

EXHIBIT C

COMPARATIVE ANALYSIS OF SPECIFIC STANDARDS OF CONDUCT

ORGANIZATION	PROHIBITIONS		
	<u>Obligations from Former Employers</u>	<u>Obligations to Former Employers</u>	<u>Outside Employment or Activities</u>
FASB <sup>1</sup> (Members, Directors and Deputy Directors)	Prohibited except for fixed, vested amounts and annuities <sup>2</sup>	Prohibited <sup>3</sup>	Employment prohibited <sup>4</sup>
FASB <sup>9</sup> (Staff)	No restriction	No restriction	Restricted <sup>10</sup>
U.S. Senate <sup>13</sup> (Senators)	No restriction, but see XLIV 3.(c)(13)	No restriction	Generally prohibited, XLV. Earned income limited to 15% of Senate salary (exceptions) <sup>23</sup> , XLIV
U.S. House of Representatives <sup>14</sup> (Representatives)	No restriction	No restriction	Earned income limited to 15% of House salary (exceptions) <sup>22</sup> XLVII
SEC (Members)	Not specifically prohibited. See 17 C.F.R. 200.735-3	Not specifically prohibited. See 17 C.F.R. 200.735-3	Prohibited, 17 C.F.R. 200.70; 15 U.S.C. 78d(a)
SEC (Staff)	Not specifically prohibited. See 17 C.F.R. 200.735-3	Not specifically prohibited. See 17 C.F.R. 200.735-3	Prohibited if outside activity is incompatible <sup>18</sup> with SEC employment, 17 C.F.R. 200.735-4
CASB (Members and Staff)	Not specifically provided. See 4 C.F.R. 302.35	Not specifically provided. See 4 C.F.R. 302.35	Prohibited if outside activity is incompatible <sup>18</sup> with employment, 4 C.F.R. 302.38
GAO (Employees)	Not specifically provided. See 4 C.F.R. 6.26	Not specifically provided. See 4 C.F.R. 6.26	Prohibited if outside activity is incompatible <sup>18</sup> with employment, 4 C.F.R. 6.30
Federal Judiciary <sup>19</sup> (Judges)	Not specifically prohibited. See 28 U.S.C. 455; Canons 2, 3 and 5. Disqualified if he or former associate served as a lawyer in the matter, 28 U.S.C. 455(b)(2); Canon 3C(1)(b)	Not specifically prohibited. See 28 U.S.C. 455; Canons 2, 3 and 5. Disqualified if he or former associate served as a lawyer in the matter, 28 U.S.C. 455(b)(2); Canon 3C(1)(b)	Prohibited from practicing law, 28 U.S.C. 454, or participating actively in any business, Canon 5C(2)

**ORGANIZATION**

**PROHIBITIONS**

ORGANIZATION	Arrangements for Future Employment Made While Currently Employed		
		Honoraria	Investments
FASB (Members, Directors and Deputy Directors)	Prohibited until notice of resignation has been given <sup>5</sup> ; academic leaves allowed for Directors and Deputy Directors	Prohibited <sup>6</sup>	No specific restriction but subject to general policy against potential conflicts <sup>8</sup>
FASB (Staff)	Two-month notice is preferred; otherwise no restriction	Prohibited <sup>11</sup>	No specific restriction but subject to general policy against potential conflicts <sup>8</sup>
U.S. Senate (Senators)	Disclosure required, XLII 2.(R)	None in excess of \$1,000 for a single appearance, XLIV.2	Not specifically restricted. See XLVI
U.S. House of Representatives (Representatives)	No restriction	None in excess of \$750 for a single appearance, XLVII.2	No restriction
SEC (Members)	Prohibited if Member participates in a matter in which the prospective future employer has a financial interest, 18 U.S.C. 208	Prohibited if appearance is related to the SEC or draws on non-public information, 5 C.F.R. 735.203(c); Ex. Order 11222	Permitted only if for "investment purposes" (held more than one year); other restrictions <sup>15</sup> , 17 C.F.R. 200.735-5
SEC (Staff)	Negotiations prohibited if future employer is party to a matter or chiefly affected by it, 17 C.F.R. 200.735-7(a); undertaking any matter in which the future employer is even indirectly affected also prohibited, 17 C.F.R. 200.735-7(b); 18 U.S.C. 208	Prohibited if appearance draws on non-public SEC information or if part of employee's official duties, 17 C.F.R. 200.735-4	Permitted only if for "investment purposes" (held more than one year); other Restrictions <sup>15</sup> , 17 C.F.R. 200.735-5
CASB (Members and Staff)	Disqualified if prospective future employer has a financial interest in a matter before the Board, 4 C.F.R. 302.35; 18 U.S.C. 208	Prohibited if appearance draws on non-public information; written approval required, 4 C.F.R. 302.38(b), (c)	Disqualified if employee has a financial interest in any matter before the Board, 4 C.F.R. 302.35; 18 U.S.C. 208; prohibited if appears to conflict substantially with Government duties, 4 C.F.R. 302.33
GAO (Employees)	Disqualified if prospective future employer has a financial interest in a matter before the Board, 4 C.F.R. 6.48, 6.49; 18 U.S.C. 208	Prohibited if appearance draws on non-public information; written approval required, 4 C.F.R. 6.31	Disqualified if employee has a financial interest in a matter before the GAO, 4 C.F.R. 6.26; 18 U.S.C. 208; prohibited if appears to conflict substantially with Government duties, 4 C.F.R. 6.24
Federal Judiciary (Judges)	Not specifically prohibited. See 28 U.S.C. 455; Canons 2, 3 and 5	Permitted if no interference with judicial duties and do not exceed reasonable amount; public disclosure required, Canons 5A and 6	Disqualified if he or any member of his family has a financial interest <sup>20</sup> in the proceedings, 28 U.S.C. 455; Canons 3C(1)(c) and 5C

ORGANIZATION	PROHIBITIONS		
	<u>Use of Inside Information</u>	<u>Gifts, Entertainment, etc. from Those Regulated</u>	<u>Appearances by Former Employees of the Organization</u>
FASB (Members, Directors and Deputy Directors)	Prohibited <sup>7</sup>	Not specifically prohibited but subject to general policies against potential conflicts <sup>8</sup>	No restriction
FASB (Staff)	Prohibited <sup>12</sup>	Not specifically prohibited but subject to general policies against potential conflicts <sup>8</sup>	No restriction
U.S. Senate (Senators)	No restriction	Prohibited, XLIII; bribery prohibited, 18 U.S.C. 201	Lobbying prohibited for one year after leaving office, XLV 9.
U.S. House of Representatives (Representatives)	No restriction	Prohibited, XLIII.4.; bribery prohibited, 18 U.S.C. 201	No restriction
SEC (Members)	Prohibited, 17 C.F.R. 200.735-3(a); Ex. Order 11222; 15 U.S.C. 78d(a)	Prohibited (exceptions) <sup>17</sup> 17 C.F.R. 200.735-3(b)(1)	Prohibited if he appears within one year after termination in a matter over which he had "official responsibility" within one year before termination, or if he appears in any matter which he personally considered, 17 C.F.R. 200.735-8; 18 U.S.C. 208
SEC (Staff)	Prohibited, 17 C.F.R. 200.735-3(a); Ex. Order 11222	Prohibited (exceptions) <sup>17</sup> 17 C.F.R. 200.735-3(b)(1)	Prohibited if he appears within one year after termination in a matter over which he had "official responsibility" within one year before termination, or if he appears in any matter which he personally considered, 17 C.F.R. 200.735-8; 18 U.S.C. 208
CASB (Members and Staff)	Prohibited, 4 C.F.R. 302.32	Prohibited (exceptions) <sup>17</sup> 4 C.F.R. 302.24	Prohibited if he appears within one year after termination in a matter over which he had "official responsibility" within one year before termination, or if he appears in any matter which he personally considered, 4 C.F.R. 302.61; 18 U.S.C. 208
GAO (Employees)	Prohibited, 4 C.F.R. 6.23, 6.24(b)	Prohibited (exceptions) <sup>17</sup> 4 C.F.R. 6.15, 6.16, 6.19	Prohibited if he appears within one year after termination in a matter over which he had "official responsibility" within one year before termination, or if he appears in any matter which he personally considered, 4 C.F.R. 6.48, 6.49; 18 U.S.C. 208
Federal Judiciary (Judges)	Prohibited, Canon 5C(7)	Prohibited (exceptions) <sup>21</sup> Canon 5C(4)	No restriction

**ORGANIZATION****PROCEDURES**

	<u>Annual Questionnaire</u>	<u>Specific Body to Advise on Conduct</u>
FASB (Members, Directors and Deputy Directors)	Provided	Provided
FASB (Staff)	Provided; no disclosure of financial information required.	Provided
U.S. Senate (Senators)	Provided, XLIV	Provided, XLIV.2
U.S. House of Representatives (Representatives)	Provided, XLIV	Provided, XLIV
SEC (Members)	Provided, Ex. Order 11222	Provided, 17 C.F.R. 200.735-15
SEC (Staff)	Provided, 17 C.F.R. 200.735-11	Provided, 17 C.F.R. 200.735-15
CASB (Members and Staff)	Provided, 4 C.F.R. 302.72	Provided, 4 C.F.R. 302.3
GAO (Employees)	Provided, 4 C.F.R. 6.50-6.64	Provided, 4 C.F.R. 6.53
Federal Judiciary (Judges)	Not Provided	Not Provided

