Financial Accounting Standards

Explanation and Analysis
16th Edition—1994

Bill D. Jarnagin

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Bill D. Jarnagin, PhD.

Allen, Gibbs & Houlik, Faculty Fellow In Accounting
School of Accountancy
Wichita State University

CCH INCORPORATED
4025 W. Peterson Ave.
Chicago, IL 60646-6085
1 800 TELL CCH

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To Dr. Lloyd Seaton, Jr., Mr. Bill Lemley and Samantha

Preface

The sixteenth edition of *Financial Accounting Standards* represents an update of the material covered in the fifteenth edition and an expansion of pronouncements covered. The sixteenth edition continues to include all FASB Interpretations, FASB Technical Bulletins and future considerations from the FASB as evidenced by Exposure Drafts and Proposed Interpretations. The fifteenth edition covered all material through SFAS No. 113 and this new edition covers material through SFAS No. 117. The explanations and analyses offered are as current as possible at the date of publication.

As with previous editions, the book groups pronouncements into subject matter Topics that, in turn, are arranged to follow major balance sheet headings as closely as possible. This organization allows the reader to find all current pronouncements that deal with a given subject in one section of the book. The Exposure Drafts and Proposed Interpretation of Statements are explained on the Contents page that begins each Topic. This material has not been included in the main body of the text because it is subject to substantial change and may never be published in the form of a Statement or Interpretation.

Three levels of explanation and analysis are offered for the Opinions and Statements. This "three-level" approach includes flowchart material, general discussion and detailed example material. First, a flowchart has been prepared to illustrate the general decision process and accounting procedures required by a pronouncement. Next, a general discussion of the major provisions of the Opinion or Statement is presented. This discussion is more detailed than the material presented in the flowchart but does not attempt to incorporate computational aspects of the pronouncement. The third level of explanation and analysis consists of detailed example material that shows the reader specific computational and accounting requirements of the pronouncement. The example material is designed to progress from simple to complex considerations. Specific implementation problems are discussed in this section of the analysis. Where appropriate, disclosures from actual reports of selected companies complete the analysis of each Opinion or Statement.

Accounting practitioners should view this book as a working guide for solutions to many complex accounting problems. I have been pleased with the response of practitioners to the presentation of the material. Once again, I encourage a careful reading of the original pronouncement, before reading the material relating to a specific Opinion or Statement. The original pronouncements of the APB and the FASB are viewed as an integral part of this book and should always be consulted as the final authority on accounting and disclosure matters.

CPA Examination candidates should benefit from this volume because approximately 60 percent of the questions on the Theory part of the Uniform CPA Examination, and a large percentage of the financial accounting questions on the Accounting Practice parts, are directly related to the professional pronouncements. Candidates are encouraged to pay particular attention to the computational notes and journal entries associated with the detailed example material.

I still find that, in the classroom, many accounting students become confused by the concise and technical presentation found in the original pronouncements, and many of the Interpretations do little to overcome this dilemma. Information contained in this text has proven to be invaluable when used as an interpretative instrument for students in the classroom. The use of this text will minimize classroom time devoted to explanations of technical provisions of the pronouncements and will free the instructor to spend more time dealing with the many conceptual issues in accounting. The book may be used as the main text or as a supplement in an undergraduate theory or pronouncements course. Graduate MBA students will benefit from the technical presentation that is often omitted from their coursework. I have found the book to be of benefit in Advanced Financial Accounting and a powerful supplement to Intermediate Accounting (especially Intermediate II).

