Statement of Financial Accounting Standards No. 16

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Prior Period Adjustments

June 1977

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 16: Prior Period Adjustments

INTRODUCTION AND BACKGROUND INFORMATION

1. The AICPA Committee on SEC Regulations and others have requested that the FASB consider the criteria for prior period adjustments stated in paragraph 23 of *APB Opinion No. 9,* "Reporting the Results of Operations," and provide further guidelines for the application of those criteria. Paragraph 23 of *APB Opinion No. 9* states:

> Adjustments related to prior periods—and thus excluded in the determination of net income for the current period—are limited to those material adjustments which (a) can be specifically identified with and directly related to the business activities of particular prior periods, and (b) are not attributable to economic events occurring subsequent to the date of the financial statements for the prior period, and (c) depend primarily on determinations by persons other than management and (d) were not susceptible of reasonable estimation prior to such determination. Such adjustments are rare in modern financial accounting. They relate to events or transactions which occurred in a prior period, the accounting effects of which could not be determined with reasonable assurance at that time, usually because of some major uncertainty then existing. Evidence of such an uncertainty would be disclosure thereof in the financial statements of the applicable period, or of an intervening period in those cases in which the uncertainty became apparent during a subsequent period. Further, it would be expected that, in most cases, the opinion of the reporting independent auditor on such prior period would have contained a qualification because of the uncertainty. Examples are material, nonrecurring adjustments or settlements of income taxes, of renegotiation proceedings or of utility revenue under rate processes. Settlements of significant amounts resulting from litigation or similar claims may also constitute prior period adjustments.

2. The requests referred to in paragraph 1 were prompted by Securities and Exchange Commission staff administrative interpretations of *APB Opinion No. 9* during 1975 limiting prior period adjustments for out-of-court settlements of litigation. The view of the SEC staff was later explained in *Staff Accounting Bulletin No. 8* (see Appendix C). In addition, differing interpretations of the criteria of paragraph 23 and of the provisions of paragraph 24 of *APB Opinion No. 9* have been cited as a basis for requesting a reconsideration of the concept of prior period adjustments.

3. Paragraph 24 of *APB Opinion No. 9* elaborates on paragraph 23 by giving examples of items that do not qualify as prior period adjustments. Paragraph 24 states:

> Treatment as prior period adjustments should not be applied to the normal, recurring corrections and adjustments which are the natural result of the use of estimates inherent in the accounting process. For example, changes in the estimated remaining lives of fixed assets affect the computed amounts of depreciation, but these changes should be considered prospective in nature and not prior period adjustments. Similarly, relatively immaterial adjustments of provisions for liabilities (including income taxes) made in prior periods should be considered recurring items to be reflected in operations of the current period. Some uncertainties, for example those relating to the realization of assets (collectibility of accounts receivable, ultimate recovery of deferred costs or realizability of inventories or other assets), would not qualify for prior period adjustment treatment, since economic events subsequent to the date of the financial statements must of necessity enter into the elimination of any previously-existing uncertainty. Therefore, the effects of such matters are considered to be elements in the determination of net income for the period in which the uncertainty is eliminated. Thus, the Board [APB] believes that prior period adjustments will be rare.

4. *APB Opinion No. 20,* "Accounting Changes," affirmed the conclusions of paragraph 24 of *APB Opinion No. 9* by requiring that "a change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods...unless the change meets all the conditions for a prior period adjustment (paragraph 23 of *APB Opinion No. 9*)."

5. *FASB Statement No. 5,* "Accounting for Contingencies," (effective for fiscal years beginning on or after July 1, 1975) establishes the conditions for accrual of an estimated loss from a loss contingency and prohibits accrual before those conditions are met. The two conditions for accrual of an estimated loss from a loss contingency set forth in paragraph 8 of Statement No. 5 are that "(a) information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements..." and "(b) the amount of loss can be reasonably estimated." Paragraph 8 of the Statement requires that "an estimated loss from a loss contingency...shall be accrued by a charge to income...." A footnote to that paragraph states that "paragraphs 23-24 of *APB Opinion No. 9*...describe the 'rare' circumstances in which a prior period adjustment is appropriate" and indicates that "those paragraphs are not amended" by Statement No. 5.