## NOTES

1. Members, Directors and deputy directors are governed by the rules set out in "Policies in Respect of Investments, Personal Activities, Speeches and Publications of Members, Directors and Deputy Directors of the Financial Accounting Standards Board (As amended December 21, 1976)."
2. The rule states that "no financial or other obligations shall be owed, directly or indirectly, to such Member or Director by any former employer, business partnership or client." Exceptions are made for normal banking relationships, limited partnerships, and holdings in government or publicly traded securities. No retirement or deferred benefits may be paid except fixed, vested amounts or annuities not materially affected by the prospects of the business.
3. The rule states that "no Member or Director shall have any financial or other obligations to any former employer, business relationship or client." Obligations such as normal banking relationships and covenants not to divulge trade secrets are excepted.
4. Members and Directors may be affiliated with non-profit organizations and may serve as directors or officers of family or personal investment holding companies, as executors, administrators, guardians, trustees of inter vivos or testamentary trusts, custodians for minors and in similar representative capacities, provided that such activities do not interfere materially with their devoting their full business time to the FASB and do not affect their independence or objectivity.
5. The rule states that "no Member or Director shall have any formal or informal agreement, arrangement or understanding with any person to the effect that after termination of his employment relationship with the Foundation or the Standards Board he can or will return to, or become affiliated with, an employer or business partnership, or resume or enter into consulting or other similar arrangements; *provided, however,* that, in the case of a Director, this subparagraph . . . shall not prohibit a leave of absence of an academician with or without tenure from an educational institution; . . . ."
6. The rule states, "Members and Directors may accept reimbursement for out-of-pocket expenses incurred in connection with any such speech or writing, but any fees, honorariums or other payments in connection therewith shall be remitted or paid over to the Foundation."
7. The rule states, "Members and Directors shall not, directly or indirectly, use or otherwise place themselves in a situation to benefit personally from, or, directly or indirectly, disclose or make available to others (other than as required by their employment and duties), any information which might be regarded as material relating to the functions or activities of the Foundation or the Standards Board obtained in the course of their employment and which has not been released or announced or otherwise made available publicly."
8. Both sets of rules provide that each member, director, deputy director, and staff member "should take great care to conduct himself and all his activities in such a manner so that [they] will not affect his independence or objectivity or be detrimental to the interests or repute of the Foundation or the Standards Board."
9. Staff members are governed by Internal Policy Bulletin, File Ref. 1.07, "Policies in Respect of Personal Activities, Speeches and Publications of Members of the Staff of the Financial Accounting Standards Board" (April 1976).

10. The rule states, "Each member of the staff is expected to devote his full business time to the activities of the Standards Board, and shall not engage in any outside activity which interferes with the performance of his duties to the Standards Board, or which in any way may be, or appear to be in conflict with the staff member's responsibilities to the Standards Board. Each member of the staff is urged to consult with the Chairman of the Standards Board at the earliest possible time if he feels that he is involved in an outside activity which might conflict with his responsibilities to the Standards Board."
11. The rule states, "Staff members may accept reimbursement for out-of-pocket expenses incurred in connection with any such speech or writing, but any fees, honorariums or other payments in connection therewith shall be remitted or paid over to the Foundation."
12. The rule states, "Members of the staff shall not, directly or indirectly, use or otherwise place themselves in a situation to benefit personally from, or, directly or indirectly, disclose or make available to others (other than as required by their employment and duties), any information which might be regarded as material relating to the functions or activities of the Foundation or the Standards Board obtained in the course of their employment and which has not been released or announced or otherwise made available publicly."
13. Citations are to Standing Rules of the Senate set out in the Senate Manual, 95th Cong.
14. Citations are to Rules of the House of Representatives set out in Jefferson's Manual and Rules of the House of Representatives, 95th Cong.
15. No member or employee of the SEC may effect transactions in commodity futures; margin accounts; short sales; securities of an issuer who has had any registration statement declared effective within 60 days or which is pending; securities of any registered public utility holding company, investment company, broker, dealer or investment adviser; or securities which are involved in any investigation.
16. Incompatible activities include employment or association with any registered broker, dealer, public utility holding company, investment company or investment adviser, work in which any government may be significantly interested, employment which creates, or appears to create, a conflict of interest, and employment which impairs any employee's ability.
17. Exceptions to the general prohibition apply when an obvious family relationship motivates the gift; when food and refreshments are offered in the course of a proper conference or tour; when promotional material such as pens, notepads and other items of nominal value are offered; or when the Commission makes an exception.
18. Incompatible activities include those which may result in, or create the appearance of, a conflict of interest and those which impair the employee's ability.
19. Citations are to the U. S. Code and the Code of Judicial Conduct adopted by the American Bar Association.
20. "Financial interest" means ownership of a legal or equitable interest, however small, or active participation in the affairs of a party. Excepted are ownership in a mutual fund, provided the judge does not participate in management; ownership by holding policies of a mutual insurance company, deposits in a mutual savings association and holdings of government securities, provided the outcome of the proceedings do not substantially affect the value of the interest; and offices in educational, religious, charitable, fraternal or civic organizations.

21. The prohibition applies to judges and members of his family residing in his household. Exceptions are made for gifts incident to public testimonials, books supplied by publishers, invitations to bar-related functions, ordinary social hospitality, gifts from relatives, wedding or engagement gifts, loans from lending institutions made in the regular course of business, scholarships and fellowships. Other gifts, etc. are permitted from those whose interests have not come and are not likely to come before the judge, but any gift over \$100 must be disclosed publicly.
22. "Earned income" does not include pensions, profit-sharing or stock bonus plans or amounts not "significant" received from family-controlled businesses.
23. Exclusions from "outside earned income" include book royalties, income from family businesses and partnerships (provided Senators' services are not materially income producing), gains from dealing in property or investments, interest, rents, dividends, alimony, annuities and buy-out arrangements not related to future profitability of the enterprise.

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The FAF's Trustees have recently directed its Committee on Personnel Policies to review existing Personnel Policies. In particular, the Trustees have charged the Committee to consider a requirement that FASB members and staff directors schedule all investments, even immaterial ones; specific limitations on certain securities transactions and receipt of gifts from non-family members; and adoption of a more general rule with respect to potential conflicts of interest. The Committee is expected to make its recommendations at a meeting of the FAF Trustees later this spring.

## THE RECORD OF THE FASB AND THE ACCOUNTING PROFESSION IN SETTING ACCOUNTING STANDARDS

### I. Introduction

Since its formation in 1973, the FASB has issued:

- 14 Statements of Financial Accounting Standards;
- 18 Interpretations of FASB Statements, APB Opinions and Accounting Research Bulletins;
- 20 Exposure Drafts; and
- 13 Discussion Memoranda analyzing significant issues, soliciting written comments and serving as bases for public hearings, including in December 1976 its second Discussion Memorandum on a *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement* and its *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises*.

In addition, the FASB has not yet taken final action on one Exposure Draft of a proposed Statement of Financial Accounting Standards. Public hearings have been announced on two projects (Conceptual Framework and Accounting for Business Combinations and Purchased Intangibles), and public hearings on the FASB's Extractive Industries Project were held on March 30-April 1 and on April 4, 1977. Additionally, the FASB has other technical projects on its agenda.

The Study asserts that the FASB's output has not improved financial accounting and reporting. As examples, the Study claims that the FASB and its standard-setting predecessors have not dealt with the significant accounting issues, have not eliminated alternative accounting practices, have not developed objectives of financial statements or a conceptual framework within which all accounting standards may be established, and have protected the prerogatives of "special interest groups."\*

This Exhibit examines the record in relation to these charges.

### II. Table of Statements, Interpretations and Discussion Memoranda Issued and Public Hearings Held by the FASB and Current Projects

#### *Statements of Financial Accounting Standards*

- No. 1 —Disclosure of Foreign Currency Translation Information—Issued December 1973
- No. 2 —Accounting for Research and Development Costs—Issued October 1974
- No. 3 —Reporting Accounting Changes in Interim Financial Statements—An Amendment of APB Opinion No. 28—Issued December 1974
- No. 4 —Reporting Gains and Losses from Extinguishment of Debt—An Amendment of APB Opinion No. 30—Issued March 1975
- No. 5 —Accounting for Contingencies—Issued March 1975

\* See also Exhibit B as to the independence and objectivity of the FASB as evidenced by the analysis of responses to its most significant accounting proposals.



- No. 6 —Classification of Short-Term Obligations Expected to Be Refinanced—An Amendment of ARB No. 43, Chapter 3A—Issued May 1975
- No. 7 —Accounting and Reporting by Development Stage Enterprises—Issued June 1975
- No. 8 —Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements—Issued October 1975
- No. 9 —Accounting for Income Taxes—Oil and Gas Producing Companies—An Amendment of APB Opinions No. 11 and 23—Issued October 1975
- No. 10 —Extension of “Grandfather” Provisions for Business Combinations—An Amendment of APB Opinion No. 16—Issued October 1975
- No. 11 —Accounting for Contingencies—Transition Method—An Amendment of FASB Statement No. 5—Issued December 1975
- No. 12 —Accounting for Certain Marketable Securities—Issued December 1975
- No. 13 —Accounting for Leases—Issued November 1976
- No. 14 —Financial Reporting for Segments of a Business Enterprise—Issued December 1976

### *Interpretations*

- No. 1 —Accounting Changes Related to the Cost of Inventory (APB Opinion No. 20)—Issued June 1974
- No. 2 —Imputing Interest on Debt Arrangements Made under the Federal Bankruptcy Act (APB Opinion No. 21)—Issued June 1974
- No. 3 —Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974 (APB Opinion No. 8)—Issued December 1974
- No. 4 —Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method—Issued February 1975
- No. 5 —Applicability of FASB Statement No. 2 to Development Stage Enterprises—Issued February 1975
- No. 6 —Applicability of FASB Statement No. 2 to Computer Software—Issued February 1975
- No. 7 —Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises—Issued October 1975
- No. 8 —Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security (FASB Statement No. 6)—Issued January 1976
- No. 9 —Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method—Issued February 1976
- No. 10 —Application of FASB Statement No. 12 to Personal Financial Statements—Issued September 1976
- No. 11 —Changes in Market Value after the Balance Sheet Date (FASB Statement No. 12)—Issued September 1976
- No. 12 —Accounting for Previously Established Allowance Accounts (FASB Statement No. 12)—Issued September 1976
- No. 13 —Consolidation of a Parent and Its Subsidiaries Having Different Balance Sheet Dates (FASB Statement No. 12)—Issued September 1976
- No. 14 —Reasonable Estimation of the Amount of a Loss (FASB Statement No. 5)—Issued September 1976
- No. 15 —Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company (FASB Statement No. 8)—Issued September 1976