I wish to thank the American Institute of Certified Public Accountants and the Financial Accounting Standards Board for permission to quote from their publications, and the editors of the *CPA Journal* for permission to reproduce certain flowchart materials. All quotes used in the book related to FASB publications are "Copyrighted by the Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut, 06856-5116, U.S.A. reprinted with permission. Copies of the complete documents are available from the FASB." In addition, I would like to thank Mary P. Arnold, Luann Brenner, Fernando DaSilva, Philip L. Defliese, Mike Denning, Calvin Engler, John R. Kirk, Teresa S. Madden, Richard L. Pannell, John Martin Stokes, Ellsworth C. (Bud) Granger, Sanyay Jaiswal, Macki Jarnagin, and the students of Dr. Arthur C. Nieminsky at California State University, Northridge, for their valuable technical assistance and Luann Bean, Terri Hollingsworth and Randall Edgar for their assistance in proofreading. The students at the University of Tulsa and the Wichita State University have proven to be an invaluable source of information and encouragement. I thank them as a group.

It is my hope that *Financial Accounting Standards—Explanation and Analysis* will provide you with new insights into, and practical understanding of, the Opinions and Statements of our professional organization. I invite your comments and suggestions for improvements in subsequent editions.

Bill D. Jarnagin

July 1994

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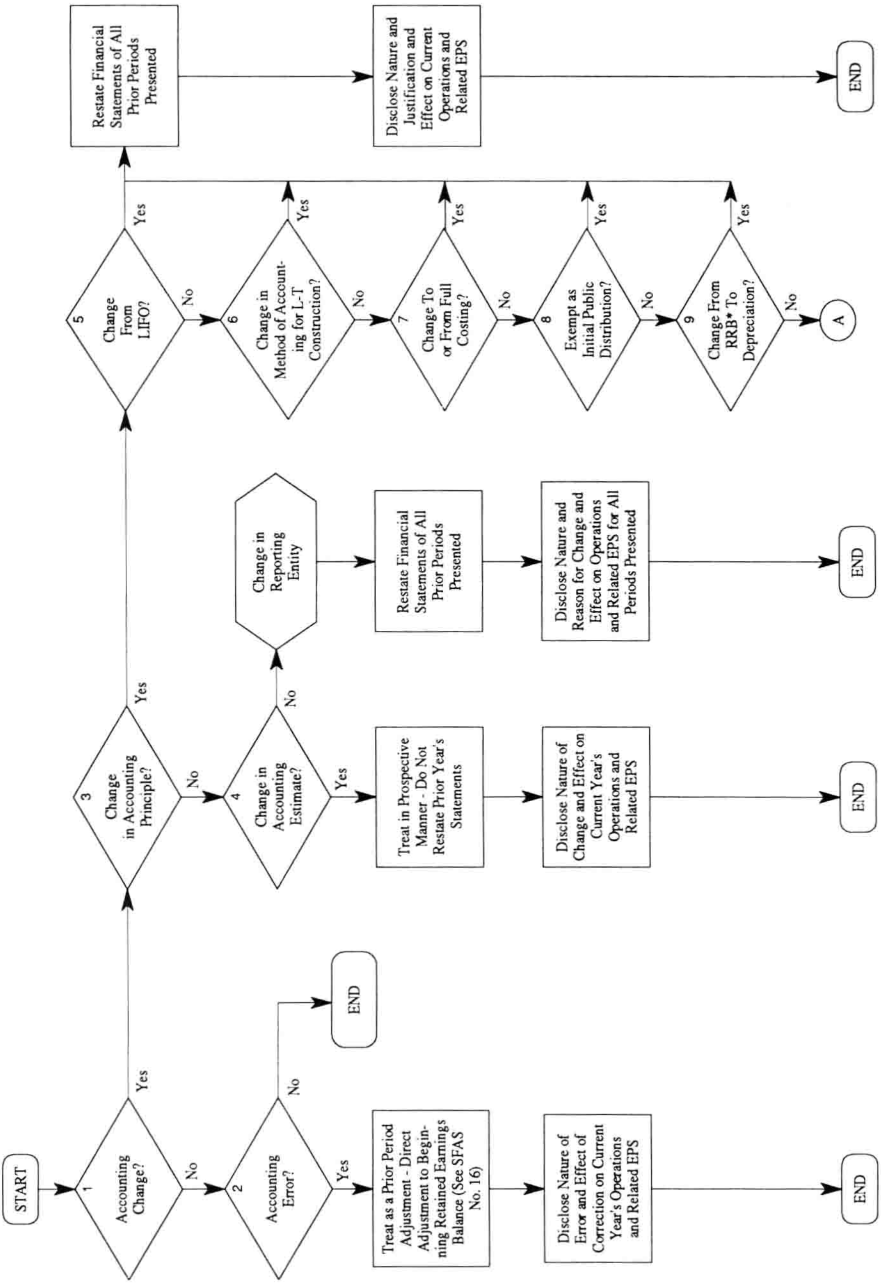
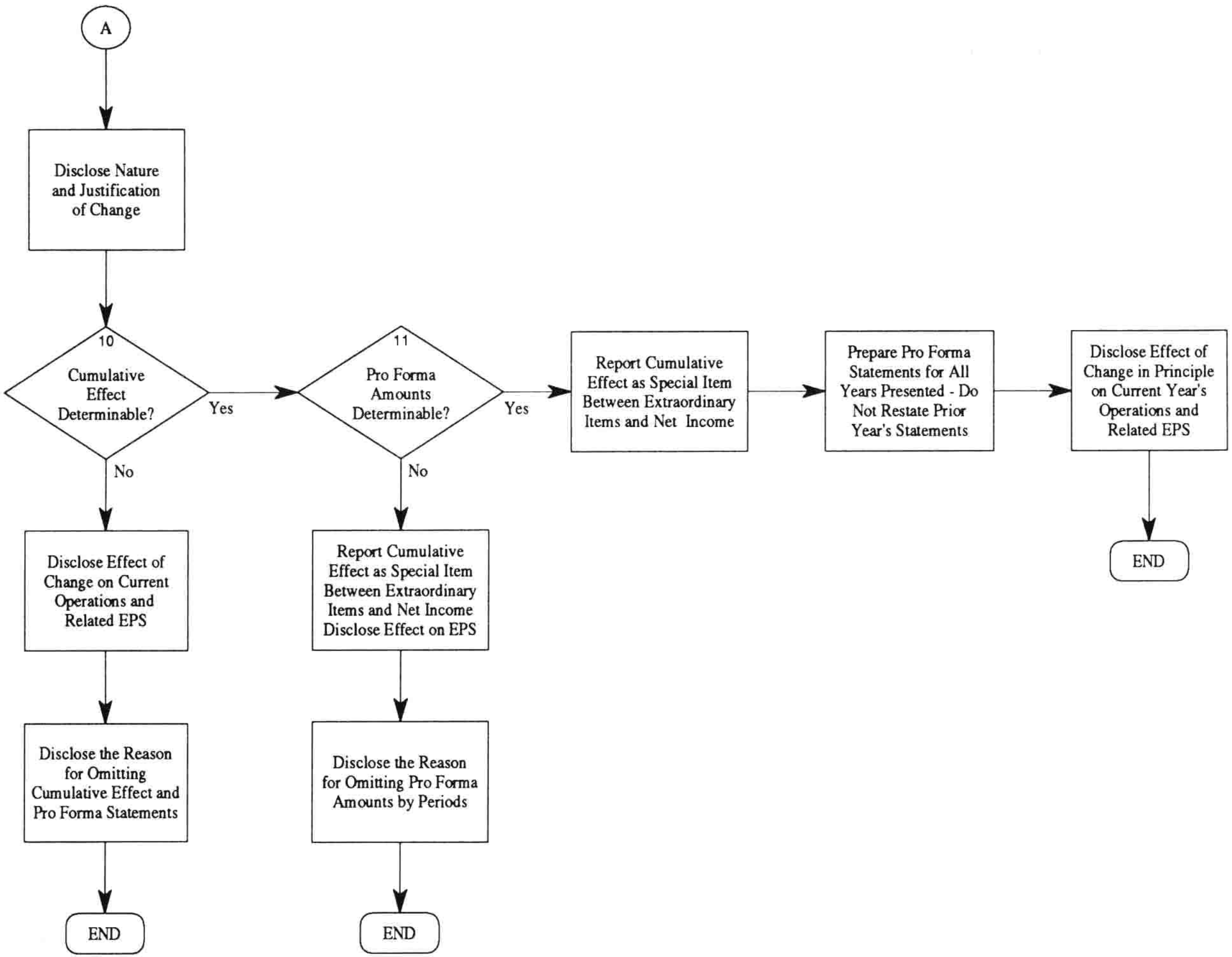
Flowchart and General Discussion

