)

Preoperating Accountability Statement
as of December 31, 1972

Cash and Investments -			
Cash		$ 17,000	
Marketable securities, at market value on date of receipt, which is below present market value ($42,000)		40,000	$ 57,000
Investment in undeveloped land, at cost			25,000
Inventories and Prepayments, at cost -			
Inventories of parts and supplies		$ 5,500	
Prepaid rent		500	6,000
			$ 88,000
Less - Liabilities -			
Accounts payable		$ 8,000	
Salaries and taxes payable		2,000	
Long-term loan, 12% - due July 1, 1977		30,000	$ 40,000
			$ 48,000
Cumulative Outlays for (Notes 1 and 3) -			
Machinery and equipment*		$ 46,000	
Patents, at cost		20,000	
Research and development	$ 92,000		
Deduct:			
Cost of abandoned project	32,000		
Revenue from research fees	7,000		
	$ 39,000	53,000	
Preoperating costs for adminstrative, market planning and organizational activities and interest		60,000	$ 179,00[illegible]
Investment by Stockholders,net - per accompanying statement			$ 227,00[illegible]

* Ordinarily, recoverability of costs incurred for plant and equipment is contingent on the outcomes of the same uncertainties that apply to the recoverability of costs incurred for research, development and preoperating costs. If recoverability of the cost of machinery and equipment is assured to a considerably greater degree, such cost may appropriately be included in the total from which liabilities are deducted. Ordinarily, the cost of land, and in some instances the cost of buildings, may also appropriately be included in that total.

APPENDIX

ACME MOTORCYCLE CO.
(A Company in the Development Stage)

Statement of Investment by Stockholders
For the Period April 1, 1971 (inception) to December 31, 1972

	Number of Shares Issued and Outstanding	Amount
Common stock, no par value, authorized 500,000 shares		
Shares issued for cash and marketable securities -		
Cash at $1.00 per share	$ 40,000	$ 40,000
Cash at $3.00 per share	40,000	120,000
Marketable securities, valued at quoted market value at date of receipt	22,000	40,000
Shares issued for other property, at estimated fair value at date of receipt as determined by the Board of Directors (Note 1) -		
Inventory	2,000	4,000
Machinery and equipment	4,000	8,000
Patents	20,000	20,000
Shares issued for services, at estimated fair value at date of receipt as determined by the Board of Directors -		
Rent	1,000	3,000
Officers' salaries	4,000	4,000
Other	2,000	6,000
Financial consultation	12,000	12,000
Research and development costs	2,000	2,000
Balance December 31, 1972	$ 149,000	$ 259,000

	Investment by Stockholders
As of December 31, 1972 -	
Common stock	$ 259,000
Reduction - Cost related to abandoned project	(32,000)
	$ 227,000

APPENDIX

ACME MOTORCYCLE CO.
(A Company in the Development Stage)

Statement of Preoperating Financial Activities

Cumulative Since April 1, 1971 (Inception) and for the Year Ended December 31, 1972

	Year - 1972		Cumulative to December 31, 1972	
Source of Financial Resources:				
Proceeds from issuance of shares for (see accompanying statement) -				
Cash and marketable securities	$120,000		$200,000	
Other property	20,000		32,000	
Services	12,000	$152,000	27,000	$259,000
Long-term loan		30,000		30,000
Revenue from research fees		6,000		7,000
Total sources		$188,000		$296,000
Use of Financial Resources:				
Investment in undeveloped land		$ 25,000		$ 25,000
Inventory of parts and supplies		-		5,500
Prepaid rent		-		500
Machinery and equipment		26,000		46,000
Patents		20,000		20,000
Research and development		55,000		92,000
Market development costs		5,000		5,000
Organization costs		-		1,000
General and administrative costs -				
Officers' and office salaries	$ 6,000		$ 24,000	
Rent	2,000		6,000	
Financial consultation	-		12,000	
Other	7,000	15,000	12,000	54,000
Total financial resources used		$146,000		$249,000
1972 excess of sources over uses		$ 42,000		
Excess of cash and marketable securities over accounts payable and accrued liabilities:				
As of December 31, 1971		5,000		
As of December 31, 1972		$ 47,000		$ 47,000
Represented by:				
Cash			$ 17,000	
Marketable securities			40,000	$ 57,000
Less accounts payable and accrued liabilities				10,000
				$ 47,000

ACME MOTORCYCLE CO.
(A Company in the Development Stage)

Notes to Financial Statements

Note 1 - Basis of Financial Statements

The accompanying financial statements give recognition to the facts that the company is in the development stage and has no operating history. Except for costs associated with an abandoned project, all costs incurred, reduced by revenues, have been accumulated because they were incurred in the expectation that they would benefit future periods. It is not practicable, at the present stage of the company's activities, to determine the extent of recoverability of the accumulated research, development or preoperating costs or of the costs incurred for property, plant, equipment or patents. Recoverability is dependent on future events, including the ability of the company to raise any needed additional capital, to attain the goals of its development program, to market its products successfully and to achieve a satisfactory level of operations. The outcome of these matters cannot be determined at this time.