- No. 16 —Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable (FASB Statement No. 12)—Issued February 1977
- No. 17 —Applying the Lower of Cost or Market Rule in Translated Financial Statements (FASB Statement No. 8)—Issued February 1977
- No. 18 —Accounting for Income Taxes in Interim Periods (APB Opinion No. 28)—Issued March 1977

*Discussion Memoranda*

- An Analysis of Issues Related to Accounting for Research and Development and Similar Costs—Issued December 28, 1973
- An Analysis of Issues Related to Reporting the Effects of General Price-Level Changes in Financial Statements—Issued February 15, 1974
- An Analysis of Issues Related to Accounting for Foreign Currency Translation—Issued February 21, 1974
- An Analysis of Issues Related to Accounting for Future Losses—Issued March 13, 1974
- An Analysis of Issues Related to Financial Reporting for Segments of a Business Enterprise—Issued May 22, 1974
- Conceptual Framework for Accounting and Reporting: Consideration of the Report of the Study Group on the Objectives of Financial Statements—Issued June 6, 1974
- An Analysis of Issues Related to Accounting for Leases—Issued July 2, 1974
- An Analysis of Issues Related to Criteria for Determining Materiality—Issued March 21, 1975
- An Analysis of Issues Related to Accounting and Reporting for Employee Benefit Plans—Issued October 6, 1975
- Accounting by Debtors and Creditors When Debt is Restructured—Issued May 11, 1976
- An Analysis of Issues Related to Accounting for Business Combinations and Purchased Intangibles—Issued August 19, 1976
- An Analysis of Issues Related to Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement—Issued December 2, 1976
- An Analysis of Issues Related to Financial Accounting and Reporting in the Extractive Industries—Issued December 23, 1976

*Public Hearings*

<u>Subject</u>	<u>Dates</u>	<u>Number of Oral Presentations</u>
Accounting for Research and Development and Similar Costs .....	March 15, 1974	14
Reporting the Effects of General Price-Level Changes in Financial Statements .....	April 23-24, 1974	23
Accounting for Contingencies .....	May 13, 1974	19
Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements .....	June 10-11, 1974	15
Financial Reporting for Segments of a Business Enterprise .....	August 1-2, 1974	21

<u>Subject</u>	<u>Dates</u>	<u>Number of Oral Presentations</u>
Conceptual Framework for Financial Accounting and Reporting.....	September 23-24, 1974	21
Accounting for Leases .....	November 18-21, 1974	32
Accounting for Income Taxes—Oil and Gas Producing Companies .....	September 10-11, 1975	27
Accounting for Certain Marketable Securities .	December 8, 1975	20
Restructuring of a Debt in a Troubled Loan Situation .....	December 12, 1975	5
Accounting and Reporting for Employee Benefit Plans.....	February 4-5, 1976	23
Criteria for Determining Materiality .....	May 20-21, 1976	16
Accounting by Debtors and Creditors When Debt is Restructured.....	July 27-30, 1976	37
Prior Period Adjustments.....	October 15, 1976	10
Financial Accounting and Reporting in the Extractive Industries .....	March 30-31 and April 1 and 4, 1977	39
	Total .....	322

### *Current Projects*

#### Exposure Draft of Proposed Statement of Financial Accounting Standards

Accounting by Debtors and Creditors for Troubled Debt Restructurings—Issued December 30, 1976

#### Other Technical Projects

Accounting for the Cost of Pension Plans

Accounting and Reporting for Employee Benefit Plans

Interim Financial Reporting

Reporting Redeemable Preferred Stock and Long-Term Debt

Accounting for Interest Costs

Accounting for Business Combinations and Purchased Intangibles

Criteria for Determining Materiality

Accounting and Reporting in the Extractive Industries

Conceptual Framework for Financial Accounting and Reporting

### **III. Summary of Work of the FASB**

#### ***A. Statements of Financial Accounting Standards***

Certain of the FASB's Statements have dealt with broad, pervasive accounting questions long in need of resolution, such as:

- Accounting for Research and Development Costs. (FASB Statement No. 2)
- Accounting for Contingencies. (FASB Statement No. 5)

- Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements. (FASB Statement No. 8)
- Accounting for Leases. (FASB Statement No. 13)

Other Statements have also addressed and resolved long-standing issues (although their application may not be as pervasive as the Statements listed above), including:

- Accounting and Reporting by Development Stage Enterprises. (FASB Statement No. 7)
- Financial Reporting for Segments of a Business Enterprise. (FASB Statement No. 14)

Still other FASB Statements have been issued in response to emerging problems perceived as urgently in need of solution:

- Reporting Accounting Changes in Interim Financial Statements. (FASB Statement No. 3)
- Reporting Gains and Losses from Extinguishment of Debt. (FASB Statement No. 4)
- Classification of Short-Term Obligations Expected to Be Refinanced. (FASB Statement No. 6)
- Accounting for Income Taxes—Oil and Gas Producing Companies. (FASB Statement No. 9)
- Accounting for Certain Marketable Securities. (FASB Statement No. 12)

Set forth below is a summary discussion of these FASB Statements of Financial Accounting Standards, prepared by the FASB technical staff, indicating the contribution of each to improving financial accounting and reporting, and the extent to which alternative accounting practices have been eliminated.\*

*Statement No. 2—“Accounting for Research and Development Costs.” October 1974.* This Statement established standards of financial accounting and reporting for research and development costs and eliminated alternative accounting practices for such costs by requiring that they be charged to expense when incurred unless related to an item with an alternative future use. Prior to the issuance of the Statement, at least four alternative methods of accounting for research and development costs existed, including (a) capitalizing all costs when incurred, (b) capitalizing some costs when incurred and charging other costs to expense, (c) deferring all costs until the existence of future benefits can be determined at which time costs without future benefits are charged to expense, and (d) charging all costs to expense when incurred.

Statement No. 2 also sets forth guidelines specifying activities that should be identified as research and development and the elements of costs that should be identified with such activities—matters that were previously undefined by the authoritative accounting literature.

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\* Discussion of Statements Nos. 1, 10 and 11 was omitted because: Statement No. 1 was superseded by Statement No. 8; Statement No. 10 simply extends the grandfather provisions of APB Opinion No. 16—“Business Combinations” until the Board completes its current project on business combinations and purchased intangibles; and Statement No. 11 only amends the transition method in Statement No. 5.

*Statement No. 3—“Reporting Accounting Changes in Interim Financial Statements.” December 1974.* Prior to the issuance of this Statement, management making an accounting change in other than the first interim period of an enterprise’s fiscal year (e.g. during the second, third or fourth quarter of the fiscal year) included in net income for the period the cumulative effect of the change. In general, the cumulative effect of the change in accounting method is the difference between net income (a) as reported using the old method of accounting, and (b) computed as if the newly adopted method were used in all prior years.

Statement No. 3 requires that the cumulative effect of the change be included in net income of the first interim period of the year of change. Further, the effect of the change on the current year must be recorded in the pre-change interim periods by applying the newly adopted accounting principle to those pre-change interim periods. The result was to eliminate the option of choosing the interim period in which a change would be made and then including the cumulative effect of the change entirely in net income for that interim period.

*Statement No. 4—“Reporting Gains and Losses from Extinguishment of Debt.” March 1975.* Prior to the issuance of Statement No. 4, gains and losses from the early repayment of debt were included in ordinary income with little or no separate disclosure of the details of the transaction or the related income tax effects.

Statement No. 4 requires that the aggregate of gains and losses from extinguishment of debt, if material, be shown separately on the face of the income statement as an extraordinary item net of the income tax effect. It also requires that the transaction be described and that the income tax effect and the per share amount of the aggregate gain or loss be shown, either on the face of the income statement or in a note to the financial statements. Thus, Statement No. 4 improved the ability of users of financial statements to determine the components of a company’s earnings.

*Statement No. 5—“Accounting for Contingencies.” March 1975.* This Statement eliminated the diversity in practice as to when an enterprise must record a loss from a loss contingency. Prior to this Statement, some enterprises accrued estimated losses from contingencies by a charge to income prior to the occurrence of a loss, while under similar circumstances other enterprises accounted for the losses only when they actually occurred.

Statement No. 5 defines a contingency as an existing condition, situation or set of circumstances involving uncertainty as to possible gain or loss that will be resolved when one or more future events occurs or fails to occur and permits accruals for loss from a loss contingency only when it is probable that an asset has been impaired or a liability has been incurred at the date of the balance sheet and the amount of the loss can be reasonably estimated.

Statement No. 5 also prohibits reserves for general contingencies or unspecified business risks or for losses that have not occurred. Prior to the issuance of Statement No. 5, reserves for a variety of contingencies were permitted, including self-insurance reserves, reserves against general losses, reserves on foreign exchange transactions, catastrophe loss reserves of casualty insurers, and reserves for future repairs, plant conversions, blast furnace relining, future losses on investments, future costs of work force reductions, and the like. The accumulation of these reserves by discretionary charges to operations, often over a number of years, and the charging of significant or recurring losses against these reserves had the effect of reducing fluctuations in earnings (often called “smoothing”).

In connection with the Study's contention that the FASB often bows to pressure from "big business", it should be noted that the FASB was and continues to be criticized within the business community over the adoption of Statement No. 5.

*Statement No. 6—"Classification of Short-Term Obligations Expected to Be Refinanced." May 1975.* Statement No. 6 conformed the various practices with respect to the balance sheet classification of short-term obligations that are expected to be refinanced. The Statement provides criteria that must be met for a short-term obligation to be excluded from current liabilities. Short-term obligations may be excluded from current liabilities only if the enterprise intends to refinance the obligation on a long-term basis *and* has the ability to consummate such a refinancing. The Statement specifies the ways that an enterprise may demonstrate its ability to consummate a refinancing.