APB Opinion No. 20 deals with the broad areas of reporting and disclosing accounting changes and accounting errors. The major accounting changes identified in the Opinion are (1) changes in accounting principles, (2) changes in accounting estimates and (3) changes in reporting entities. While reporting of errors in previously issued financial statements is not an accounting change, it also is included in the Opinion.

Flowchart 1 depicts the general accounting principles and reporting requirements promulgated by the Opinion. The major decision points have been numbered for reference in the discussion that follows. Each of the sections below will be divided into three parts: (1) general discussion of specific accounting change or error correction; (2) technical considerations in accounting for and reporting the change; and (3) required disclosures with specific examples. This organization will allow the reader to go directly to the problem area of interest.



* RRB = Retirement-Replacement-Betterment Accounting



A
Disclose Nature and Justification of Change
10
Cumulative Effect Determinable?
Yes
No
Disclose Effect of Change on Current Operations and Related EPS
Disclose the Reason for Omitting Cumulative Effect and Pro Forma Statements
END
11
Pro Forma Amounts Determinable?
Yes
No
Report Cumulative Effect as Special Item Between Extraordinary Items and Net Income Disclose Effect on EPS
Disclose the Reason for Omitting Pro Forma Amounts by Periods
END
Report Cumulative Effect as Special Item Between Extraordinary Items and Net Income
Prepare Pro Forma Statements for All Years Presented - Do Not Restate Prior Year's Statements
Disclose Effect of Change in Principle on Current Year's Operations and Related EPS
END

Changes in Accounting Principles—General Discussion

A change in accounting principle (Block 3) is the "adoption of a generally accepted accounting principle different from the one used previously for reporting purposes" (APB Opinion No. 20, Paragraph 7). Examples include changing methods of depreciation from, say, straight-line to sum-of-the-years' digits method, or a change in the method of pricing inventories from specific identification to first-in first-out.[1] A change in accounting principle must be from one generally accepted principle to another generally accepted principle. A change from an accounting principle that is *not* generally accepted to one that is generally accepted is treated as an error correction, rather than as a change in accounting principle.

APB Opinion No. 20, as amended by SFAS No. 73, identifies five types of accounting changes that require special treatment. These five are: (1) a change *from* Last-in, First-out (LIFO) inventory method *to* some other method (Block 5); (2) a change *to* or *from* percentage of completion method of accounting for long-term construction contracts (Block 6); (3) a change *to* or *from* the "full cost" method of accounting used in the extractive industry (Block 7); (4) special cases where companies are involved in initial public offerings of securities (Block 8); and (5) a change from retirement-replacement-betterment accounting (RRB) to depreciation accounting for railroad track structures (Block 9). These five changes are handled differently from other types of changes in accounting principles.

A change in accounting principles is accounted for by reporting the "cumulative effect" of the change in the income statement. The cumulative effect of the change is reported on a "net of tax basis" and should appear after any extraordinary items, but before net income. The cumulative effect will be a special line item on the income statement.

The cumulative effect is the difference between the *beginning* retained earnings balance of the year in which the change is reported and the beginning retained earnings balance that *would have been reported* if the new principle had been applied retroactively. The cumulative effect is measured by assuming that the "new" principle was used in all previous periods, and by comparing the results obtained under this assumption with the actual results reported. An important point to remember is that the cumulative effect is the impact on *beginning* retained earnings of the period in which the change in accounting principles occurred.

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[1] In addition to these examples, FASB Interpretation No. 1 requires that changes in the computation of the cost elements included in inventory be treated as a change in accounting principle.