Statement of Financial Accounting Standards No. 3

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FAS3 Summary

Reporting Accounting Changes in Interim Financial Statements

an amendment of APB Opinion No. 28

December 1974

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

1. As a result of numerous inquiries concerning the appropriate procedures for reporting a change to the LIFO method of inventory pricing in interim financial reports, the FASB has examined certain conclusions of *APB Opinion No. 28,* "Interim Financial Reporting," with respect to two aspects of reporting accounting changes in interim financial reports:

a. Reporting a cumulative effect type accounting change (as described in *APB Opinion No. 20,* "Accounting Changes") including a change to the LIFO method of inventory pricing for which a cumulative effect cannot be determined.
b. Reporting an accounting change made during the fourth quarter of a fiscal year by a company whose securities are publicly traded.

2. *APB Opinion No. 28* became effective for interim periods relating to fiscal years beginning on or after January 1, 1974, and paragraphs 23-29 of that Opinion set forth standards for reporting accounting changes in interim financial reports. Those paragraphs provide that, in general, an accounting change made in an interim period should be reported in accordance with the provisions of *APB Opinion No. 20*.

3. Paragraphs 9-14 of this Statement establish standards of financial accounting and reporting that address the matters identified in paragraph 1. The Appendices to this Statement contain examples of application of *APB Opinion No. 28* (as amended by this Statement) and the requirements of *APB Opinion No. 20* as they are incorporated by reference in *APB Opinion No. 28*.

4. An Exposure Draft of a proposed Statement on "Reporting Accounting Changes in Interim Financial Statements" was issued on November 11, 1974. Fifty-five letters were received in response to the request for comments. This Statement incorporates a number of changes suggested by those respondents. The principal change is to require that, if an accounting change

is made in other than the first interim period of an enterprise's fiscal year, the cumulative effect of the change on retained earnings at the beginning of that year shall be included in the determination of net income of the first interim period of the year of change (by restatement of that period's financial information).

5. The Board has concluded that it can make an informed decision on the matters identified in paragraph 1 of this Statement without a public hearing. It has also concluded that the effective date in paragraph 16 of this Statement is advisable to permit application of the provisions of this Statement before divergent interpretations of *APB Opinion No. 28* develop in practice.

Cumulative Effect Type Accounting Changes

6. Paragraph 27 of *APB Opinion No. 28* provides that "a change in accounting principle or practice adopted in an interim period that requires an adjustment for the cumulative effect of the change to the beginning of the current fiscal year should be reported in the interim period in a manner similar to that to be followed in the annual report.... The effect of the change from the beginning of the annual period to the period of change should be reported as a determinant of net income in the interim period in which the change is made." That paragraph goes on to require, however, that when information is subsequently presented for the period in which the change is made or for pre-change interim periods of that year, that information should be restated to give effect to the accounting change.

7. As a result of those requirements, if a cumulative effect type accounting change is made, the cumulative effect of the change on retained earnings at the beginning of that fiscal year is a component of net income of the interim period in which the change is adopted. If a change is made in other than the first interim period, since the cumulative effect remains a component of that interim period's income when financial information for that period is subsequently reported, reissued pre-change interim period balance sheets would not reflect the cumulative effect of the change on retained earnings at the beginning of the fiscal year on a retroactive basis, whereas reissued pre-change interim period income statements would be restated. In addition, an enterprise may issue interim financial information knowing that the information will subsequently have to be revised. For example, during the second quarter of its fiscal year an enterprise may make an accounting change as of the beginning of that quarter. If, subsequently during that second quarter, the enterprise issues first quarter financial information (perhaps in a report to its securityholders, in a report to a bank, or in a filing with the SEC), that first quarter information would be prepared on the basis of the old accounting principle—not the newly adopted one. When that enterprise later issues second quarter information, both the cumulative effect of the change up to the beginning of the fiscal year and the effect from the beginning of the year to the beginning of the second quarter would be included in the determination of second quarter net income. However, in any subsequent report that separately presents information either for that first quarter or that second quarter, the first quarter information would be retroactively restated on the basis of the newly adopted accounting principle, and the effect of the change from the beginning of the year to the beginning of the second quarter would no longer

be included in second quarter net income. Thus the enterprise issued both first and second quarter information that had to be restated in subsequent periods. A similar situation arises if the accounting change were made during the third or fourth quarters.