6. The Board has, among other things, (a) reviewed an FASB staff survey of prior period adjustments made in recent years pursuant to the criteria of *APB Opinion No. 9,* (b) considered the relationship of the criteria of *APB Opinion No. 9* for prior period adjustments to the rationale of subsequent APB Opinions (see paragraphs 29-36), and (c) examined the relationship of the criteria of *APB Opinion No. 9* for prior period adjustments to the conditions of *FASB Statement No. 5* for accrual of estimated losses from loss contingencies (see paragraph 37).

7. An Exposure Draft of a proposed Statement on "Prior Period Adjustments" was issued July 29, 1976, and

a public hearing based on the Exposure Draft was held on October 15, 1976. The Board received 162 position papers and letters of comment in response to the Exposure Draft. Ten presentations were made at the public hearing. On April 12, 1977 the FASB announced that it was unable to attain the necessary five assenting votes for issuance of a final Statement on Prior Period Adjustments. That announcement stated that four FASB members agreed to support the position in the Exposure Draft, modified in certain respects for interim reporting, and that the other three Board members dissented for varied reasons. On June 21, 1977 the Trustees of the Financial Accounting Foundation announced that they had approved the implementation of a number of the recommendations made by the Trustees' Structure Committee in its April 1977 report, "The Structure of Establishing Financial Accounting Standards." The recommendations approved included amending the Foundation's by-laws to change the voting requirement for adoption of pronouncements by the FASB from five affirmative votes among the seven members to a simple majority. Subsequent to the action by the Trustees, the Board reconsidered the subject and voted to issue this Statement.

8. The Board concluded that, with limited exceptions, items of profit and loss recognized during a period shall be included in the determination of net income of that period. Paragraphs 11 and 13-15 describe the exceptions that shall be accounted for and reported as prior period adjustments. The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in Appendix A to this Statement. The results of the FASB staff survey of prior period adjustments made pursuant to the criteria of *APB Opinion No. 9* in annual financial statements for fiscal years ending from July 1973 through June 1975 are summarized in Appendix B to this Statement.

9. The Addendum to *APB Opinion No. 2*, "Accounting for the 'Investment Credit'," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process," and discusses the application of generally accepted accounting principles to regulated industries. FASB Statements and Interpretations should therefore be applied to regulated companies that are subject to the rate-making process in accordance with the provisions of the Addendum.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

10. Except as specified in paragraph 11 and in paragraphs 13 and 14 with respect to prior interim periods of the current year, all items of profit and loss recognized during a period,[1] including accruals of estimated losses from loss contingencies, shall be included in the determination of net income for that period.[2]

11. Items of profit and loss related to the following shall be accounted for and reported as prior period adjustments [3] and excluded from the determination of net income for the current period:

a) Correction of an error in the financial statements of a prior period [4] and
b) Adjustments that result from realization of income tax benefits of pre-acquisition operating loss carryforwards of purchased subsidiaries.[5]

12. This Statement does not affect the manner of reporting accounting changes required or permitted by an FASB Statement, an FASB Interpretation, or an APB Opinion.[6]

Adjustments Related to Prior Interim Periods of the Current Fiscal Year

13. For purposes of this Statement, an "adjustment related to prior *interim* periods of the current fiscal year" is an adjustment or settlement of litigation or similar claims, of income taxes, of renegotiation proceedings, or of utility revenue under rate-making processes provided that the adjustment or settlement meets each of the following criteria:

a. The effect of the adjustment or settlement is material in relation to income from continuing operations of the current fiscal year or in relation to the trend of income from continuing operations or is material by other appropriate criteria, and
b. All or part of the adjustment or settlement can be specifically identified with and is directly related to business activities of specific prior interim periods of the current fiscal year, and
c. The amount of the adjustment or settlement could not be reasonably estimated prior to the current interim period but becomes reasonably estimable in the current interim period.

