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Theory & Practice: Pronouncements and Other Developments

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FINANCIAL ACCOUNTING STANDARDS BOARD

The FASB issued two more Statements of Financial Accounting Standards and three interpretations of its statement on Accounting for Research and Development Costs. These are, of course, in addition to several exposure drafts of proposed statements and a discussion memorandum on Criteria for Determining Materiality which will be summarized in the future as these projects are finalized.

Statement No. 4

Statement No. 4, entitled Reporting Gains and Losses from Extinguishment of Debt (an amendment of APB Opinion No. 30), provides that if such gains and losses in the aggregate are material, they shall be classified as an extraordinary item, net of related income tax effect.

This treatment shall be accorded debt extinguishment whether it is early, at the scheduled maturity date, or after the scheduled due date. However, gains or losses from cash purchases of debt instruments made to satisfy current or future sinking fund requirements are not to be treated as extraordinary items. Some obligations to acquire debt have the characterisitics of sinking fund requirements. For example, if an enterprise is required to purchase each year a certain percentage of its outstanding bonds before their scheduled maturity, the gain or loss from such purchase is not required to be classified as an extraordinary item. On the other hand, debt maturing serially does not have the characteristics of sinking fund requirements, and gain or losses from extinguishment shall be classified as an extraordinary item.

Adequate description of the transactions resulting in the gains or losses from extinguishment of debt shall be shown on the face of the earnings statement or in a note to the financial statements to enable users of the financial statements to evaluate the significance of the gains or losses. The sources of any funds used to extinguish debt if identifiable, the income tax effect in the period of extinguishment, and the per share amount of the aggregate gain or loss net of related income tax effect shall be disclosed.

Retroactive application of the provisions of this Statement are not required. It is effective for extinguishments occurring after March 31, 1975; however, the following should be noted:

- It need *not* be applied to extinguishments occurring on or after April 1, 1975 pursuant to the terms of an offer or other commitment made prior to that date.
- Application to *all* extinguishments occurring during a fiscal year in which April 1, 1975 falls is encouraged.
- Retroactive application to extinguishments occurring in prior fiscal years is encouraged but not required.

Further, retroactive application is not intended to change the accounting for amounts deferred on refundings of debt that occurred prior to the effective date of APB Opinion No. 26 (January 1, 1973) or the classification of the amortization of these amounts in the statement of earnings.

Accounting for Contingencies, FASB Statement No. 5, defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. All uncertainties in the accounting process do not give rise to contingencies as the term is used in this Statement. For example, estimating the life of a depreciable fixed asset or the liability for services rendered but not billed involves a degree of uncertainty, but no uncertainty exists as to the fact that the asset's life (usefulness to the business) will end or that a liability has been incurred.

Criteria for accruing an estimated loss by a charge to earnings are two, both of which must be met:

- Information available prior to issuance of the financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statement (the end of the most recent accounting period for which financial statements are being presented). It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

- The amount of loss can be reasonably estimated.

Disclosure requirements are given for losses accrued, contingencies not accruable because both criteria are not met, and events giving rise to losses occurring after the date of the financial statements but before the date of the auditors' report.

Catastrophe and self-insurance reserves, as well as reserves for general contingencies, are eliminated, since under the criteria losses are accruable only after the event giving rise to the loss has taken place.

An appropriation of retained earnings is not prohibited providing it is shown within the stockholders' equity section of the balance sheet and is clearly identified as an appropriation of retained earnings. Losses shall not be charged to an appropriation of retained earnings, and no part of the appropriation shall be transferred to earnings.

This Statement is effective for fiscal years beginning on or after July 1, 1975. Earlier application is encouraged. Any changes in accounting principle resulting from its application are to be made by a cumulative effect adjustment in accordance with APB Opinion No. 20 and not by restatement and prior period adjustment, as proposed in the exposure draft of this Statement. Reclassification of an appropriation of retained earnings to comply with the requirement that such appropriation must be within the equity section of the balance sheet shall be made in any financial statements for periods before the effective date of this Statement that are presented after the effective date of this Statement.

Although possible gain was included in the FASB definition of contingency, the provisions of paragraphs 3 and 5 of Accounting Research Bulletin No. 50 were not reconsidered by the FASB. Those paragraphs of ARB No. 50 which, therefore, continue in effect provide generally that contingencies that might result in gains usually are not reflected in the financial statements and, while disclosure of such contingencies may be made, care is required to avoid misleading implications as to the likelihood of realization.

Insurance companies strongly opposed elimination of the castastrophe reserve. The "income smoothing" effect of such a reserve had been discussed previously by the AICPA and the Accounting Principles Board. In January, 1973, the SEC issued ASR No. 134 which, while not taking a position opposing such a reserve, required specific disclosure of the impact of following this accounting practice on the balance sheet and statement of earnings.

Statement No. 2

FASB Statement No. 2, Accounting for Research and Development Costs, concluded that all research and development costs encompassed by the Statement shall be charged to expense when incurred. Costs of research and development conducted for others under contractual arrangements and those specifically reimbursable under the terms of a contract, as well as costs related to exploration and mineral development in the extractive industries are excluded.

The Statement is effective for fiscal years beginning on or after January 1, 1975.

The required expensing of Research and Development Costs is to be applied retroactively by prior period adjustment. This also means that when a statement of earnings includes one or more prior periods in addition to the current period:

- Companies changing to a policy of expensing Research and Development Costs as incurred in accordance with the Statement are to restate all prior periods presented to reflect as expense the Research and Development Costs incurred in each of these prior periods.
- Companies who during any of the prior periods presented changed from a policy of deferring and amortizing Research and Development Costs to one of expensing as incurred in accordance with APB Opinion No. 20 are to eliminate the cumulative effect amount and restate the periods prior to the change to reflect Research and Development Costs as incurred in each prior period.
- Companies who during one or more of the prior periods presented completed the amortization of previously deferred Research and Development Costs are to restate these prior periods to reflect Research and Development Costs incurred in each period.