Fourth Quarter Accounting Changes Made by Publicly Traded Companies

8. Paragraphs 30-33 of APB *Opinion No. 28* set forth special requirements for disclosure of summarized financial data by publicly traded companies (as defined in footnote 1 to that Opinion). Some publicly traded companies are required by paragraph 31 of the Opinion to disclose certain fourth quarter information in a note to the annual financial statements. Information about the effects of an accounting change made during the fourth quarter is not explicitly identified as one of the items for which disclosure is required.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Cumulative Effect Type Accounting Changes Other Than Changes to LIFO

9. If a cumulative effect type accounting change is made during the *first* interim period of an enterprise's fiscal year, the cumulative effect of the change on retained earnings at the *beginning of that fiscal year* shall be included in net income of the first interim period (and in last-twelve-months-to-date financial reports that include that first interim period).

10. If a cumulative effect type accounting change is made in *other than the first* interim period of an enterprise's fiscal year, no cumulative effect of the change shall be included in net income of the period of change. Instead, financial information for the pre-change interim periods of the fiscal year in which the change is made shall be restated by applying the newly adopted accounting principle to those pre-change interim periods. The cumulative effect of the change on retained earnings at the *beginning of that fiscal year* shall be included in restated net income of the first interim period of the fiscal year in which the change is made (and in any year-to-date or last-twelve-months-to-date financial reports that include the first interim period). Whenever financial information that includes those pre-change interim periods is presented, it shall be presented on the restated basis.

11. The following disclosures about a cumulative effect type accounting change shall be made in interim financial reports:

a) In financial reports for the interim period in which the new accounting principle is adopted, disclosure shall be made of the nature of and justification for the change.
b) In financial reports for the interim period in which the new accounting principle is adopted, disclosure shall be made of the effect of the change on income from continuing operations,

net income, and related per share amounts for the interim period in which the change is made. In addition, when the change is made in other than the first interim period of a fiscal year, financial reports for the period of change shall also disclose (i) the effect of the change on income from continuing operations, net income, and related per share amounts for each pre-change interim period of that fiscal year and (ii) income from continuing operations, net income, and related per share amounts for each pre-change interim period restated in accordance with paragraph 10 of this Statement.

c) In financial reports for the interim period in which the new accounting principle is adopted, disclosure shall be made of income from continuing operations, net income, and related per share amounts computed on a pro forma basis for (i) the interim period in which the change is made and (ii) any interim periods of prior fiscal years for which financial information is being presented. If no financial information for interim periods of prior fiscal years is being presented, disclosure shall be made, in the period of change, of the actual and pro forma amounts of income from continuing operations, net income, and related per share amounts for the interim period of the immediately preceding fiscal year that corresponds to the interim period in which the change is made. In all cases, the pro forma amounts shall be computed and presented in conformity with paragraphs 19, 21, 22, and 25 of *APB Opinion No. 20*.

d) In year-to-date and last-twelve-months-to-date financial reports that include the interim period in which the new accounting principle is adopted, the disclosures specified in the first sentence of subparagraph (b) above and in subparagraph (c) above shall be made.

e) In financial reports for a subsequent (post-change) interim period of the fiscal year in which the new accounting principle is adopted, disclosure shall be made of the effect of the change on income from continuing operations, net income, and related per share amounts for that post-change interim period.

Changes to the LIFO Method of Inventory Pricing and Similar Situations

12. Paragraph 26 of *APB Opinion No. 20* indicates that in rare situations—principally a change to the LIFO method of inventory pricing [1]—neither the cumulative effect of the change on retained earnings at the beginning of the fiscal year in which the change is made nor the pro forma amounts can be computed. In those situations, that paragraph requires an explanation of the reasons for omitting (a) accounting for a cumulative effect and (b) disclosure of pro forma amounts for prior years. If a change of that type is made in the *first* interim period of an enterprise's fiscal year, the disclosures specified in paragraph 11 of this Statement shall be made (except the pro forma amounts for interim periods of prior fiscal years called for by paragraph 11(c) will not be disclosed).

