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Theory & Practice: AICPA and FASB: Environs and Decisions

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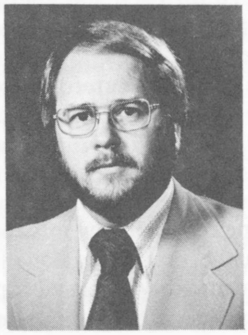

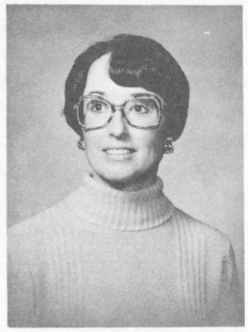

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This column recaps some of the events and pressures that have influenced our profession over the past year or two. In addition, summaries of FASB Statements Nos. 15 through 20 are presented, along with brief reviews of some other FASB projects that are still underway.

In order to appreciate the changes in the AICPA and the FASB, it is important to understand that the process employed in reaching authoritative decisions, as well as the decisions themselves, has undergone critical scrutiny. This scrutiny has been from within the profession and from public and governmental bodies.

Two committees of Congress focused their attention primarily on the process employed in reaching authoritative decisions. Their reports questioned whether accounting firms are truly independent of their audit clients and whether the public accounting industry, the establishment of accounting principles and the American Institute of CPAs are dominated by a few large firms to the competitive disadvantage of smaller firms. These Congressional committees expressed reservations about the ability and willingness of CPAs to force their peers to adhere to standards established by the profession. The committees have temporarily delayed any move toward setting up a new regulatory mechanism while the profession attempts to satisfy the criticisms that were brought forth.

Several measures were taken to counter the pressures placed on the accounting profession. The council of the AICPA established a separate division within the American Institute for CPA firms. Meetings of standard-setting committees and other committees whose activities have a significant public interest were opened to the public.

Changes in the AICPA's bylaws and Code of Professional Ethics were adopted to increase the participation of the public and those CPA's who are not in public practice in the operations of the AICPA. These changes provide general standards covering all areas of public practice and modify ethical rules on solicitation and advertising, incompatible occupations and offers of employment to employees of other firms.

It is still not altogether clear that these efforts at self-regulation will satisfy Congress sufficiently to accomplish their primary purpose of preventing the establishment of a regulatory body outside of the accounting profession.

FASB No. 19 CHALLENGED

A challenge to both the process used in establishing GAAP and the results of that process has arisen as a consequence of attempts by the FASB to specify accounting for oil and gas producers. Until the 1960's, most oil and gas producing companies used the successful efforts method of accounting for their activities involving the acquisition, exploration, development and production of oil and gas interests. Under this method, mineral interests are capitalized as assets when acquired. Exploration costs, except the cost of drilling exploratory wells, are expensed as incurred. The cost of drilling exploratory wells is capitalized until it is known whether commercial oil or gas reserves are discovered; if the well is unsuccessful, its drilling cost is expensed. Costs of drilling successful exploratory wells and of drilling development wells are capitalized and amortized.

Within the past twenty years, some companies have adopted the full costing method of accounting for their activities relating to oil and gas production. This method capitalizes all costs incurred in searching for oil and gas reserves within a large cost center, such as a country, with the limit that the total capitalized costs are not permitted to exceed the estimated value of the reserves within the cost center.

The primary difference between the two methods is in the treatment of costs that are not directly related to the discovery of specific oil and gas reserves. Under the full costing method, these items are capitalized with the result that earnings might not reflect clearly the risks and failures of the firm on a year to year basis.

Because of the controversy surrounding accounting for oil and gas producing companies, the FASB approached the issue carefully. Before issuing its Statement No. 19, the FASB staff surveyed bank loan officers, trust department officers and securities underwriters who have dealt directly with oil and gas producing companies in an effort to determine whether the method of accounting used by a particular company would affect its ability to raise capital or to borrow funds. The majority of those surveyed felt it would not. The FASB held a public hearing on the discussion draft and attracted more than 300 persons. Thirty-nine presentations were heard and 140 position papers were submitted. Studies were conducted to determine whether stock prices of oil and gas producers had been affected by the exposure draft prohibiting use of the full costing method and the findings were that no statistically significant impact could be measured. Finally, after having rejected appeals for a second public hearing, Statement No. 19 requiring use of successful efforts accounting was issued and made effective for years beginning after December 15, 1978.