Criterion (b) above is not met solely because of incidental effects such as interest on a settlement. Criterion (c) would be met by the occurrence of an event with currently measurable effects such as new retroactive tax legislation or a final decision on a rate order. Treatment as adjustments related to prior interim periods of the current fiscal year shall not be applied to the normal recurring corrections and adjustments that are the result of the use of estimates inherent in the accounting process. Changes in provisions for doubtful accounts shall not be considered to be adjustments related to prior interim periods of the current fiscal year even though the changes result from litigation or similar claims.

14. If an item of profit or loss occurs in *other than the first* interim period of the enterprise's fiscal year and all or a part of the item of profit or loss is an adjustment related to prior interim periods of the current fiscal year, as defined in paragraph 13 above, the item shall be reported as follows:

a. The portion of the item that is directly related to business activities of the enterprise during the current interim period, if any, shall be included in the determination of net income for that period.
b. Prior interim periods of the current fiscal year shall be restated to include the portion of the item that is directly related to business activities of the enterprise during each prior interim period in the determination of net income for that period.
c. The portion of the item that is directly related to business activities of the enterprise during prior fiscal years, if any, shall be included in the determination of net income of the first interim period of the current fiscal year.

15. The following disclosures shall be made in interim financial reports about an adjustment related to prior interim periods of the current fiscal year. In financial reports for the interim period in which the adjustment occurs, disclosure shall be made of (a) the effect on income from continuing operations, net income, and related

per share amounts for each prior interim period of the current fiscal year, and (b) income from continuing operations, net income, and related per share amounts for each prior interim period restated in accordance with paragraph 14 of this Statement.

Amendments to Existing Pronouncements

16. The conclusions of this Statement require the following amendments to existing pronouncements:

a. *APB Opinion No. 9*. Delete paragraphs 23 and 24. The first sentence of paragraph 18 is modified to read as follows:

> Those items that are reported as prior period adjustments shall, in single period statements, be reflected as adjustments of the opening balance of retained earnings.

b. *APB Opinion No. 20*. Delete footnote 9 to paragraph 31.

c. *APB Opinion No. 30*. Delete the following words from the second and third sentences of paragraph 25: "should not be reported as a prior period adjustment unless it meets the criteria for a prior period adjustment as defined in paragraph 23 of APB Opinion No. 9. An adjustment that does not meet such criteria," and combine the remainder of the two sentences into one sentence as follows:

> Each adjustment in the current period of a loss on disposal of a business segment or of an element of an extraordinary item that was reported in a prior period should be separately disclosed as to year of origin, nature, and amount and classified separately in the current period in the same manner as the original item.

d. *FASB Statement No. 5*. Delete footnote 3 to paragraph 8.

Effective Date and Transition

17. This Statement shall be effective for financial statements for fiscal years beginning after October 15, 1977. Application in financial statements for fiscal years beginning before October 16, 1977 that have not been previously issued, and in interim periods within those fiscal years, is encouraged but not required. This Statement shall not be applied retroactively to previously issued annual financial statements.

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

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Sprouse, Litke, and Walters dissented.