13. If the change is made in *other than* the first interim period of an enterprise's fiscal year, the disclosure specified in paragraph 11 of this Statement shall be made (except the pro forma amounts for interim periods of prior fiscal years called for by paragraph 11(c) will not be disclosed) and in addition, financial information for the pre-change interim periods of that fiscal year shall be restated by applying the newly adopted accounting principle to those pre-change

interim periods. Whenever financial information that includes those pre-change interim periods is presented, it shall be presented on the restated basis.

Fourth Quarter Accounting Changes Made by Publicly Traded Companies

14. When a publicly traded company that regularly reports interim information to its securityholders makes an accounting change during the fourth quarter of its fiscal year and does not report the data specified by paragraph 30 of *APB Opinion No. 28* in a separate fourth quarter report or in its annual report [2] to its securityholders, the disclosures about the effect of the accounting change on interim periods that are required by paragraphs 23-26 of *APB Opinion No. 28* or by paragraphs 9-13 of this Statement, as appropriate, shall be made in a note to the annual financial statements for the fiscal year in which the change is made.

Amendments to Existing Pronouncement

15. Paragraph 27 of *APB Opinion No. 28* is superseded by paragraphs 9-13 of this Statement. Paragraph 31 of that Opinion is amended by this Statement to require the additional disclosures set forth in paragraph 14.

Effective Date

16. The provisions of this Statement shall apply to accounting changes made in interim periods ending on or after December 31, 1974.

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

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

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

Appendix A: REPORTING A CUMULATIVE EFFECT TYPE ACCOUNTING CHANGE (OTHER THAN A CHANGE TO LIFO)

The following are examples of application of *APB Opinion No. 28* (as amended by this Statement) and the requirements of *APB Opinion No. 20* as they are incorporated by reference in APB *Opinion No. 28.* The examples do not encompass all possible circumstances and are not intended to indicate the Board's preference for a particular format.

FACTS

In the year 19x5, ABC Company decides to adopt the straight-line method of depreciation for plant equipment. The straight-line method will be used for new acquisitions as well as for previously acquired plant equipment for which depreciation had been provided on an accelerated method.

These examples assume that the effects of the change are limited to the effect on depreciation, incentive compensation, and related income tax provisions and that the effect on inventories is not material. The pro forma amounts have been adjusted for an assumed 10% pre-tax effect of the change on the provisions for incentive compensation and an assumed 50% income tax rate. The per share amounts are computed assuming that throughout the two years 19x4 and 19x5, 1,000,000 shares of common stock were issued and outstanding with no potential dilution. Other data assumed for these examples are:

Period	Net Income on the Basis of Old Accounting Principle (Accelerated) Depreciation	Gross Effect of Change to Straight-Line Depreciation	Gross Effect Less Income Taxes	Net Effect after Incentive Compensation and Related Income Taxes
Prior to first quarter 19X4		$ 20,000	$ 10,000	$ 9,000
First quarter 19X4	$1,000,000	30,000	15,000	3,500
Second quarter 19X4	1,200,000	70,000	35,000	31,500
Third quarter 19X4	1,100,000	50,000	25,000	22,500
Fourth quarter 19X4	1,100,000	80,000	40,000	36,000
Total at beginning of 19X5	$4,400,000	$250,000	$125,000	$112,500
First quarter 19X5	$1,059,500	$ 90,000	$ 45,000	$ 40,500
Second quarter 19X5	1,255,000	100,000	50,000	45,000
Third quarter 19X5	1,150,500	110,000	55,000	49,500
Fourth quarter 19X5	1,146,000	120,000	60,000	54,000
[Total at end of 19X5]	$4,611,000	$420,000	$210,000	$189,000

EXAMPLE 1

The change in depreciation method is made in the first quarter of 19x5. The manner of reporting the change in the first quarter of 19x5, with comparative information for the first quarter of 19x4, is as follows:

	Three Months Ended March 31,	
	19X5	**19X4**
Income before cumulative effect of a change in accounting principle	$1,100,000	$1,000,000
Cumulative effect on prior years (to December 31, 19X4) of changing to a different depreciation method (Note A)	125,000	
Net income	$1,225,000	$1,000,000
Amounts per common share:		
Income before cumulative effect of a change in accounting principle	$ 1.10	$ 1.00
Cumulative effect on prior years (to December 31, 19X4) of changing to a different depreciation method (Note A)	.13	
Net income	$ 1.23	$ 1.00
Pro forma amounts assuming the new depreciation method is applied retroactively (Note A):		
Net income	$1,100,000	$1,013,500
Net income per common share	$ 1.10	$ 1.01