Prior to Statement No. 6, because existing authoritative literature did not provide definitive criteria, short-term obligations expected to be refinanced were presented in balance sheets in a number of ways, including: a) classification as current liabilities, b) classification as long-term liabilities, and c) presentation as a class of liabilities distinct from both current liabilities and long-term liabilities.

*Statement No. 7—"Accounting and Reporting by Development Stage Enterprises." June 1975.* Statement No. 7 applies to companies devoting substantially all of their efforts to establishing a new business and not yet commencing substantial operations and requires them to follow generally accepted accounting principles applicable to established operating enterprises.

Prior to the issuance of Statement No. 7, many development stage enterprises had adopted special accounting and reporting practices, including special forms of financial statement presentation or types of disclosure. Special accounting practices included (a) deferring all costs without regard to the possibility of recovering them, (b) offsetting revenue against deferred costs, and (c) not assigning dollar amounts to shares of stock issued for consideration other than cash. Special reporting formats included statements of (a) assets and unrecovered pre-operating costs, (b) liabilities, (c) capital shares, and (d) cash receipts and disbursements. Before eliminating these alternatives, the FASB investigated the potential economic effects of such action. The Board was advised that conforming development stage accounting to accounting principles applicable to established operating enterprises was unlikely to have a significant adverse effect on the ability of development stage enterprises to obtain capital.

*Statement No. 8—"Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements." October 1975.* This Statement continues to be one of the FASB's most controversial Statements, eliciting strong criticism from business.

Statement No. 8 specifies the method for translating foreign currency transactions and foreign currency financial statements. It requires that exchange gains or losses resulting from application of that method must be included in net income currently (except for exchange gains or losses relating to the hedge of an identifiable foreign currency commitment, which gains or losses are deferred and included in the dollar basis of the related foreign currency transaction). It eliminated all alternative methods of accounting and reporting for foreign currency transactions and for translating foreign currency financial statements incorporated in the financial statements of a domestic enterprise. To incorporate foreign currency transactions and foreign currency financial statements in its own financial statements, an enterprise must translate (i.e. express in its reporting currency—generally the U.S. dollar for U.S. companies) all assets, liabilities, revenues, or expenses that are measured or denominated in foreign currency.

Prior to Statement No. 8, a wide variety of methods of translating foreign currency had evolved and a variety of methods of determining and accounting for exchange gains and losses existed in practice. In addition to those divergent practices, international business activities of U.S. companies had expanded rapidly after the publication of the basic accounting pronouncements in this area, and the international monetary system had undergone significant changes, including U.S. dollar devaluations in 1971 and 1973 and the switch from fixed to floating rates in most foreign exchange markets.

*Statement No. 9—“Accounting for Income Taxes—Oil and Gas Producing Companies.” October 1975.* Statement No. 9 was issued to provide new accounting standards required as a result of the passage by Congress of the Tax Reform Act of 1975 (the “Act”). Among other things, the Act substantially reduced or eliminated percentage depletion as a federal income tax deduction for many oil and gas producing companies as of January 1, 1975. APB Opinions issued prior to the Act had not required the recording of deferred income taxes for intangible development costs that oil and gas producing companies capitalized for financial reporting and expensed for Federal income tax reporting, because percentage depletion over the life of oil and gas properties was generally expected to exceed the amount of costs capitalized and amortized in the financial statements (sometimes referred to as “interaction”). Prior to Statement No. 9, some oil and gas producing companies had recorded deferred taxes applicable to intangible development costs but most had not.

Statement No. 9 requires that commencing January 1, 1975 all enterprises must record deferred income taxes for intangible development costs and other costs of exploration for, and development of, oil and gas reserves entering into the determination of financial accounting income and taxable income in different periods. Oil and gas producing companies that the Act still permits to deduct statutory depletion for income tax reporting and that have statutory depletion in excess of cost depletion may elect to recognize that excess statutory depletion in the computation of the amount of deferred taxes to be recorded. The Statement permits oil and gas producing companies to adopt interperiod tax allocation retroactively for intangible development costs without recognizing interaction with percentage depletion.

*Statement No. 12—“Accounting for Certain Marketable Securities.” December 1975.* This Statement also continues to be highly controversial. The Statement requires that both current and non-current equity security portfolios be valued at and shown in the financial statements of an enterprise at the lower of cost or market value, with the difference between cost and market value being shown as a reduction of income for current portfolios and as a reduction of stockholders’ equity for non-current portfolios.

Prior to the issuance of Statement No. 12 and in accordance with then existing accounting requirements, many companies reported marketable securities at cost, with disclosure of market value, even though market value was less than cost. A significant decline in the market prices of equity securities occurred during the recession of 1973-1975.

Certain specialized industries (e.g., insurance companies, broker-dealers, and investment companies) are exempt from the lower of cost or market requirement of Statement No. 12, because companies in those industries report marketable securities at current market value, whether above or below cost, under specialized industry accounting practices.

*Statement No. 13—“Accounting for Leases.” November 1976.* This Statement eliminates inconsistencies in lease accounting practices and provides specific and objective

criteria for determining when a lease is a capital lease (which must be accounted for as if the lessee purchased an asset and incurred a liability), and when a lease is an operating lease (which does not result in the recording of an asset and liability).

The Statement provides standards of financial accounting and reporting for leases that are consistent for both lessees and lessors and also eliminates alternative methods of accounting for leveraged leases and all alternative definitions of what constitutes a leveraged lease.

Over the years the Accounting Principles Board had issued several Opinions and the SEC had issued several Accounting Series Releases as to accounting by lessees and lessors. Despite these Opinions and Releases, criteria were stated in broad terms so that similar transactions sometimes were accounted for differently. In addition, the same lease was often accounted for differently (i.e., capital vs. operating) by the lessor and the lessee. Moreover, a variety of accounting practices had developed with respect to leveraged leases, a comparatively recent method of financing but one of growing significance.

Statement No. 13 provides standards applicable to substantially all leasing transactions. It is based on the premise that a lease which transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. Criteria are specified for determining whether substantially all benefits and risks incident to ownership have been transferred. Special provisions apply to leases of land, sales and leasebacks, related party leases, subleases and leveraged leases.

This Statement has received a great deal of attention, even though it has only been issued recently. For example, the Interstate Commerce Commission and the Civil Aeronautics Board have already announced that they will adopt it in its entirety for purposes of carriers and air carriers subject to their respective jurisdictions.

*Statement No. 14—“Financial Reporting for Segments of a Business Enterprise.”* December 1976. Statement No. 14 requires that an enterprise report specified financial information including revenues, profitability, assets, depreciation and capital expenditures for each significant segment of its business. A segment is regarded as significant if its sales, operating profit, or identifiable assets are 10% or more of the related combined amounts for all a company's industry segments. Information similar to that required for industry segments also is required for a company's operations in different geographic areas of the world, as is certain information as to sales to major customers. The Statement also provides guidelines as to the manner in which such information is to be derived and presented.

Prior to Statement No. 14, authoritative accounting literature did not require comprehensive reporting of segment information in an enterprise's financial statements, although existing pronouncements required disclosures related to an enterprise's foreign operations, information concerning companies accounted for by the equity method, and information as to discontinued operations of a segment of a business. Information as to sales and profits by lines of business was required by the SEC in certain of its filings, but because this information was not a part of the financial statements, it was not required to be assembled in any particular way.

Statement No. 14 is significant in terms of the Study in that it demonstrates that the FASB not only can, but will, require more than a Federal agency when the Board views this to be in the public interest.



## ***B. Interpretations***

FASB Interpretations are issued to explain, clarify or elaborate on FASB Statements of Financial Accounting Standards and the pronouncements of its predecessors. The Interpretations eliminate or severely restrict differing applications of the related accounting standards or practices.

For example, FASB Interpretation No. 1 interpreted the criteria in APB Opinion No. 20 to require that an accounting change must be justified on the basis that the new accounting method is preferable and will constitute an improvement in financial reporting; tax savings alone are not adequate justification for an accounting change.

Another example is FASB Interpretation No. 3, which the Board issued shortly after passage of the Employee Retirement Income Security Act of 1974 (ERISA). The Board interpreted APB Opinion No. 8 so that any change in pension cost resulting from compliance with the new Act would be recorded when the plan became subject to the Act's participation, vesting and funding requirements.

In a case involving the application of APB Opinions No. 16 and 17, the Board found that two methods were being used to record certain acquisitions. FASB Interpretation No. 9 rejected the use of one method before its use became widely accepted, thereby eliminating an alternative practice.

The FASB's most recent interpretation, No. 18, "Accounting for Income Taxes in Interim Periods", also demonstrates the Board's willingness to eliminate differences in accounting for similar situations. Interpretation No. 18 describes the general computation of interim period income taxes and its application in specific complex situations.

## ***C. Summary of Significant Current Projects***

### **1. Conceptual Framework and Objectives**

A recurring theme of the Study is that the accounting profession and more recently the FASB have failed to prescribe a clear set of objectives and a conceptual framework within which further improvements in financial accounting and reporting can occur. These charges do not take into account the substantial progress that the Board has made, particularly in the past year.

The history of the accounting profession's efforts to establish a more logical conceptual basis for its principles and standards includes (a) two important studies prior to the establishment of the FASB and (b) the major program that the Board currently has well under way. APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," was issued by the Accounting Principles Board in October 1970 following work extending over a five-year period. In that Statement, the APB (i) discussed the nature of financial accounting, the environmental forces influencing it, and the potential and limitations of accounting in providing useful information, (ii) suggested objectives of financial accounting and financial statements, (iii) discussed the basic elements of financial accounting, (iv) emphasized the dynamic nature of accounting, and (v) set forth proposals for future changes. The heart of APB Statement No. 4 was a description of those accounting principles that were generally accepted at the time. The "Statement" was not an "Opinion" of the APB, however, so members of the profession were not obligated to call attention to departures from it.

In 1971 the Board of Directors of the AICPA constituted a special study group to hold hearings and to investigate thoroughly the objectives of financial statements. This Study Group, chaired by the late Robert Trueblood, issued its report, "Objectives of Financial Statements" (often referred to as the Trueblood Report), in October 1973. The Trueblood Report was in the nature of a research study with recommendations and was to provide a basis for the FASB's further consideration of objectives.