Of course, in all of these restatements elimination of the amortization previously taken and adjustment of the provision for income tax are also required.

The Statement also requires that disclosure be made in the financial statements of the total Research and Development Costs charged to expense in each period for which an income statement is presented. Companies who have not previously capitalized Research and Development Costs, as well as those who have, should revise their accounting systems to the extent necessary to accumulate their Research and Development Costs as defined in the Statement to comply with this disclosure requirement.

Three interpretations of the Statement have been issued. They are generally effective on or after March 31, 1975. As usual earlier application is encouraged; however, none of these interpretations are to be applied prior to initial application of the provisions of FASB Statement No. 2.

Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method (FASB interpretation No. 4) applies the "alternative future use" tests to assets that are acquired in a purchase business combination for use in the Research and Development activities of the combined enterprise. Accordingly, amounts assigned to purchased tangible or intangible assets would be charged to expense when the combination is consummated unless the asset has an alternative future use. Application of this Interpretation to Business Combinations accounted for by the purchase method (a) is required for business combinations initiated after March 31, 1975, (b) is encouraged for combinations initiated prior to April 1, 1975 and consummated after March 31, 1975 (application may be applied selectively to those combinations) and (c) may be applied to combinations initiated and consummated prior to April 1, 1975; however, if a company chooses to apply this Interpretation to those combinations it must be applied retroactively to all business combinations accounted for by the purchase method that were consummated prior to April 1, 1975.

Applicability of FASB Statement No. 2 to Development Stage Enterprises (FASB Interpretation No. 5) requires that Research and Development Costs be charged to expense as incurred if a development stage enterprise prepares conventional financial statements (as opposed to those special financial statements commonly referred to as Article 5A statements) or if its financial statements are included, either by consolidation or by the equity method, in conventional financial statements. Further, when a development stage enterprise commences operations and begins issuing financial statements in the conventional format, the provisions of FASB Statement No. 2 shall be applied retroactively by prior period adjustment. It should be noted that FASB Statement No. 2 is applicable to Research and Development Costs but not to other similar costs such as preoperating and start-up. This Interpretation is effective on March 31, 1975, for fiscal years beginning on or after January 1, 1975.

Applicability of FASB Statement No. 2 to Computer Software (FASB Interpretation No. 6) provides that:

- Costs incurred to acquire or develop computer software that is to be used in an enterprise's selling and administrative activities are not Research and Development Costs.
- Costs incurred to purchase or lease computer software developed by others are not Research and Development Costs unless the software is for use in research and development activities, in which case such costs are to be charged to expense as incurred subject to the "alternative future use" tests.
- All costs incurred for the internal development of software for use in research and development activities are to be charged to expense as incurred.
- If computer software is developed internally as part of a new process (for example, software to accompany a computerized typesetting machine), or if software developed internally is itself a marketable product or process (for example, software to be used by a service bureau), costs incurred for conceptual formulation or the translation of knowledge into a design are Research and Development Costs. Programming and testing costs in connection with these purposes are also Research and Development Costs when incurred in the search for or evaluation of product or process alternatives or in the design of pre-production models.
- Costs incurred for programming and testing are not Research and Development Costs when they are incurred for routine or other ongoing efforts to improve or adopt an existing product to a particular need.
- Costs of developing software for others under a contractual arrangement is beyond the scope of FASB Statement No. 2.

This interpretation is effective for fiscal years beginning on or after April 1, 1975. Retroactive application of this Interpretation, and therefore, restatement of prior fiscal years, is encouraged but not required.

Accounting and Reporting by Development Stage Companies, the second exposure draft of a proposed Statement resulting from the discussion memorandum and subsequent public hearings on research and development and similar costs, is presently being accorded "second level" priority by the FASB.

FORECASTS AND PROJECTIONS

The AICPA has been dealing with the problems of financial forecasts in three parts. Guidelines for preparing financial forecasts and developing forecasting systems have been published by the Management Advisory Services Division. The Accounting Standards Division has distributed an exposure draft of a statement of position containing guidelines for presentation and disclosure of financial forecasts. Comments on this exposure draft are currently being considered. Guidelines for reviewing and reporting upon financial forecasts are being drafted by the Auditing Standards Executive Committee.

The Securities and Exchange Commission has now issued its proposed economic projection rules. These proposed rules generally follow the conclusions set forth in a release issued by the SEC after its public hearings to gather information for a reassessment of its policy of prohibiting projections, except that the proposed rules include disclosure and reporting standards for a "reviewer's report". The SEC had previously concluded that a statement of verification of a projection by a third party should not be permitted.

Differences between the AICPA's approach and that of the SEC will have to be resolved, but it is possible that forecasts or projections will be seen in annual reports and in SEC registration and reporting forms in the not too distant future.

ACCOUNTING STANDARDS DIVISION

From time to time the AICPA's Accounting Standards Division issues Statements of Position relating to accounting for specific items or to accounting in certain industries. The portions of these statements which relate to auditing procedures and the auditors' report are "authoritative;" however, the portions which relate to accounting principles and financial reporting are considered recommendations to the FASB.

The latest of these statements were Accounting Practices in the Mortgage Banking Industry and Revenue Recognition When Right of Return Exists. In addition to the guidelines for presentation and disclosure of financial forecasts, a proposed statement on accounting practices of real estate investment trusts is being prepared.