NOTE A: Change in Depreciation Method for Plant Equipment

In the first quarter of 19x5, the method of computing depreciation of plant equipment was changed from the . . . (state previous method) . . . used in prior years, to the straight-line method . . . (state justification for the change in method) . . . and the new method has been applied to equipment acquisitions of prior years. The $125,000 cumulative effect of the change on prior years (after reduction for income taxes of $125,000) is included in income of the first quarter of 19x5. The effect of the change on the first quarter of 19x5 was to increase income before cumulative effect of a change in accounting principle $40,500 ($.04 per share) and net income $165,500 ($.17 per share). The pro forma amounts reflect the effect of retroactive application on depreciation, the change in provisions for incentive compensation that would have been made in 19x4 had the new method been in effect, and related income taxes.

EXAMPLE 2

Assume the same facts as in Example 1, except that the change is made in the third quarter of 19x5.

The manner of reporting the change in the third quarter of 19x5, with year-to-date information and comparative information for similar periods of 19x4, is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	19X5	19X4	19X5	19X4
Income before cumulative effect of a change in accounting principle	$1,200,000	$1,100,000	$3,600,000	$3,300,000
Cumulative effect on prior years (to December 31, 19X4) of changing to a different depreciation method (Note A)			125,000	
Net income	$1,200,000	$1,100,000	$3,725,000	$3,300,000
Amounts per common share:				
Income before cumulative effect of a change in accounting principle	$ 1.20	$ 1.10	$ 3.60	$ 3.30
Cumulative effect on prior years (to December 31, 19X4) of changing to a different depreciation method (Note A)			.13	
Net income	$ 1.20	$ 1.10	$ 3.73	$ 3.30
Pro forma amounts assuming the new depreciation method is applied retroactively (Note A):				
Net income	$1,200,000	$1,122,500	$3,600,000	$3,367,500
Net income per common share	$ 1.20	$ 1.12	$ 3.60	$ 3.37

NOTE A: Change in Depreciation Method for Plant Equipment

In the third quarter of 19x5, the method of computing depreciation of plant equipment was changed from the . . . (state previous method) . . . used in prior years, to the straight-line method . . . (state justification for the change in method) . . . and the new method has been applied to equipment acquisitions of prior years. The $125,000 cumulative effect of the change on prior years (after reduction for income taxes of $125,000) is included in income of the nine months ended September 30, 19x5. The effect of the change on the three months ended September 30, 19x5 was to increase net income $49,500 ($.05 per share); the effect of the change on the nine months ended September 30, 19x5 was to increase income before cumulative effect of a change in accounting principle $135,000 ($.14 per share) and net income $260,000 ($.26 per share). The pro forma amounts reflect the effect of retroactive application on depreciation, the change in provisions for incentive compensation that would have been made in 19x4 had the new method been in effect, and related income taxes. The effect of the change on the first quarter of 19x5 was to increase income before cumulative effect of a change in accounting principle $40,500 ($.04 per share) to $1,100,000 ($1.10 per share) and net income $165,500 ($.17 per share) to $1,225,000 ($1.23 per share); the effect of the change on the second quarter was to increase net income $45,000 ($.04 per share) to $1,300,000 ($1.30 per share).

Alternatively, the last sentence of Note A could be replaced with the following tabular disclosure:

The effect of the change on the first and second quarters of 19x5 is as follows:

	Three Months Ended	
	March 31, 19X5	**June 30, 19X5**
Net income as originally reported*	$1,059,500	$1,255,000
Effect of change in depreciation method	40,500	45,000
Income before cumulative effect of a change in accounting principle	1,100,000	1,300,000
Cumulative effect on prior years (to December 31, 19X4) of changing to a different depreciation method	125,000	
Net income as restated	$1,225,000	$1,300,000
Per share amounts:		
Net income as originally reported*	$1.06	$1.26
Effect of change in depreciation method	.04	.04
Income before cumulative effect of a change in accounting principle	1.10	1.30
Cumulative effect on prior years (to December 31, 19X4) of changing to a different depreciation method	.13	
Net income as restated	$1.23	$1.30

Appendix B: REPORTING A CHANGE TO THE LIFO METHOD OF INVENTORY PRICING

The following are examples of application of *APB Opinion No. 28* (as amended by this Statement) and the requirements of *APB Opinion No. 20* as they are incorporated by reference in *APB Opinion No. 28.* The examples do not encompass all possible circumstances and are not intended to indicate the Board's preference for a particular format.