Before the Trueblood Report was issued, the FASB was established. On April 1, 1973 the Board placed on its initial technical agenda a comprehensive project to identify the objectives of financial statements and provide a conceptual framework for financial accounting. This project was to build on the Trueblood Report and on APB Statement No. 4. In June 1974, the FASB issued a Discussion Memorandum on the objectives of financial statements and in September 1974 held public hearings on this subject. In December 1976, the Board published its *Tentative Conclusions on the Objectives of Financial Statements of Business Enterprises* and issued an additional Discussion Memorandum entitled *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*. Public hearings have been scheduled for June 1977.

At the time the Board issued its second Discussion Memorandum in December 1976, it also issued a document entitled *Scope and Implications of the Conceptual Framework Project*, a non-technical summary of the other two 1976 publications and their significance. A brief review of this simplified summary indicates the enormous complexity of the subject. For example, the summary describes a conceptual framework as a constitution to provide "a coherent system of interrelated objectives and fundamentals that can lead to consistent standards"; it characterizes objectives as identifying the goals and purposes of accounting, and fundamentals as the underlying concepts that guide the events to be accounted for, their measurement and the means of summarizing and communicating them to users. The summary states that the project is expected to lead to FASB pronouncements involving (i) objectives of financial statements, (ii) qualitative characteristics of financial statement information (e.g. relevance, objectivity and comparability), (iii) basic elements (e.g. what is an asset, a liability, revenue, expense; should earnings be defined in terms of changes in assets and liabilities or should assets and liabilities be determined only after revenue, expenses and earnings have been defined?), (iv) bases of measurement (e.g. historical cost, replacement cost, current selling price and present values of future cash flows), and (v) units of measure (e.g. current dollars or dollars adjusted for changes in general purchasing power). These issues are extremely complex and require logical, objective and thorough analysis by the most competent professionals available. Work on this critical project is continuing as a matter of priority.

## **2. Extractive Industries: PL 94-163**

The Board also is engaged currently in a project related to Section 503 of the "Energy Policy and Conservation Act" enacted in 1975 (Public Law 94-163). In that Section, Congress empowered the SEC either to prescribe accounting rules applicable to persons engaged in the production of crude oil or natural gas or to recognize accounting practices developed by the Financial Accounting Standards Board if the SEC is assured that such practices will be observed to the same extent as if the SEC had prescribed the practices by rule.

In December 1976, the FASB issued its Discussion Memorandum, *Financial Accounting and Reporting in the Extractive Industries*. This project is broader than the concern of the "Energy Policy and Conservation Act" with oil and gas producers in that the FASB is

considering the accounting and reporting issues applicable to companies engaged in other extractive industries. In addition, the Discussion Memorandum presents issues and seeks public comment relevant to the financial information needed for the energy data base specified by the Act. At the request of the SEC, the FASB also included in its Discussion Memorandum a series of issues developed by the SEC in connection with its responsibilities under the Act, and the FASB expects to issue a Statement of Financial Accounting Standards prior to the end of 1977 on which the SEC may rely. Representatives of the SEC, the Federal Energy Administration, the General Accounting Office, the Cost Accounting Standards Board and the Federal Power Commission, as well as one committee of the Congress, have observed the activities of the FASB's task force on this project. Public hearings were held on March 30-April 1 and on April 4, 1977. Apart from the national significance of accounting and energy data compilation in respect of oil and gas producers, the issues involved in this project have been debated for years, and the FASB regards this project as not only one of priority, but one of the most difficult it has faced.

### **3. Other Significant Projects**

Of the other projects on the Board's current technical agenda, several are also matters of priority and of great significance in the improvement of financial accounting and reporting.

For example, a project receiving national attention is the Board's project on *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. This project has evolved because of the many loan restructurings involving the nation's financial institutions. The significant increase in restructurings resulted from the economic recession and inflation affecting the economy in recent years and the attempts by the City of New York to resolve its financial difficulties through moratoriums on the payment of its maturing debt and through exchange offers by the Municipal Assistance Corporation.

The Board issued an Exposure Draft relating to accounting by debtors in such circumstances in November 1975, and held hearings in December of that year. It became clear at this stage of the project that accounting by creditors should also be encompassed within the scope of the project, and, accordingly, the Board appointed a task force and issued a Discussion Memorandum in May 1976. The Board received nearly 900 written responses to its Discussion Memorandum, and heard 37 oral presentations at four days of public hearings in July. In December 1976, the Board issued an Exposure Draft covering accounting by both debtors and creditors for troubled debt restructurings. The public comment period on this Exposure Draft ended on March 10, 1977. The Board expects to issue a final Statement towards the middle of this year.

While the FASB acted promptly in 1974 to issue an Interpretation to prevent divergent practices from developing following enactment of the Employee Retirement Income Security Act of 1974, the significance of this legislation caused the FASB to add two related major projects to its technical agenda—*Accounting for the Cost of Pension Plans* and *Accounting and Reporting for Employee Benefit Plans*. The Board issued a comprehensive Discussion Memorandum on the latter project in October 1975 and held public hearings in February 1976. The staff is currently developing a proposed Statement for exposure and public comment within the next few months.

### **4. Summary of Work of the Accounting Principles Board**

The Accounting Principles Board, the FASB's predecessor standard-setting body, made significant contributions to financial accounting and reporting in its 31 Opinions and 4 Statements by reducing alternatives in some very significant areas. A table listing the

Opinions and Statements is set forth at the end of this section. Set forth below is a summary discussion of certain of the more significant APB Opinions and their contribution to improved accounting and reporting.\*

*APB Opinion No. 8—“Accounting for the Cost of Pension Plans.” November 1966.* This Opinion made a significant contribution to accounting literature in view of the increasing significance of pension cost in relation to the financial position and results of operations of many businesses. This Opinion establishes the basic accounting method for pension plans, acceptable actuarial cost methods and the accounting for actuarial gains and losses. The Opinion requires that pension costs be accrued during the period of employment and prohibits accounting for pensions on a pay-as-you-go basis.

In light of the enactment of the ERISA legislation, the FASB is currently reassessing accounting for pension costs and is considering accounting for employee benefit plans.

*APB Opinion No. 9—“Reporting the Results of Operations,” Part I—“Net Income and the Treatment of Extraordinary Items and Prior Period Adjustments”, December 1966, and APB Opinion No. 30—“Reporting the Results of Operations”, June 1973.* Part I of Opinion No. 9 made a significant contribution by eliminating an alternative accounting practice that permitted an enterprise to exclude significant items from net income.

Prior to Opinion No. 9, extraordinary items, other material charges and credits, and prior period adjustments often were charged or credited directly to stockholders' equity thereby bypassing the income statement. Opinion No. 9 resolved a considerable diversity of view as to this practice. According to one viewpoint, if extraordinary items or prior period adjustments were required to be included in net income for a current period, the significance of “net income” as a measurement of the ordinary recurring operations of an enterprise would be impaired and misleading inferences might be drawn. A contrary view was that “net income” should reflect all transactions affecting the net increase or decrease in owners' equity of the enterprise during a current period (except dividend distributions and transactions of a capital nature). APB Opinion No. 9 requires that net income for a current period should reflect all items of profit and loss recognized during the period, including extraordinary items, except for certain limited prior period adjustments. APB Opinion No. 9 also requires that extraordinary items be segregated from the results of ordinary operations and be shown separately in the income statement and that their nature and amounts be disclosed.

APB Opinion No. 30 addressed certain differences of opinion that continued to exist after the issuance of Opinion No. 9 with respect to determining what was an extraordinary item. It provides that an event or transaction should be presumed to be an ordinary and usual activity, the effects of which should be included in income from operations, unless the transaction is distinguished by both its unusual nature and the infrequency of its occurrence. The Opinion also specifies accounting and reporting standards for disposal of a segment of a business, requiring that the results of continuing operations should be reported separately from discontinued operations and that any gain or loss from disposal of a segment of a

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\* The Opinions not discussed were omitted because: they were superseded by subsequent APB Opinions or FASB Statements (for example, FASB Statement No. 13, “Accounting for Leases”, superseded four APB Opinions); or they dealt with special applications of an Opinion discussed below (for example, Opinion No. 23 deals with special areas of accounting for income taxes; income taxes were dealt with by Opinion No. 11); or they may not have pervasive application, even though they resolved long-standing issues (for example, Opinion No. 14 deals with accounting for convertible debt and debt issued with stock purchase warrants).

business should be reported in conjunction with the related results of discontinued operations and not as an extraordinary item.

*APB Opinion No. 11—“Accounting for Income Taxes.” December 1967.* This Opinion eliminated numerous alternative practices in accounting for income taxes, principally involving accounting for the tax effects of transactions that enter into the determination of financial accounting income and taxable income in different reporting periods (referred to as “timing differences”).

The amount of income taxes payable for a period is not necessarily equal to income tax expense applicable to transactions recognized for financial accounting purposes in that period because the objectives of financial reporting are not the same as the goals and objectives of Federal tax policy. Divergent practices existed as to the measurement and the recording of the effects of differences between financial accounting and taxable income. For example, the Internal Revenue Service permits a “net operating loss” in one period to be deducted in determining taxable income of other periods. In some instances the tax effects of an operating loss were reflected in the financial statements in the period of the loss, while in other cases the tax effects of the loss were reflected in income of the periods in which income taxes payable were reduced.

Opinion No. 11 requires that income tax expense include the tax effects of all revenue and expense transactions included in the determination of pretax accounting income for that period. The Opinion also establishes reporting requirements concerning the reporting of income tax expense and deferred income taxes and guidelines for accounting for the tax effects of timing differences, operating losses and similar items.