Mr. Sprouse and Mr. Litke dissent primarily because the effect of this Statement is to include in the current year's *income from continuing operations* adjustments related to prior years that previously would have been excluded in the determination of the current year's *net income*. In their opinion this is a quantum leap that detracts from the usefulness of the measure of income from continuing operations and that should not be undertaken without comprehensive consideration of the presentation of information about earnings activities. Mr. Sprouse and Mr. Litke believe that application of this Statement produces anomalous results including (i) reporting tax benefits of loss carryforwards as extraordinary items when realized (a practice with which they concur) but including other adjustments or settlements of income taxes related to prior periods in income from continuing operations, (ii) reporting gains and losses from extinguishing debt during the current period as extraordinary items (a practice with which they concur) but including adjudications and out-of-court settlements of litigation, results of renegotiation proceedings, and other financial results related to prior periods in income from continuing operations, and (iii) excluding adjustments related to prior interim periods from the net income of the current interim period (except that such adjustments made during the first interim period are included in that period's income from continuing operations) because the Board is reconsidering interim reporting and some respondents to the Exposure Draft argued that the inclusion of those adjustments would detract from the usefulness of interim reporting (paragraph 46) but rejecting similar considerations related to annual reporting (paragraphs 23 and 52). If, without comprehensive consideration of the presentation of information about earnings activities, certain adjustments related to prior periods that previously were excluded in the determination of net income for the current period are now to be included in that determination, Mr. Sprouse and Mr. Litke believe that, as a minimum, those adjustments should be specifically designated (as they are in paragraph 13) and be reported as extraordinary items.

Further, Mr. Litke would provide an additional specific exception in paragraph 11 (as is now provided by paragraph 23 of *APB Opinion No. 9*) for cost-of-service regulated utility companies in those instances where revenues collected subject to refund are required to be refunded. He believes that the circumstances applicable to regulated utility companies in those instances are sufficiently different from circumstances applicable to other industries to warrant such special treatment.

With respect to current practice for such companies, the amount of the refund generally is attributed to the year of collection and not to the year of the refund. Mr. Litke agrees with this practice. He notes that when management believes a reasonable estimate can be made of the amount of revenues currently being collected which are likely to be refunded, they generally record a reserve against revenue for that amount in accordance with *FASB Statement No. 5*. However, management is often unable to make a reasonable estimate as to what, if any, refunds may be required. In that case, all revenues resulting from such rate increases collected but subject to refund are frequently recorded as current revenue in the determination of the current period's income (even though the revenue and the income are subject to final adjudication), and the auditor's report is normally qualified. When the amount of the refund is determined, it generally is attributed to the year(s) of collection by prior period adjustment.

Mr. Litke believes that, if prior period adjustments were not permitted for a regulated company required to refund amounts previously collected subject to refund, the revenue, operating profit, and net income for prior periods could be materially misstated based on what the rate regulatory body finally allowed.

In addition, Mr. Litke believes that a specific exception is necessary because this Statement does not specifically respond to the questions raised by many as to the applicability of the Addendum to *APB Opinion No. 2* to refunds of utility revenues for which a reasonable estimate cannot be made.

Mr. Walters dissents because he does not believe the elimination of prior period adjustments improves financial reporting. To the contrary, he believes that there are clearly valid items, admittedly somewhat rare, whose inclusion in prior periods with which they are specifically identified, enhances the relevance, comparability, and understandability of financial statements and therefore their usefulness. He also does not believe the Board should tinker with this narrow, but basic, issue outside the conceptual framework project. As a minimum, it should be part of a broader project dealing with the meaning and presentation of results of operations.

Members of the Financial Accounting Standards Board:

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

Appendix A: BASIS FOR CONCLUSIONS

18. This Appendix contains a discussion of the factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others. Individual Board Members gave greater weight to some factors than to others.

Scope

19. The initial request referred to in paragraph 1 was for clarification of the application of criterion (b)[7] and criterion (c) [8] of paragraph 23 of *APB Opinion No. 9* to negotiated settlements of litigation. Paragraph 23 of *APB Opinion No. 9* included "settlements of significant amounts resulting from litigation or similar claims" as an example of items that may qualify as prior period adjustments. SEC *Staff Accounting Bulletin No. 8* states the SEC staff's conclusion that "litigation is inevitably an 'economic event' and that settlements would constitute 'economic events' of the period in which they occur. Accordingly, it would seem that charges or credits relating to settlements would also not meet" criterion (b).[9] *Staff Accounting Bulletin No. 8* also states the view that when litigation is settled, management must make a number of significant judgments, and, hence, criterion (c) [10] has not been met.

