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Statement of
Position
on

74-4 (FASB)

Accounting
for
Future Losses

April 25, 1974

Responses to Issues Raised in FASB Discussion Memorandum,
March 13, 1974 (FASB File Reference 1006)

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

Notes

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

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

ACCOUNTING FOR FUTURE LOSSES

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants has considered the Discussion Memorandum, Accounting For Future Losses, dated March 13, 1974, and has formulated on behalf of the Accounting Standards Division this Statement of Position on the issues raised in that document.

RECOMMENDATION

This Statement of Position has been prepared using as a frame of reference existing accounting principles concerning the nature of assets, liabilities, revenue and expenses, and the broad qualitative objectives of financial reporting, such as verifiability and neutrality. The Division has concluded that accruable future losses are generally rare and unusual and suggests criteria that reflect that view. Comments of the Division on the individual issues are set forth in the remainder of this Statement of Position. Minority positions which might exist are not presented herein.

THE MAJOR ISSUES

ONE: What are the Criteria That Should Determine Whether Losses Should be Accrued in Advance of Their Occurrence?

The Division urges that the FASB define the term "future loss". The Division does not consider losses from uncollectible receivables, product warranties and probable tax assessments as "future losses" but rather sees these items as "incurred costs or expenses" relating to operations of the current or prior period.

The Division believes that the existence of all of the following criteria should determine whether losses should be accrued in advance of their occurrence:

- There is an existing condition, event or set of circumstances that can reasonably be expected to result in a loss and the occurrence of this loss is sufficiently predictable.
- The loss is demonstrably related to the operations of the current period or a prior period.
- The loss can be measured with reasonable approximation.

These criteria differ from those set forth in the Discussion Memorandum for the following reasons:

- The Division feels that criterion (a) is too broad to be identified separately as a criterion.
- The Division feels that the initial clause in criterion (c), "the loss is properly chargeable to current revenues", prejudices the issue and should not be set forth as a criterion since the purpose of the criteria is to determine if a loss is chargeable to current revenue. The Division also feels that a future loss should be more than "reasonably related" to the operations of the current period or a prior period. The Division believes that an accruable future loss should be "demonstrably related" to the operations of current or prior periods.

An accruable future loss will therefore only evolve from an existing contractual relationship, from laws or governmental regulations, or from current or past revenue.

TWO: Can the Following Types of Future Losses Satisfy the Criteria for Accrual in Advance of Their Occurrence?

Based upon the criteria that the Division feels should determine whether losses should be accrued in advance of their occurrence, the Division believes that:

- Future self-insured losses could not satisfy all of the criteria because the loss would not be demonstrably related to the operations of the current period or a prior period.
- Future losses from expropriations by foreign governments could not satisfy all of the criteria unless expropriation was deemed to be imminent. The Division recognizes the need to identify those circumstances when expropriation might be deemed to be imminent and offers the following situations for consideration:
 - a. Accession to power by groups advocating nationalization.
 - b. Expropriation of assets of other companies.
 - c. Indication to management and/or the public that assets will be expropriated.
 - d. Seizure of assets.

- Future catastrophe losses of property and casualty insurance companies, including reinsurance companies, could not satisfy any of the criteria.
- Future losses from pending or threatened litigation could satisfy all of the criteria if the future loss could be measured with reasonable approximation.
- Future losses from the general risk of litigation could not satisfy any of the criteria.
- Future losses from requirements or adverse rulings of such agencies as the Cost of Living Council and the Environmental Protection Agency could satisfy all of the criteria if the future losses were both imminent and measurable with reasonable approximation.
- Future losses from strikes, including those of customers and suppliers, could not satisfy any of the criteria.

The Division believes that foreign exchange losses might be identified by commentators as a type of future loss to be accrued. The Division feels that such future losses could not satisfy any of the criteria.

The Division suggests that the FASB reconsider the conclusions reached by the APB in Paragraph 15 of Opinion No. 30 in light of the criteria that it establishes to determine whether losses should be accrued in advance of their occurrence.

ACCOUNTING AND IMPLEMENTATION ISSUES

As previously indicated, the Division concluded that accruable future losses are generally rare and unusual and suggested criteria reflecting that view. The majority of Issues Three through Fourteen deal with matters relating to standards for accruable future losses and their implementation. The Division offers the following comments on those issues for consideration in the event that the FASB approves criteria different from those proposed by the Division.

THREE: How Should Accruable Future Losses be Measured?

A future loss should not be accrued unless the amount of the related balance sheet liability or allowance can be measured with reasonable approximation. The Division does not believe that the balance sheet item should be a residual amount or that it should represent an arbitrary number of periods' estimated losses.

The Division recommends that consideration be given to the present value of the balance sheet item but takes no position on this issue.

FOUR: How Shall Certain Matters Concerning the Disposition of the Balance Sheet Item (Resulting From the Accrual of Future Losses) be Resolved?

The Division has concluded that a debit balance implies the deferral of a loss, which is contrary to traditional accounting principles. Therefore, debit balances should be charged to operations.

A credit balance that evidence indicates to be excessive should be considered the result of a change in an accounting estimate as defined in APB Opinion No. 20 and should be adjusted to its appropriate amount in the current period by a credit to operations.

