Statement of Financial Accounting Standards No. 11

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FAS11 Summary

Accounting for Contingencies—Transition Method

(an amendment of FASB Statement No. 5)

December 1975

Financial Accounting Standards Board
of the Financial Accounting Foundation
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INTRODUCTION AND BACKGROUND INFORMATION

1. *FASB Statement No. 5,* "Accounting for Contingencies," was issued by the Board in March 1975. With respect to that Statement's effective date and transition, paragraph 20 of that Statement reads as follows:

> This Statement shall be effective for fiscal years beginning on or after July 1, 1975, although earlier application is encouraged. A change in accounting principle resulting from compliance with paragraph 8 or 14 of this Statement shall be reported in accordance with *APB Opinion No. 20*, "Accounting Changes." Accordingly, except in the special circumstances referred to inparagraphs 29-30 of *APB Opinion No. 20*, the cumulative effect of the change on retained earnings at the beginning of the year in which the change is made shall be included in net income of the year of the change, and the disclosures specified in *APB Opinion No. 20* shall be made. Reclassification of an appropriation of retained earnings to comply with paragraph 15 of this Statement shall be made in any financial statements for periods before the effective date of this Statement, or financial summaries or other data derived therefrom, that are presented after the effective date of this Statement.

2. In Appendix C, "Basis for Conclusions," of that Statement, paragraph 104 reads as follows:

> The Board considered three alternative approaches to a change in the method of accounting for contingencies: (1) prior period adjustment, (2) the "cumulative effect" method described in *APB Opinion No. 20,* "Accounting Changes," and (3) retention of amounts accrued for contingencies that do not meet the conditions for accrual in paragraph 8 until those amounts are exhausted by actual losses charged thereto. The Exposure Draft had proposed the change be effected by the prior period adjustment method. A large number of respondents to the Exposure Draft, however, opposed the prior period adjustment method for a number of reasons, including significant difficulties involved in determining the degree of probability and estimability that had existed in prior periods as would have been required if the conditions in paragraph 8 were applied retroactively. On further consideration of all the circumstances, the Board has concluded that use of the "cumulative effect" method described in *APB Opinion No. 20* represents a

satisfactory solution and has concluded that the effective date in paragraph 20 is advisable.

3. The Exposure Draft of *FASB Statement No. 5* proposed a transition requiring retroactive restatement by prior period adjustment. In Appendix B, "Basis for Conclusions," of the Exposure Draft, the Board stated a preference for the prior period adjustment method because, in its judgment at the time, it would provide the most useful information for comparing financial data for periods after the adoption of the Statement with prior periods.

4. The Board recently issued *FASB Statement No. 8,* "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements." With respect to that Statement's effective date and transition, paragraphs 35 and 36 of that Statement read as follows:

> This Statement shall be effective for fiscal years beginning on or after January 1, 1976,[14] although earlier application is encouraged. Thereafter, if financial statements for periods before the effective date, and financial summaries or other data derived therefrom, are presented, they shall be restated, if practicable, to conform to the provisions of paragraphs 7-31 of this Statement. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period restated.
>
> If restatement of financial statements or summaries for all prior periods presented is not practicable, information presented shall be restated for as many consecutive periods immediately preceding the effective date of this Statement as is practicable, and the cumulative effect of applying paragraphs 7-31 on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which the Statement is first applied if it is not practicable to restate any prior periods) shall be included in determining net income of that period (see paragraph 20 of *APB Opinion No. 20,* "Accounting Changes").[15] The effect on income before extraordinary items, net income, and related per share amounts of applying this Statement in a period in which the cumulative effect is included in determining net income shall be disclosed for that period, and the reason for not restating all of the prior periods presented shall be explained.
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> [14] For enterprises having fiscal years of 52 or 53 weeks instead of the calendar year, this Statement shall be effective for fiscal years beginning in late December 1975.
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> [15] Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* are not applicable.

5. Although the Exposure Draft of *FASB Statement No. 8* indicated that transition under that Statement would be required in accordance with paragraphs 19-21, 25, and 39 of *APB Opinion No. 20* (viz., to include in the determination of net income in the year of change the effect of the accounting change), in the final Statement, the Board concluded that prior period restatement is the preferable method to provide useful information about foreign currency transactions and foreign operations for comparing financial data for a number of periods. In Appendix D, "Basis for Conclusions," of that Statement, paragraphs 240 and 241 read as follows:

The Board concluded that because of the various methods of translation or of recognition of exchange gains and losses now followed in practice and because of the complex nature of the translation process, a prospective method of transition is not feasible. The Board considered whether the transition should be by prior period restatement or by cumulative effect adjustment (the method specified in the Exposure Draft). The Board concluded that prior period restatement is the preferable method to provide useful information about foreign currency transactions and foreign operations for purposes of comparing financial data for periods after the effective date of this Statement with data presented for earlier periods.