*APB Opinion No. 15—“Earnings per Share.” May 1969.* Opinion No. 15 establishes guidelines to assure that earnings per share data are computed on a consistent basis and presented uniformly in financial statements. This was an important contribution to accounting in view of the increasing preoccupation of investors in the 1960’s with earnings per share data. Among other things, the Opinion aids investors by requiring corporations with complex capital structures to present two measures of earnings per share with equal prominence on the face of the income statement—the first based on the number of common shares outstanding plus those securities that are in substance equivalent to common shares (e.g., stock options and warrants) and that would have a dilutive effect (“primary earnings per share”); the second, a pro-forma presentation to show the maximum potential dilution of current earnings on a prospective basis by assuming that all contingent issuances of common stock having a dilutive effect had taken place at the beginning of the period (“fully diluted earnings per share”).

*APB Opinion No. 16—“Business Combinations” and Opinion No. 17—“Intangible Assets.” August 1970.* The era of the 1960’s was marked by increased acquisition activity, and the complexity and variety of these transactions multiplied greatly. APB Opinions No. 16 and 17 eliminated as accounting alternatives a number of divergent accounting practices that had evolved at the time, and prescribed strict rules to standardize accounting in this important area.

Among other things, Opinion No. 16 drastically reduces the availability of pooling of interests as an acceptable method of accounting for a business combination. Although both the purchase method and the pooling of interests method of accounting for a business combination remain in use, the two methods are no longer available alternatives in accounting for the same business combination. Opinion No. 16 sharply defines the circumstances in which each method must be used. In the case of a purchase transaction,

the Opinion specifies how to allocate the purchase price among assets received and liabilities assumed. Amounts remaining after that allocation are considered an intangible asset, often called goodwill. It also requires substantial additional disclosure of information for business combinations.

Opinion No. 17 prescribes standards for accounting and disclosure of intangible assets purchased from others. A generally accepted practice prior to this Opinion was not to amortize the cost of intangibles. No specific disclosure requirements as to intangibles existed prior to Opinion No. 17. Among other things, this Opinion requires that the cost of intangibles, including the excess of the purchase price over the fair value of the assets acquired ("goodwill"), be amortized by systematic charges to income over the estimated life of the intangibles but not more than 40 years.

The FASB currently has the subject of "Accounting for Business Combinations and Purchased Intangibles" on its technical agenda and issued a Discussion Memorandum on this subject in August 1976.

*APB Opinion No. 18—“The Equity Method of Accounting for Investments in Common Stock.” March 1971.* This Opinion clearly defines the circumstances under which the "cost" method or the "equity" method must be used and eliminates the use of these methods as alternatives in accounting for investments in common stock.

Under the equity method, an investor initially records his investment in stock of another enterprise (the "investee") at cost and adjusts the carrying amount of the investment to recognize his share of the earnings or losses of the investee after the date of acquisition. Under the cost method, an investor records income on his investment only when dividends are paid or when the investment is liquidated. In the circumstances specified by the Opinion, the equity method is considered superior to the cost method because the results of the investment (i.e., equity in earnings and losses) are reflected currently rather than only when dividends are received.

Prior to APB Opinion No. 18, the equity method was required in consolidated financial statements in accounting for investments in nonconsolidated domestic subsidiaries. While both the equity method and the cost method were permitted in accounting for investments of nonconsolidated foreign subsidiaries, the cost method was generally used for corporate joint ventures and investments in common stocks of enterprises not controlled by the investor. The use of the equity method was not permitted, however, for investments in any subsidiaries whose principal activity was leasing property to its parent or other affiliates; consolidation of those subsidiaries was required. APB Opinion No. 18 extends the applicability of the equity method to all nonconsolidated subsidiaries of an enterprise (except subsidiaries that lease property to a parent or affiliates and that must be consolidated) and to investments in common stock of joint ventures and other investees over which an investor has the ability to exert significant influence.

*APB Opinion No. 19—“Reporting Changes in Financial Position.” March 1971.* This Opinion requires a third basic financial statement—a statement summarizing changes in financial position for each period for which an income statement is presented. This new financial statement, which summarizes financial and investment activities and the extent to which the enterprise generated funds from operations during a period, is of particular public benefit, as it requires information that financial statements and footnotes either had not previously provided or had previously provided only to those able to derive such information by analysis.

*APB Opinion No. 20—“Accounting Changes.” July 1971.* This Opinion serves to limit accounting changes to those that are to a preferable method and that result in an improvement in financial reporting.

Prior to this Opinion, practice varied as to the circumstances under which an accounting principle once adopted could subsequently be changed, as well as the method by which the effects of the change were reflected in an enterprise's financial statements. Opinion No. 20 concludes that there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type. That presumption could be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable and constitutes an improvement in financial reporting. Further, the Opinion requires extensive disclosure of the reasons for and the effects of the accounting change.

This Opinion is of special significance in assessing the accuracy and completeness of the Study's assertions that businesses have an "unrestricted" ability to change from one accounting principle to another.

*APB Opinion No. 21—"Interest on Receivables and Payables." August 1971.* Opinion No. 21 eliminated numerous variations in accounting for the exchange of cash or property for a note or similar instrument when the face amount and the stated interest rate of the note or instrument did not reasonably represent either the present value of the obligation or the prevailing market rate of interest. The Opinion specifies that accounting for such transactions should be based on the economic substance of the financing transaction rather than its form.

Prior to the issuance of the Opinion, authoritative accounting literature generally did not distinguish between indebtedness issued for cash and that issued in exchange for property or goods, and did not address transactions involving interest rates or principal amounts that appeared unrealistic in the light of existing conditions. The authoritative literature also provided no guidelines for determining an appropriate discount rate in computing the present value of long-term receivables or payables.

Among other things, the Opinion sets forth general guidelines for determining an appropriate interest rate, including recognition of the credit standing of the issuer, collateral, repayment terms, tax consequences of the transaction to both buyer and seller, and a proviso that the rate should be at least equal to the rate at which the debtor could obtain financing of a similar nature at the date of the transaction.

*APB Opinion No. 22—"Disclosure of Accounting Policies." April 1972.* While brief in content, APB Opinion No. 22 is long in significance. By requiring disclosure of all significant accounting policies used by an enterprise for which there are generally accepted alternatives, users may assess matters such as whether the enterprise is using conservative accounting methods. Information of this type may also facilitate some assessment as to future prospects or risks associated with a continuing, or new, investment in the enterprise.

*APB Opinion No. 26—"Early Extinguishment of Debt." October 1972.* APB Opinion No. 26 eliminated two alternative practices for reflecting gains and losses on debt retirements.

Debt is frequently extinguished in various ways before its scheduled maturity and generally the amount paid upon acquisition of the debt securities differs from the amount at which the debt is carried on the enterprise's books at the time of acquisition. The Opinion addresses the question of which of three generally accepted methods should be used to account for gains and losses on such transactions—(i) amortization over the remaining life of the extinguished issue, (ii) amortization over the life of the new issue, or (iii) recognition of gain or loss currently in income. It concludes that all extinguishments of debt prior to

maturity are fundamentally alike, and thus the accounting treatment should be the same regardless of the means used to achieve the extinguishments. The Opinion requires that the difference between the acquisition price and the net carrying amount of the extinguished debt should be recognized currently in income as losses or gains in the period in which the extinguishment occurs and identified as a separate item.

FASB Statement No. 4, "Reporting Gains and Losses from Extinguishment of Debt", now requires that such gains or losses be reported as extraordinary items; this presentation benefits users by facilitating their assessment of the components of an enterprise's earnings. Debt restructurings in troubled situations have grown in significance as a result of the recent economic recession, and the FASB is currently considering specific accounting for these debt restructurings.

*APB Opinion No. 28—"Interim Financial Reporting." May 1973.* Prior to Opinion No. 28, there was no definitive pronouncement on interim reporting and a wide variety of divergent practices had evolved. In recognition of this fact and the increasing significance of interim reports to investors, Opinion No. 28 prescribes modifications of annual accounting practices required in the preparation of interim financial information. The Opinion also sets forth guidelines for the preparation, presentation and reporting of interim financial information, with particular attention to problems involving revenues, costs and expenses, income tax provisions, seasonal factors, accounting changes, disposal of a segment of a business, and extraordinary, unusual, infrequently occurring and contingent items.

*APB Opinion No. 29—"Accounting for Nonmonetary Transactions." May 1973.* In Opinion No. 29, the APB addresses business transactions involving (a) an exchange with another entity that involves principally nonmonetary assets (e.g., inventory or real estate) or liabilities (e.g., rent collected in advance) or (b) a transfer of nonmonetary assets where no assets are received or relinquished in exchange (as contrasted with business transactions involving exchanges of cash or other monetary assets or liabilities).

The Opinion notes varying practices as to the amount to assign to a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction and to the recognition of gain or loss on a nonmonetary asset transferred in a nonmonetary transaction. Some nonmonetary transactions had been accounted for at the estimated fair value of the assets transferred and some at the amounts at which the assets transferred were previously recorded. The Opinion concludes that, with certain exceptions, accounting for nonmonetary transactions should be based on the fair values of the assets involved (which is the same basis as that used in monetary transactions), thus eliminating a then accepted alternative. Accordingly, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange.

*Addendum to APB Opinion No. 2, "Accounting for the 'Investment Credit'." December 1962.* The Addendum to APB Opinion No. 2, "Accounting for the 'Investment Credit'," discusses the application of generally accepted accounting principles to regulated industries (such as electric utility companies) and states that differences may arise in the application of generally accepted accounting principles as between regulated and non-regulated businesses because of the effect of the rate-making process. These differences usually concern the time at which various items enter into the determination of net income. FASB Statements and Interpretations and APB Opinions are applied to regulated companies in accordance with the provisions of the Addendum. For example, FASB Statement No. 2, "Accounting for Research and Development Costs," requires that research and development costs must be charged to expense when incurred. An electric utility may be



permitted for rate-making purposes to amortize these expenses to operations over a specified number of future periods. In this situation the Addendum permits the utility to defer to future periods those research and development costs that are to be amortized to future operations.

When the Addendum permits regulated companies to follow accounting practices other than those required by FASB Statements and Interpretations and APB Opinions, disclosure may be required of the effect on reported results of operations and financial position as a result of using those alternative accounting practices.