20. As described in Appendix B, the FASB staff searched approximately 6,000 annual reports for fiscal years ended from July 1973 through June 1975 and identified 191 annual reports that showed prior period adjustments that appeared to have been made pursuant to the criteria of paragraph 23 of *APB Opinion No. 9*. The purpose of the research was to determine the extent and nature of those prior period adjustments and the possible interpretative problems the Board would face if it decided to clarify the criteria in paragraph 23 of *APB Opinion No. 9*. Over one-third of the identified adjustments resulted from litigation and similar claims, and most of

these were negotiated. Income tax settlements also represented over one-third of the identified adjustments. Because of the similarity of the process involved in settling litigation and income taxes, and because they constitute most of the identified prior period adjustments made pursuant to the criteria of paragraph 23 of *APB Opinion No. 9,* the Board concluded that this Statement should not be limited to the area of negotiated settlements of litigation, but rather, should address all items reported as prior period adjustments pursuant to the criteria of paragraph 23 of *APB Opinion No. 9.*

21. Some respondents to the Exposure Draft questioned whether this Statement was intended to change the reporting of adjustments that are required by *APB Opinions No. 9, 11,* and *16* to be reported as adjustments to paid-in capital, goodwill, or other assets. This Statement is not intended to require those adjustments to be included in the determination of net income of the current period. This Statement is also not intended to proscribe restatements of earnings per share that are required by *APB Opinions No. 15,* "Earnings Per Share," and *16* or by other APB Opinions and FASB Statements.

Summary

22. In considering possible clarification of the criteria in paragraph 23 of *APB Opinion No. 9* (see paragraph 24), the purpose of the criteria (see paragraph 25), and the effect on prior period adjustments of subsequent pronouncements (see paragraphs 29-37), the Board determined that an amendment of *APB Opinion No. 9* was needed. The Board concluded for the reasons indicated in paragraphs 24-39 that all items of profit and loss recognized during a period, with the limited exceptions indicated in paragraphs 11 and 13-15 and explained in paragraphs 41-46, shall be included in the determination of net income for that reporting period. The Board also concluded, for the reasons indicated in paragraphs 47-51, that the manner of reporting accounting changes should not be modified at this time (see paragraph 12).

23. Some respondents recommended that this project be included in or deferred pending completion of the Board's agenda project entitled "Conceptual Framework for Financial Accounting and Reporting." The Board determined that this problem required resolution at this time and could be resolved in the existing accounting framework. As outlined in paragraphs 29-37, the all-inclusive income statement is predominant in the existing accounting framework.

Possible Clarification of Criteria

24. Relating the criteria of paragraph 23 of *APB Opinion No. 9* and the examples given in that paragraph to prior period adjustments identified in the FASB staff survey (see Appendix B) led to the conclusion that any attempted clarification could result in an amendment of *APB Opinion No. 9* and that the problem could not be satisfactorily resolved by an Interpretation as indicated by the following examples:

a. Settlements of income taxes and litigation constitute the majority of identified prior period adjustments. The former is included in paragraph 23 as an example of a prior period adjustment when material and nonrecurring and the latter is included as an example of an item that *may* qualify as a prior period adjustment. Such settlements are usually negotiated and often do not depend *primarily* on determinations by *any* single party. Accordingly, for out-of-court settlements of both income taxes and litigation to qualify as prior period adjustments, the phrase "depend primarily on determinations by persons other than management" (criterion(c)) would have to be amended to read "not depending primarily on management."

b. The term "economic events" in criterion (b) [11] has been interpreted in significantly different ways (see paragraph 19 and Appendix C). Refining the definition of this term could result in an effective amendment.

c. Refining the requirement that prior period adjustments be "material" or of the word "nonrecurring" in the examples in paragraph 23 would likely be an effective amendment.