During the time period in which the FASB was considering proper financial accounting treatment, Congress was attempting to deal with the energy problem and felt that one factor causing difficulty in formulating a national energy policy was the lack of reliable data. To aid in its deliberations, Congress enacted the Energy Policy and Conservation Act in which the Securities and Exchange Commission (SEC) was required to develop a reliable national energy data base to be compiled by the Department of Energy (DOE). In addition, the Act required the SEC to assure the development of accounting practices to be followed by all entities engaged in the production of crude oil and natural gas within the U.S. The SEC, however, withheld action pending the completion of the FASB's pronouncement.

Upon its release, FASB No. 19 evoked angry response from those favoring retention of accounting alternatives. The intense pressure exerted on Congress resulted in the introduction of an amendment to the energy act whose effect would have been to permit the continuation of accounting alternatives. The Department of Justice joined in the furor by suggesting that required use of the successful efforts method would possibly impair competition. The DOE held hearings in February of 1978 on the issue. SEC hearings in early spring focused on reporting requirements for the national energy information system and for SEC filings. Representatives of the FASB appeared at both sets of hearings and urged that the reporting for financial statement purposes be as adopted in FASB No. 19.

It is too soon to predict the outcome of the issue at the hands of the SEC. It is clear that this will be a strong test of the authority of the FASB to establish accounting principles and to narrow accounting alternatives. The situation is shaping up as a particularly tough test of the SEC's resolve to avoid taking over the accounting standard-setting function.

Work Progresses

Not all of the challenges to our profession have been from outsiders. As the economic substance of accounting events has become more complicated, accounting pronouncements have become more sophisticated and practicing accountants have increasingly questioned the relevance of some disclosure requirements for certain types of businesses.

In response to this concern, the AICPA Accounting Standards Division studied the question and recommended that the FASB develop criteria for disclosures that should be required by GAAP. The FASB recently added a major project to its agenda to develop guidelines for distinguishing between information that should be disclosed in financial statements and information that should be disclosed in some other form of financial reporting. In addition, criteria are to be developed to distinguish between information that should be disclosed by all enterprises and that which should be required only of certain types of enterprises.

In April 1978 the Standards Board issued Statement No. 21, Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises. The Statement is an amendment of APB Opinion No. 15 (EPS) and FASB Statement No. 14 (segment information). For purposes of this statement, a nonpublic enterprise is one other than one whose debt or equity securities trade in a public market on either a foreign or domestic stock exchange or in the over-the-counter market, or, other than an enterprise that is required to file financial statements with the SEC. The Statement is effective April 30, 1978 retrospective to fiscal years beginning after December 15, 1976.

The FASB has continued work on its conceptual framework project and has issued an exposure draft entitled "Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises." This is the first in a new series of Statements of Financial Accounting Concepts, the purpose which is to set forth fundamentals on which financial and reporting standards will be based. Other phases of the conceptual framework project deal with qualitative characteristics of financial information, measurement of financial statement elements and the earnings report.

Official Prounouncements

• *FASB No. 15:* In 1972 the APB issued Opinion No. 26 to establish accounting by a debtor when debt was extinguished prior to its scheduled maturity. Situations such as uncertainties regarding the ability of state and local governments to meet their debt obligations and financial difficulties encountered by real estate investment trusts have arisen that are not covered by APB No. 26. This FASB excludes troubled debt restructurings from APB No. 26 but otherwise leaves that APB in force.

The identifying characteristic of debt restructurings now governed by FASB No. 15 is that the creditor, for economic or legal reasons related to the financial difficulties of the debtor, grants the debtor a concession that otherwise would not be granted. The concession is granted with the objective of maximizing the creditor's recovery in a difficult situation.