FACTS

In the year 19x5, XYZ Company decides to change to the LIFO method of inventory pricing. These examples assume that the effects of the change are limited to the effect on inventory, incentive compensation, and related income tax provisions. A 10% pre-tax effect of the change on incentive compensation and a 50% income tax rate are assumed. The per share amounts are computed assuming that throughout 19x4 and 19x5, 1,000,000 shares of common stock were issued and outstanding with no potential dilution. Other data assumed for these examples are:

Period	Net Income on the Basis of Old Accounting Principal	Gross Effect of Change to LIFO	Net Effect after Incentive Compensation and Income Taxes
First quarter 19X5	$1,095,500	$ (90,000)	$ (40,500)
Second quarter 19X5	1,295,000	(100,000)	(45,000)
Third quarter 19X5	1,194,500	(110,000)	(49,500)
Fourth quarter 19X5	1,194,000	(120,000)	(54,000)
	$4,779,000	$(420,000)	$(189,000)

EXAMPLE 3

The change to LIFO is made in the first quarter of 19x5. The manner of reporting the change in the first quarter of 19x5, with comparative information for the first quarter of 19x4, is as follows:

	Three Months Ended March 31,	
	19X5	**19X4**
Net income (Note A)	$1,055,000	$1,000,000
Net income per common share (Note A)	$1.06	$1.00

NOTE A: Change to LIFO Method of Inventory Pricing

In the first quarter of 19x5, the Company changed its method of inventory pricing from . . . (state previous method) . . . used previously to the LIFO method because . . . (state justification for change and reasons for not disclosing a cumulative effect on, and pro forma amounts for, prior periods). The effect of the change on the first quarter of 19x5 was to decrease net income $40,500 ($.04 per share).

EXAMPLE 4

Assume the same facts as in Example 3, except that the change is made in the third quarter of 19x5.

The manner of reporting the change in the third quarter of 19x5, with year-to-date information and comparative information for similar periods of 19x4, is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	19X5	**19X4**	**19X5**	**19X4**
Net income (Note A)	$1,145,000	$1,200,000	$3,450,000	$3,400,000
Net income per common share (Note A)	$1.15	$1.20	$3.45	$3.40

NOTE A: Change to LIFO Method of Inventory Pricing

In the third quarter of 19x5, the Company changed its method of inventory pricing from . . . (state previous method) . . . used previously to the LIFO method because . . . (state justification for change and reasons for not disclosing a cumulative effect on, and pro forma amounts for, prior periods). The effect of the change on the three months and nine months ended September 30, 19x5 was to decrease net income $49,500 ($.05 per share) and $135,000 ($.14 per share), respectively. The effect of the change on the first and second quarters of 19x5 was to decrease net income $40,500 ($.04 per share) to $1,055,000 ($1.06 per share) and $45,000 ($.05 per share) to $1,250,000 ($1.25 per share), respectively.

Alternatively, the last sentence of Note A could be replaced with the following tabular disclosure:

The effect of the change on the first and second quarters of 19x5 is as follows:

	Three Months Ended	
	March 31, 19X5	**June 30, 19X5**
Net income as originally reported*	$1,095,500	$1,295,000
Effect of change to LIFO method of inventory pricing	(40,500)	(45,000)
Net income as restated	$1,055,000	$1,250,000
Per share amounts:		
Net income as originally reported*	$1.10	$1.30
Effect of change to LIFO method of inventory pricing	(.04)	(.05)
Net income as restated	$1.06	$1.25

Footnotes

FAS3, Foonote1--In making disclosures about changes to the LIFO method, enterprises should be aware of the limitations the Internal Revenue Service has placed on such disclosures.

FAS3, Footnote 2--See footnote 1.