Purpose of the Criteria of Paragraph 23 of APB Opinion No. 9

25. Paragraph 17 of *APB Opinion No. 9* states that "net income should reflect all items of profit and loss recognized during the period with the sole exception of...prior period adjustments...." *APB Opinion No. 9* requires restatement of affected prior periods only if the statements of the affected prior periods are presented; otherwise, only the effect on beginning retained earnings of the earliest period presented is required. The Board believes that a decision to exclude certain items of profit and loss recognized during a period from the determination of net income for that period should be based on a determination that some expected user or class of users would be benefited. Items of profit and loss clearly related to prior period operations and unrelated to the current period operations, for example, might be excluded from the determination of net income for the current period because existing and potential investors might be misled by their inclusion. The criteria of paragraph 23 of *APB Opinion No. 9* do not serve this purpose because they do not comprehend many other items of profit and loss related to prior periods and unrelated to the current period operations. The Board concluded that users will not be benefited by special treatment for some items of profit and loss recognized during a period but not for other similar items. The reasons for the limited exceptions indicated in paragraphs 11 and 13-15 are explained in paragraphs 41-46.

The Matching Concept

26. A number of respondents to the Exposure Draft noted that adjustments that are reported as prior period adjustments are unrelated to operations of the current period. In their view, inclusion in net income of the current period of costs or revenues that are directly related to business activities of prior periods distorts net income in the current period by matching revenue of one period with costs of another period.

27. *APB Statement No. 4*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," explicitly avoids using the term "matching" because it has a variety of meanings in the accounting literature. In its broadest sense, matching refers to the entire process of income determination—described in paragraph 147 of *APB Statement No. 4* as "identifying, measuring, and relating revenue and expenses of an enterprise for an accounting period." Matching may also be used in a more limited sense to refer only to the process of expense recognition or in an even more limited sense to refer to the recognition of expenses by associating costs with revenue on a cause and effect basis.

28. The Board reviewed items that were reported as prior period adjustments in recent years. The results of that review are summarized in Appendix B. Based on that review, the Board concluded that the items that were

reported as prior period adjustments were not sufficiently different from other items that were included in the determination of net income in the current period to justify their exclusion.

Relationship to Subsequent Pronouncements

29. *APB Opinion No. 9* was issued in December 1966. Since then, other APB Opinions and FASB Statements have changed the standards of accounting for some items related to prior periods. The following paragraphs refer to certain of those changes and their relationship to prior period adjustments.

30. Paragraph 23 of *APB Opinion No. 9* includes "material, nonrecurring adjustments or settlements of income taxes" as an example of items that would meet the criteria for prior period adjustments. Paragraph 24 of Opinion No. 9 states that "relatively immaterial adjustments of provisions for liabilities (including income taxes) made in prior periods should be considered recurring items to be reflected in operations of the current period." *APB Opinion No. 11*, issued in December 1967, requires the use of comprehensive allocation in accounting for income taxes. Prior to the issuance of that Opinion, some enterprises applied partial allocation, a method that did not require taxes to be allocated for certain timing differences. Many settlements of income taxes involve timing differences. With the use of comprehensive allocation, tax settlements relating to timing differences normally do not affect income; thus, *APB Opinion No. 11* probably has reduced the income effect of some settlements of income tax and accordingly the number of settlements that would be accounted for as prior period adjustments.

31. Paragraph 45 of *APB Opinion No. 11* requires that the benefits of prior year tax loss carryforwards not recognized in the year of the loss be recognized as an extraordinary item in the year in which the benefits are realized. Previously, Chapter 10B, "Income Taxes," of *ARB No. 43* provided that "...where it is believed that misleading inferences would be drawn from such inclusion, the tax reduction should be credited to surplus." Thus, *APB Opinion No. 11* requires that an item that is related to specific prior periods be included in the determination of current income.

32. Paragraph 50 of *APB Opinion No. 11* requires that realized tax benefits of loss carryforwards arising prior to a "quasi-reorganization" be added to contributed capital if not recognized prior to the "quasi-reorganization." Thus, *APB Opinion No. 11* requires inclusion of an item that relates to specific prior periods as an addition to contributed capital in the current period. (See paragraph 34.)