## **5. Table of Opinions and Statements issued by the APB**

### *Opinions*

- No. 1 —New Depreciation Guidelines and Rules—Issued November 1962
- No. 2 —Accounting for the “Investment Credit”—Issued December 1962
- No. 3 —The Statement of Source and Application of Funds—Issued October 1963
- No. 4 —Accounting for the “Investment Credit” (Amending No. 2)—Issued March 1964
- No. 5 —Reporting of Leases in Financial Statements of Lessee—Issued September 1964
- No. 6 —Status of Accounting Research Bulletins—Issued October 1965
- No. 7 —Accounting for Leases in Financial Statements of Lessors—Issued May 1966
- No. 8 —Accounting for the Cost of Pension Plans—Issued November 1966
- No. 9 —Reporting the Results of Operations—Issued December 1966
- No. 10 —Omnibus Opinion—1966—Issued December 1966
- No. 11 —Accounting for Income Taxes—Issued December 1967
- No. 12 —Omnibus Opinion—1967—Issued December 1967
- No. 13 —Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks—Issued March 1969
- No. 14 —Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants—Issued March 1969
- No. 15 —Earnings per Share—Issued May 1969
- No. 16 —Business Combinations—Issued August 1970
- No. 17 —Intangible Assets—Issued August 1970
- No. 18 —The Equity Method of Accounting for Investments in Common Stock—  
Issued March 1971
- No. 19 —Reporting Changes in Financial Position—Issued March 1971
- No. 20 —Accounting Changes—Issued July 1971
- No. 21 —Interest on Receivables and Payables—Issued August 1971
- No. 22 —Disclosure of Accounting Policies—Issued April 1972
- No. 23 —Accounting for Income Taxes—Special Areas—Issued April 1972
- No. 24 —Accounting for Income Taxes—Investments in Common Stock Accounted  
for by the Equity Method (Other than Subsidiaries and Corporate Joint  
Ventures)—Issued April 1972
- No. 25 —Accounting for Stock Issued to Employees—Issued October 1972
- No. 26 —Early Extinguishment of Debt—Issued October 1972
- No. 27 —Accounting for Lease Transactions by Manufacturer or Dealer Les-  
sors—Issued November 1972
- No. 28 —Interim Financial Reporting—Issued May 1973

- No. 29 —Accounting for Nonmonetary Transactions—Issued May 1973
- No. 30 —Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions—Issued June 1973
- No. 31 —Disclosure of Lease Commitments by Lessees—Issued June 1973

*Statements*

- No. 1 —Statement by the Accounting Principles Board—Issued April 1962
- No. 2 —Disclosure of Supplemental Financial Information by Diversified Companies—Issued September 1967
- No. 3 —Financial Statements Restated for General Price-Level Changes—Issued June 1969
- No. 4 —Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises—Issued October 1970

## THE STUDY'S OUTDATED ANALYSIS OF ALTERNATIVE ACCOUNTING PRINCIPLES

The Study supports its criticism of accounting alternatives by reproducing a table attributed to Professor Abraham Briloff which shows a variety of alternative accounting methods available to account for the same business transactions.

The Study's reliance on that table is misplaced, for the data presented are based on a 1965 research study which was not updated in the Study to reflect 12 years of progress by the FASB and its predecessor, the Accounting Principles Board. The Study also makes no effort to distinguish among those alternatives necessary to reflect clearly different circumstances or wholly different transactions, even though the 1965 research study took care to do so when originally published.

This Exhibit E, prepared by the FASB's technical staff, discusses in detail the Study's outdated tabulation and the Staff's assertions. Set forth at the conclusion of this Exhibit is a table which restates the information shown in the Study on the basis of accounting principles in effect in 1977.

Of the 42 "alternatives" listed in the Study's table, 30 are not alternatives or are of such minor import as to be immaterial in their effect on financial statements, as the following tabulation and the reconciliation on page E-8, updating and correcting the Study's table, show:

14	apply to circumstances which clearly differ and for which there are recognized criteria for determining the appropriate practice, or apply to wholly different transactions.
4	have been eliminated.
1	is now the sole practice.
1	is not an accounting method.
10	relate to items having no material effect on financial statements.
2	are rare and disappearing.
10	are practices which may be alternatives.
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42	
<hr style="width: 100%; border: 0.5px solid black;"/>	

Of the 10 practices which may be alternatives, 2 are currently under study by the FASB in its Extractive Industries project.

The basis for the Study's chart is a tabulation from *Accounting Research Study No. 7*, "Inventory of Generally Accepted Accounting Principles," prepared for the AICPA by Paul Grady in 1965. As mentioned, no attempt was made in the Study to update Mr. Grady's research to account for developments in the twelve years since its publication. Further, in borrowing from Grady's inventory, the Study distorts its significance and ignores the distinctions Grady highlighted between true alternatives and variant practices required

by differing circumstances or transactions. In this regard, Mr. Grady was careful to preface his "inventory" with the following statement:

"The following list of alternative methods does not purport to be all inclusive. The methods listed are not all of the same nature, some are truly 'either-or' choices of management while others are applicable or not applicable depending on the circumstances. The latter illustrate the versatility of accounting to meet different conditions and to prevent financial and accounting abuses."  
(*Accounting Research Study No. 7*, at 373)

The following summary of the accounting methods tabulated by the Study shows that—rather than constituting interchangeable alternatives—certain of the methods are essential to meet differing circumstances or wholly different transactions, others have been or are being addressed in official pronouncements aimed at narrowing areas of difference and inconsistencies in practice, and with respect to others, the method chosen has little effect on financial statements generally used by investors and creditors.

1. *When revenue generally recognized*

Grady stated in 1965 that revenue is recognized in the sale of products or services on three bases:

1. At the time of sale
2. At the time of collection of sales price
3. At the time of completion of the product.

Notwithstanding the existence of separate approaches to revenue recognition, accounting standards provide criteria for the application of the appropriate method, depending upon the circumstances. Generally, revenue recognition is based upon the principle of realization. Thus, under ARB No. 43, Chapter 1A and APB Opinion No. 10, where the collection of receivables can be estimated with reasonable accuracy, revenue is realized at the time of sale and it is recognized for financial accounting purposes at that time. When the collectibility of a receivable is subject to a significant degree of uncertainty, proper recognition of revenue must await collection following sale. As Grady explains and as existing accounting literature confirms, it is only in the exceptional case that revenue may be properly recognized upon completion of the product and prior to its sale. As stated in ARB No. 43, Chapter 4, Statement 9, such method of recognition is appropriate only in highly specialized circumstances where, by the nature of the product, an assured market and price exist, as, for example, in the case of certain agricultural products and precious metals.

Clearly, each of the three "alternatives" cited by the Study addresses a specific set of circumstances, and no one uniform method of revenue recognition would be appropriate for all.

## 2. *When revenue recognized for long-term contractors*

Grady's inventory noted in 1965 that revenue is recognized in the context of long-term contracting operations on two alternative bases: either proportionately over the period of performance ("percentage-of-completion method") or at the time the contract is completed ("completed contract method").

Percentage-of-completion accounting was developed in response to the unique character of long-term construction contracts that often require years to complete. When reliable estimates are available, the percentage-of-completion method permits the financial statements of construction contractors to reflect periodic progress over a period of years. In the same circumstances, the completed-contract method might produce wide swings of losses and profits because all accumulated progress would be reported in the year the contract is completed. APB Statement No. 4 states that the appropriateness of the recognition of revenue as construction progresses is based on the consensus that a better measure of periodic income results. ARB No. 45 expressly notes that, when estimates of costs to complete and the extent of progress toward completion are reasonably dependable, the percentage-of-completion method is preferable. Where the lack of dependable estimates or inherent hazards cause estimates to be doubtful, however, ARB No. 45 states that recognition upon completion of the contract is preferable.

Here again, the existence of alternative modes of revenue recognition provides improved financial reporting where circumstances differ.

## 3. *Accounting for unfunded pension cost*

The Study lists the two methods of accounting for pension payments to employees that were cited by Mr. Grady in 1965. It overlooks, however, that in 1966 APB Opinion No. 8 prohibited one of the two methods and affirmed the appropriateness of the other for accounting for such payments.

The first method, commonly referred to as "pay-as-you-go", was, at the time of Grady's research, a vestige of earlier pensions "voluntarily" granted by corporations. With the surge of formal pension plans in the late 1940's and 1950's, however, advance funding of pensions developed as a general practice. In 1956, ARB No. 47 prohibited "pay-as-you-go" accounting for vested pension benefits and required that those benefits be accounted for on the accrual basis. In 1966, APB Opinion No. 8 responded to the surviving diversity in accounting practice by prohibiting pay-as-you-go accounting for the cost of pension plans and by requiring that unfunded pension costs be accounted for on the accrual basis (the second of the prior two methods) independent of the method of funding.

Thus, "pay-as-you-go" is no longer an acceptable method of accounting for unfunded pension costs. Also, as a result of the Employee Retirement Income Security Act of 1974 (ERISA), the subject of accounting for pension costs is on the FASB's technical agenda as noted below.

## 4. *Accounting for funded pension cost*

Grady stated in 1965 that pension payments made indirectly to retired employees through the medium of a fund are charged to expense on three different bases:

1. When payments are made to the fund
2. Normal or current costs on an accrual basis over the period of service of the employees . . .

3. So-called past service credits at time of adoption of plan—

(a) Not provided for, except as to interest

(b) Accrued over period permitted in Income Tax Code, over remaining service life of employees or over longer period such as total average service life of employees . . . ”

In borrowing from Mr. Grady's 1965 tabulation, the Study overlooks the fact that in 1966 APB Opinion No. 8 prohibited the first of Grady's three "alternatives". Items 2 and 3 are not, in fact, alternatives but are different subjects: normal costs and past service costs (i.e., costs related to service prior to adoption of the pension plan or amendment of it). Actuarial methods determine the annual pension costs to be accrued for normal costs and past service costs. APB Opinion No. 8 requires that pension costs be accrued annually on a consistent basis and sets limits within which the annual accrual must fall.