FIVE: How Should Accrued Future Losses be Classified?

The Division believes that an accrued future loss should be classified only as a liability or as an asset valuation account. Liability classification is appropriate when the accrued future loss is an amount which is expected to be paid. An accrued future loss should be classified as an asset valuation account when it measures the net realizable value of an asset.

SIX: In the Financial Statements, What Terminology Should be Used to Describe Accruals of Future Losses and What Terminology Should be Avoided?

Accruable future losses should be described as liabilities or allowances in the balance sheet and as provisions in the income statement. Terms such as reserve, contribution, or fund should be avoided since they may suggest meanings to different users that are not implied in the recording of the accounting entry.

SEVEN: Should Standards be set for the Disclosure of Accruable Future Losses in Financial Statements?

The Division believes that the FASB should establish standards of disclosure. The report on Objectives of Financial Statements recommended that disclosures should assist statement users in assessing the uncertainties of the amount and timing of future cash transactions. Future losses are clearly characterized as relating to future events and transactions, the financial effects of which can only be estimated in the current period.

The Division recommends the adoption of informative disclosure standards as outlined in Statement on Auditing Standards No. 1, Section 430. Judgment must be exercised in distinguishing between adequate disclosures and excessive information which can only confuse the user and obscure significant data.

EIGHT: How Should the Following Issues of Implementation be Resolved?

- The treatment of a change in method -

Any change in accounting method made as a result of an FASB statement on accruable future losses should be accounted for by restating amounts reported in financial statements of all prior periods presented.

- The amount to be established in the year the standard is initiated -

The amount to be established should be the amount of the balance sheet liability or allowance. If that amount cannot be determined, then the criteria for accruing future losses are not satisfied. This applies to both established and new companies.

- The effective date of the adoption of the practice of accruing future losses -

The provisions of the statement should become effective not earlier than the date prescribed by the FASB rules of procedure.

- Applicability of the standards to regulated industries -

The statement should be applicable to regulated industries, subject to the provisions of Addendum to APB Opinion No. 2.

NINE: Should Future Losses That do not Meet the Criteria for Accrual be Disclosed?

The Division has concluded that the disclosure standards of existing accounting pronouncements, particularly ARB No. 50, Contingencies, are adequate. Also, those disclosures should be made in footnotes to financial statements, not by appropriations of retained earnings.

TEN: For Those Types of Future Losses That Should not be Accrued in Advance of Their Occurrence, What Should be the Treatment of the Discontinuance of the Practice by Those Enterprises That are Presently Doing so?

As recommended in Issue Eight, the change in accounting method resulting from an FASB statement should be accounted for by restating financial statements of all prior periods.

ISSUES RELATED TO CERTAIN
TYPES OF FUTURE LOSSES

ELEVEN: Questions Raised if Self-Insured Losses are to be Accrued in Advance of Their Occurrence.

The questions and alternatives in Issue Eleven confirmed the view expressed earlier that self-insured losses do not meet any of the criteria for accrual and, therefore, the Division has not developed recommendations on this issue.

TWELVE: Should Uninsured or Partially Insured Risks be Disclosed?

The Division feels that uninsured or partially insured risks that would normally be insured should be disclosed by broad categories.

THIRTEEN: Questions Raised if Future Losses from Expropriations by Foreign Governments are to be Accrued in Advance of Their Occurrence.

The Division believes that future losses from expropriations by foreign governments should be accrued only when they are imminent as discussed in response to Issue Two.

FOURTEEN: If Future Catastrophe Losses of Property and Casualty Insurance Companies are to be Accrued in Advance of Their Occurrence, What Standards Should be Prescribed?

The questions inherent in allowing insurance companies to accrue for catastrophe losses are complex. The AICPA Committee on Insurance Accounting, submitted its report to the FASB (included as Appendix M in the Discussion Memorandum). The Division has concluded that the report, which was the result of extensive discussions and research by the committee, best expresses the various views.

OTHER MATTERS RELATING TO
ACCOUNTING FOR INSURANCE

The Division believes that Issues Fifteen and Sixteen do not relate to future losses and questions their inclusion in any statement to be issued.

FIFTEEN: What Would be the Accounting Treatment of Amounts Paid and Collected on Insurance Policies With Retrospectively Rated Premiums?

The Division believes that an insured should estimate the ultimate net cost of the policy which should be amortized to expense over the term of the policy, if that net cost is reasonably measurable. If the net cost is not reasonably measurable, the entire initial premium paid should be amortized over the policy term and return premiums or additional premiums should be credited to income when received or paid.

SIXTEEN: What Should be the Accounting Treatment of Amounts
Paid and Collected on Funding Plans and Arrangements
Between Property and Casualty Insurance Companies?

The Division holds the view that these transactions are entered into to level earnings, not to provide insurance. Accordingly, a portion of the premium paid should be deferred to the period of recovery of the loss, effectively accounting for the transaction as a financing arrangement, which is the substance of the transaction.

ACCOUNTING STANDARDS EXECUTIVE COMMITTEE

April 25, 1974

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