In the accompanying financial statements, transactions effected in cash or by acquiring or incurring obligations payable in cash have been recorded at the amounts thereof. The costs ascribed to assets or services acquired in exchange for shares of capital stock and the amounts assigned to the capital stock thus issued have been the fair values of the assets or services at the dates of receipt as determined by the board of directors giving consideration to such factors as replacement cost, bona fide offers, and recent cost to a developer. The major exchange

transactions which have occurred were the following:

(a) The issuance of 20,000 shares of stock for all of the rights to a patent owned by the president of the company who owned 20% of the 40,000 shares outstanding prior to the issuance. The amount ascribed to this exchange by the board is the amount which it would have been willing to pay in cash, and for which it believes it could have acquired such patent rights.

(b) The issuance of 12,000 shares of stock to an individual, who was previously unrelated to the company, for management consulting services rendered. These shares were valued at the amount billed, which the individual has informed the board was based on his regular billing rates for such services.

Note 2 - Federal Income Taxes

The company, being in the development stage and without earnings, has no liability for Federal income taxes. At December 31, 1972, it had net operating loss carryforwards of $145,000 expiring in 1976 and 1977. Of this amount, $32,000 has been charged to capital and $113,000 has been accumulated in the preoperating accountability statement. Any tax benefits resulting from carryforward of the former amount will be credited to capital; additional benefits will be credited to deferred tax accounts if realized before the related accumulated costs are charged to income.

Note 3 - Future Accounting Policies

Depreciation is not being recorded while the company is in the development stage. The company intends when it reaches the operating stage to use the straight-line method of depreciation for plant and equipment, to amortize the research and development costs accumulated during the development stage against the first model production run and to write off accumulated preoperating costs by the straight-line method over a three-year period.

ACCOUNTING FOR COMPANIES IN THE DEVELOPMENT STAGE

AN ALTERNATIVE VIEW

Norman O. Olson

Mr. Olson disagrees with the position taken in the guide that the development stage justifies what amounts to the automatic capitalization of all expenditures, even when there is no evidence of future recoverability. In his view, the guide has stretched the application of the matching concept to support deferment of losses and postponement of realism -- the realism being that initial deficits or losses are in fact an expected consequence of starting most new business enterprises. The recommended accounting greatly increases the risk that the financial statements of companies in the development stage will prove to be misleading to investors and other users of the statements since they will disguise deficits in a manner which suggests they are assets.

Mr. Olson believes that cost outlays, whether by cash or stock, for such items as research and development and for preoperating activities involving administrative, marketing and organizational effort should be shown as deductions from the stockholders' investment during the development stage. Thus, these cost outlays would not be shown with a company's separable resources and property rights which have instrinsic asset values by reason of generally possessing some alternative usefulness should the development activity prove to be unsuccessful.

At the conclusion of the development stage, a company would adopt an accounting for research and development costs incurred during the development stage that is consistent with the treatment to be accorded similar expenditures when incurred during the operating stage. Should a company elect to capitalize research and development costs under options presently available under generally accepted accounting principles, appropriate recoverability measures would then be applied to assure that asset recognition is proper. (The present options in accounting for research and development underscore the need for a solution to the broad problem of accounting for such costs in all circumstances.) Expenditures for other preoperating activities during the development stage would not be capitalized but would constitute an initial deficit at the time a company entered its operating stage.

Under this proposal there would be complete disclosure of the accumulated expenditures in the preoperating accountability statement and in the statement of financial activities. Hence, accountability to the investor would be achieved as effectively as under the approach recommended in the guide.

In Mr. Olson's view accounting for these cost outlays according to the method described above would (a) lessen the risk of improper inferences that such outlays during the development stage possess the customary attributes of assets; (b) possibly reduce significantly certain problems in accounting for these costs at the time of transition from the development stage to the operating stage; and (c) avoid during the early years of the operating stage the duplication of charges for general, administrative and similar period expenses; that is, those currently incurred plus the amortization of those incurred and accumulated during the devlopment stage.