The Board recognizes, however, that the procedures called for by this Statement may sometimes differ significantly from procedures followed in previous periods. In addition, restatement requires the availability of records or information that an enterprise may no longer have or that its past procedures did not require. Therefore, if the effect of the restatement on all individual periods presented cannot be computed or reasonably estimated, the cumulative effect adjustment method shall be used in accordance with paragraph 36.

Reconsideration of the Transition Method of FASB Statement No. 5

6. In considering and resolving the issue of transition in *FASB Statement No. 8,* the Board was mindful that there were similarities in characteristics of certain accounts affected by *FASB Statement No. 8* and *FASB Statement No. 5.* As indicated in paragraph 104 of *FASB Statement No. 5,* one of the factors that led the Board to conclude that use of the cumulative effect method would be preferable to restatement of financial statements for prior periods was its concern about the cases in which there might be significant difficulties in determining the degree of probability and estimability that existed in the prior periods. After reconsideration of the differences in the transition methods required by *FASB Statements No. 5* and *8* and the factors that led the Board to reach different conclusions on transition in those two Statements, the Board has concluded that the cumulative effect method should not be required as it now is by *FASB Statement No. 5* in those cases in which the difficulties of determining probability and estimability retroactively are not present. On reconsideration of all the circumstances, the Board has concluded that in order to provide the most useful information, it is preferable for an enterprise adopting *FASB Statement No. 5* to restate its financial statements for as many immediately preceding periods as is practicable in accordance with the revised transition method set forth in paragraph 10 of this Statement.

7. Some enterprises elected to apply *FASB Statement No. 5* prior to its effective date (as encouraged in paragraph 20 of the Statement) and issued annual or interim financial statements or financial summaries or other data derived therefrom using the cumulative effect method of transition. The Board considered whether those enterprises should now be required to conform to the method of transition to *FASB Statement No. 5* specified by this Statement. Although the Board strongly encourages those enterprises to restate their financial statements in a manner similar to that required of enterprises that did not elect early application, it has concluded that it should not require them to do so.

8. An Exposure Draft of a proposed Statement on "Accounting for Contingencies—Transition Method" was

issued on October 31, 1975. Forty-five letters were received in response to that Exposure Draft.

9. The Board concluded that on the basis of existing data it could make an informed decision on the matter addressed in this Statement without a public hearing and that the effective date in paragraph 11 is advisable.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to FASB Statement No. 5

10. Paragraph 20 of *FASB Statement No. 5* is amended to read as follows:

> *FASB Statement No. 5* shall be effective for fiscal years beginning on or after July 1, 1975, although earlier application is encouraged. Thereafter, if financial statements for periods before the effective date, and financial summaries or other data derived therefrom, are presented, they shall be restated, if practicable, to conform to the provisions of paragraph 8 or 14 of *FASB Statement No. 5*.* In the year that the Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period restated. If restatement of financial statements or summaries for all prior periods presented is not practicable, information presented shall be restated for as many consecutive periods immediately preceding the effective date of *FASB Statement No. 5* as is practicable, and the cumulative effect of applying paragraph 8 or 14 on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which the Statement is first applied if it is not practicable to restate any prior periods) shall be included in determining net income of that period (see paragraph 20 of *APB Opinion No. 20*).** The effect on income before extraordinary items, net income, and related per share amounts of applying *FASB Statement No. 5* in a period in which the cumulative effect is included in determining net income shall be disclosed for that period, and the reason for not restating all of the prior periods presented shall be explained. Reclassification of an appropriation of retained earnings to comply with paragraph 15 of *FASB Statement No. 5* shall be made in any financial statements for periods before the effective date of the Statement, or financial summaries or other data derived therefrom, that are presented after the effective date of the Statement.
>
> *This does not alter the accounting for changes in estimates—see paragraph 31 of *APB Opinion No. 20.*
>
> **Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* are not applicable.

Effective Date and Transition

11. This amendment to *FASB Statement No. 5* shall be effective retroactively to the effective date of *FASB Statement No. 5* except that enterprises that have issued financial statements for annual or interim periods, or financial summaries or other data derived therefrom, prior to January 1, 1976 based on the original transition

requirement in paragraph 20 of *FASB Statement No. 5* are strongly encouraged but not required to comply with this Statement when those financial statements or financial summaries or other data derived therefrom are subsequently presented for the first time on or after January 1, 1976.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Litke dissented.

Mr. Litke dissents because paragraph 11 of this Statement permits companies that have issued financial statements using the cumulative effect method of transition to *FASB Statement No. 5* to elect not to change to the method specified by this Statement. He believes that the Board, once having determined that restatement is the appropriate method of transition to *FASB Statement No. 5*, should have required all companies to follow that method. In Mr. Litke's judgment, an important objective of the Board should be to eliminate, rather than create, accounting differences among enterprises that are not justified by differences in underlying circumstances.

Members of the Financial Accounting Standards Board:

Marshall S. Armstrong, *Chairman*
Oscar S. Gellein
Donald J. Kirk
Arthur L. Litke
Robert E. Mays
Walter Schuetze
Robert T. Sprouse