The accounting treatment depends upon the manner in which the restructuring is accomplished. When a restructuring occurs through a transfer of assets or an equity interest in the debtor, the debtor recognizes a gain equal to the amount of the debt over the fair market value (FMV) of the items transferred on the date of the consummation of the restructuring. Any difference between the carrying value of the assets transferred and their FMV is recorded as a gain or loss on disposition of assets per APB No. 30. The creditor records the assets or equity interest received at FMV and reports as a loss the unrecovered carrying value of the receivable.

The second type of restructuring involves a change in the terms of the debt. These changes would include reducing the stated interest rate, extending the maturity date at a stated interest rate lower than the current market rate, reducing the face or maturity amount of the debt or reducing the amount of accrued interest. When the terms of the debt are modified, the effects of the restructuring are accounted for prospectively from the time of the restructuring. The excess of the cash to be paid (received by the creditor) over the carrying value of the debt is the interest to be amortized over the term of the debt, using the interest method of APB No. 21. If the cash to be paid (received) is less than the carrying value of the debt, the payable (receivable) should be written down to the total of the cash to be paid (received).

The debtor is required to disclose a description of the major changes in the debt, the aggregate gain on restructuring and the related tax effect, the aggregate net gain or loss on asset transfers relating to restructurings and the earnings per share amount of the aggregate gain on restructuring net of related income tax effects.

For each category of restructured debt that yields an interest rate lower than market, the creditor is required to disclose the aggregate gross investment, the gross interest income per the original debt terms and the interest income recognized during the accounting period.

FASB No. 15 is to be applied to troubled debt restructurings consummated after December 31, 1977. Application to debt restructurings occurring earlier is encouraged; however, previously issued financial statements may not be restated. Creditor disclosure requirements are effective for fiscal years ending after December 15, 1977.

• *FASB No. 16:* This statement relating to prior period adjustments is effective for annual financial statements for fiscal years beginning after October 15, 1977. It requires that all items of profit and loss recognized during the period be included in net income for that period except for two types of items that will continue to be considered prior period adjustments. The exceptions are for the correction of an error in prior period financial statements and for adjustments resulting from realization of income tax benefits of pre-acquisition operating loss carry-forwards of purchased subsidiaries.

This statement does not significantly change accounting for adjustments related to prior interim periods of the current fiscal year in expectation that a comprehensive pronouncement on interim financial reporting will be forthcoming.

• *FASB No. 17:* The definition of the term, initial direct costs, as employed in FASB 13 on leases is modified by this statement. Initial direct costs are now to be considered as those costs incurred by the lessor that are directly associated with negotiating and consummating completed leasing transactions. These costs include those that vary either with specific leasing transactions or with the general level of leasing acquired. Initial direct costs may not include a portion of salaries applicable to time spent in negotiating leases that are not consummated. The statement is effective for leasing transactions and lease agreement revisions entered into on or after January 1, 1978.

• *FASB No. 18:* This statement eliminated the requirement to report in interim financial statements information about the enterprise's operations in different industries, its foreign operations and export sales, and its major customers pending completion of the FASB's project on interim financial reporting. FASB No. 18 is effective retroactively to the effective date of FASB No. 14 (December 15, 1976).

• *FASB No. 20:* This pronouncement, designed to clarify the FASB position on two matters relating to forward exchange contracts, is effective prospectively beginning January 1, 1978.

Some users interpreted FASB No. 8 on foreign currency matters as denying deferral of gain or loss on forward exchange contracts that were entered into after the date of an existing foreign currency commitment. According to the FASB, this interpretation had not been intended. Therefore, FASB No. 20 provides a transition period during which an enterprise may enter into a forward contract to hedge a commitment that was entered into before the effective date of FASB No. 8.

In addition, FASB No. 20 specifies that the amount of a forward contract on which gain or loss is deferred may include an amount in excess of the foreign currency commitment sufficient to provide a hedge on an after-tax basis. ■

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