In view of the recent ERISA legislation, the FASB has the subject of accounting for pension costs on its technical agenda.

With regard to pension funding methods, it is interesting to note that, in enacting ERISA, Congress allowed alternative practices in a number of important areas in recognition of the variety of conditions existing among employers and their pension plans.

5. *Charging of real and personal property taxes to income*

Grady cited in 1965 eight different methods of charging real and personal property taxes against income. Grady's list quoted verbatim from ARB No. 43 (1953), which, in turn, summarized ARB No. 10 (1941). ARB No. 10 and ARB No. 43, though observing that the eight methods listed were methods that had been followed, recommended the monthly accrual of such taxes during the fiscal period of the taxing authority as the most acceptable basis.

The differences in methods stem basically from the question of when these taxes should be accrued and recognize legal technicalities that may vary significantly among taxing jurisdictions.

The subject of accounting for real and personal property taxes has not appeared in subsequent pronouncements of accounting standards because of the relative insignificance of these taxes in almost all financial statements. Moreover, any of the eight methods, followed consistently, produces virtually the same result year after year as any other, with any differences caused by changes in assessed valuations or tax rates from year to year.

For the above reasons, these items are poor examples for any of the Study's assertions on alternatives. It is nevertheless interesting that the methods cited by the Study for this relatively unimportant item account for almost 20% of its outdated listing of accounting alternatives.

6. *Treatment of tax versus financial accounting divergencies*

Grady stated in 1965 that "when items affecting taxable income are reported in financial statements and income tax returns in different periods:

1. The tax effect is allocated between periods in the financial statements
2. The tax effect is not allocated between periods
3. The tax effect is allocated for some items but not for others."

The three different practices cited by Grady in 1965 were used in accounting for the tax effects of "timing differences" (transactions that are reported in financial statements and income tax returns in different periods). Subsequent to the date of Grady's study the differences in tax allocation practices have been substantially narrowed through the issuance of *APB Opinion No. 11* (1967), *APB Opinions No. 23 and No. 24* (1972), *AICPA Interpretations* (1969-1972), and *FASB Statement No. 9* (1975).

Nonallocation of the tax effects of timing differences among periods (the second practice cited by Grady) has been eliminated. Allocation of the tax effects of timing differences among periods is now required except for a limited number of specific timing differences or in circumstances for which recognized criteria have been established to determine whether tax allocation is required.

### 7. *Methods of depreciation*

Grady cited in 1965 the following four methods of depreciation for charging off the cost of depreciable assets over their estimated lives:

1. Increasing charge (annuity, sinking fund)
2. Production or "use" methods
3. Straight-line
4. Decreasing charge (declining balance, sum-of-years' digits).

Depreciation has probably been the subject of more legal controversy in the rate-making and tax accounting contexts than any other accounting subject. The underlying economic theory is that depreciable cost should be amortized over the useful life of an item in proportion to the consumption of its economic potential. The difficulty in its application is that in most cases no one method can be objectively demonstrated as best carrying out the theory. Therefore, the general accounting principle simply requires that depreciable cost be amortized over the estimated useful life in a systematic and rational manner. All four of the depreciation methods listed by Grady meet this criterion.

The annuity or sinking fund depreciation method is rarely used.

The unit-of-production (production or use) method is encountered more frequently, but is quite clearly a minority practice. The idea of charging each unit of output the same depreciation cost as all others over the estimated life of a facility is perhaps the most logical method of all. However, in most circumstances, estimating the likely total number of units of output over the useful life of the facility is far more difficult than estimating the useful life itself, and thus for sound practical reasons, this method is not widely used.

The straight-line method is by far the most widely used method. Its rationale is that the passage of time is as good as any standard by which to measure the expiration of economic potential of a depreciable asset.

The use of accelerated depreciation methods has increased considerably in the last 25 years, in large part because the Internal Revenue Code of 1954 permits the use of accelerated depreciation methods for Federal income tax purposes. The earlier, higher cash flow, through reduced income taxes, recovers dollars of investment sooner.

The Government's Cost Accounting Standards Board accepts all three of the above-described widely used depreciation methods.

## 8. *Inventory methods*

The Study's tabulation relies on the following five "alternative" methods for determining inventory cost described by Grady:

1. First in, first out (FIFO)
2. Last in, first out (LIFO)
3. Average cost
4. Base stock, and
5. Various combinations of these methods.

The "base stock" method cited by Grady in 1965 is a forerunner of the LIFO method but for all practical purposes this method is now extinct. Item 5 is not a separate accounting practice, and thus discussion of "alternative" inventory methods must focus on FIFO, LIFO and average cost.

An analysis of inventory accounting methods reveals that no single method listed above is likely to result in a fair matching of revenues and costs for all companies under all circumstances.

So long as the rate of inflation experienced by an enterprise is not substantial, the FIFO or average cost methods of valuing inventory permit a reasonable matching of revenues and costs. Under inflationary conditions, however, FIFO or average cost results in including in income for the year an "unrealized inventory profit" when lower beginning-of-the-year costs, rather than higher current replacement costs, are matched with current revenues. Under such circumstances, many companies have elected to use the LIFO method of inventory costing, which charges higher current costs against higher current revenues.

One aspect of inventory accounting is that the method that achieves a better matching of cost and revenue in the income statement may not produce the most realistic balance sheet. For example, in an inflationary period LIFO puts current cost in the income statement and leaves earlier costs in the balance sheet, while FIFO would put more current costs in the balance sheet.

The Government's Cost Accounting Standards Board permits any of the three alternatives. The SEC has given particular consideration to the disclosure of information about inventory values in ASR 151 and ASR 190 without, however, eliminating any of the acceptable inventory methods.

## 9. *Accounting for discounts*

Grady noted in 1965 two existing accounting practices for cash discounts on sales: discounts may be recognized either at the time of sale or at the time of collection.

Discounts are among the numerous types of transactions that have not been dealt with to any degree in recent accounting literature. This is probably because the timing of recognition of discounts taken on repetitive transactions makes little difference in financial statements. Also, in terms of accounting for discounts, the potential for what the Study calls "creative accounting" is almost nil because one method must be used consistently.



#### 10. *Fixed asset acquisition*

Grady's 1965 survey states that acquired properties may be recorded at:

1. cost
2. appraisal amounts
3. original cost to first owner using them for utility purposes, in the case of public utilities, and
4. book value to previous owner in business combinations accounted for as poolings of interests.

As with many of the practices tabulated by the Study, those four methods are not true "alternatives" because each particular method applies to a different type of transaction.

Except where special circumstances require a different treatment, acquired properties are recorded at cost. (Method 1). Although in the early part of this century there were examples of write-ups to appraised values (Method 2), this procedure was generally eliminated by APB Opinion No. 6. Today, appraisal values are used only to allocate the total cost paid to acquire a group of assets among the various assets acquired. Method 3 describes an accounting practice required by most public utility regulatory authorities and is unique to public utilities. Finally, Method 4 describes the accounting treatment required for assets obtained in a business combination that meets specified criteria to be accounted for as a pooling of interests.

Accounting for business combinations is currently on the FASB's technical agenda.

#### 11. *Fixed asset construction*

Grady's 1965 inventory shows constructed properties recorded at:

1. direct costs only
2. direct costs plus partial overhead costs
3. direct costs plus all overhead costs, including interest on all funds used in the construction (funds from equity sources as well as debt).

The three methods listed usually apply to three different types of relationships between a company's construction activities and its main business activities. The relationship of construction to main activities can vary widely among companies, of course, as can the involvement of executive and other overhead personnel.

A company that uses employees normally employed in its principal business activity in occasional construction may charge the project only with direct costs and not with a part of the overhead that would be incurred in any event. A company that has more frequent self-construction activities will usually have assigned to such work more or less continuously a certain number of people from the overhead pool—engineers, draftsmen, etc.—and may assign a portion of the overhead to the construction project. (Method No. 2).

Finally, the "full costing" of construction projects (Method 3) exists largely in the area of regulated utilities where regulatory commissions prescribe accounting methods and permit such costs to be included in the utility's rate base.

The practice of capitalizing interest during construction is one of general concern within the profession and is currently one of the topics on the FASB's technical agenda. Pending resolution of this issue by the FASB, the SEC, in its Accounting Series Release 163, prohibited the use of this method to those who had not used it consistently in the past.

12. *Development costs in extractive industries*

Grady cited in 1965 three methods of accounting for the development costs of extractive industries:

1. capitalized and allocated to future production through depletion charges
2. capitalized but not charged to future income statements (certain mining enterprises)
3. capitalized in part and the remaining part charged to expense currently; the portion capitalized is allocated to future production through depletion charges.

Accounting for exploration and development costs in the extractive industries is on the FASB's technical agenda. In this regard, the FASB recently issued a Discussion Memorandum (December 23, 1976), "Analysis of Issues Related to Financial Accounting and Reporting in the Extractive Industries", specifically addressing this and other problems relating to accounting for extractive enterprises.

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***THE STUDY'S "42 ALTERNATIVES" IN 1977***

The following table summarizes the current status of the "42 alternatives" tabulated in the Study:

<i>Grady's Issue No.:</i>	1	2	3	4	5	6	7	8	9	10	11	12
Different Circumstances or Wholly Different Transactions (14)	3	2		2		2				3	1	1
Eliminated (4)			1	1		1				1		
Sole Practice (1)			1									
Not Accounting Method (1)								1				
Immaterial (10)					8				2			
Rare and Disappearing (2)							1	1				
Alternatives (10)							3	3			2	2
Total (42)	3	2	2	3	8	3	4	5	2	4	3	3

In summary, if current accounting principles are applied to the Study's 1965 table, it is apparent that, on an issue by issue basis, only 10 may be alternative practices. Of these, 2 are currently under study by the FASB in its Extractive Industries project, and of the remaining 8, the 6 dealing with depreciation and inventories are accepted for government contract costing purposes by the Cost Accounting Standards Board.