33. Paragraphs 79-83 of *APB Opinion No. 16* require that adjustments resulting from resolution of certain contingencies be accounted for as adjustments of the cost of the acquired enterprise. The required accounting is prospective rather than retroactive. Thus, *APB Opinion No. 16* requires that resolution of certain contingencies relating to specific prior periods be reported as an adjustment of the purchase price of assets in the current period. (See paragraph 34.)

34. *APB Opinion No. 19*, "Reporting Changes in Financial Position," established the statement of changes in financial position as a new basic financial statement. This statement purports to present all changes in financial position that occur during the period. The interaction of Opinion No. 19, *APB Opinion No. 9*, and other APB

Opinions results in the following anomalies:

a. Realized tax benefits of loss carryforwards arising prior to a "quasi-reorganization" are considered related to prior operations and are added to contributed capital, but are reported as changes in financial position in the current period (see paragraph 32); whereas settlements of income taxes, when they meet the criteria of paragraph 23 of *APB Opinion No. 9,* are reported as changes in financial position in the prior period.
b. Adjustments arising from resolution of certain pre-acquisition contingencies of acquired subsidiaries, considered unrelated to current operations and thus reported as adjustments to the cost of the acquired enterprise, are reported as changes in financial position in the current period (see paragraph 33); whereas adjustments of contingencies that meet the criteria of paragraph 23 of *APB Opinion No. 9* are reported as changes in financial position in the prior period.

The Board concluded that all items of profit and loss recognized in a period, with the limited exceptions indicated in paragraphs 11 and 13-15 and explained in paragraphs 41-46, shall be included in the determination of net income and accordingly shall be reported as changes in financial position in that reporting period.

35. Paragraph 31 of *APB Opinion No. 20* requires that the effect of changes in accounting estimates be accounted for in the current period, or the current and future periods if the change affects both. Restatement of amounts reported in prior periods and reporting of pro forma amounts for prior periods are prohibited. However, the Opinion includes a footnote that states:

> Financial statements of a prior period should not be restated for a change in estimate resulting from later resolution of an uncertainty which may have caused the auditor to qualify his opinion on previous financial statements unless the change meets all the conditions for a prior period adjustment (paragraph 23 of *APB Opinion No. 9*).

Thus, Opinion No. 20 requires that most items related to prior periods be included in the determination of current net income without disclosure of the pro forma effect of those items on prior periods but continues the requirements of paragraph 23 of *APB Opinion No. 9* that a few similar items be reported as prior period adjustments.

36. In addition to establishing criteria for prior period adjustments, which were expected to be rare, *APB Opinion No. 9* also established criteria for "extraordinary items," which were to be reported separately in net income of the current period. *APB Opinion No. 30,* "Reporting the Results of Operations," issued in June 1973, established new criteria for extraordinary items, including a change of "would not be expected to recur frequently" in *APB Opinion No. 9* to "not reasonably expected to recur in the foreseeable future" in *APB Opinion No. 30*. Although *APB Opinion No. 30* did not address prior period adjustments, it significantly restricted the eligibility for classification as an extraordinary item. Under Opinion No. 9 the statement that prior period adjustments would be *nonrecurring* adjustments was often interpreted in practice to mean adjustments that would not be expected to recur frequently, but in the current accounting environment, including *APB Opinion No. 30, nonrecurring* would be defined as "not reasonably expected to recur in the foreseeable future."

37. Paragraph 8 of *FASB Statement No. 5,* issued in March 1975, establishes two conditions for accrual of an estimated loss from a loss contingency and prohibits accrual before those conditions are met. The Board did not reexamine the concept of prior period adjustments at that time. Consideration in this Statement of the kinds of items, if any, to be accounted for as prior period adjustments led to the following questions: If pursuant to *FASB Statement No. 5* a loss cannot be accrued in the period when it is probable that an asset had been impaired or a liability had been incurred because the amount of loss cannot be reasonably estimated, should the loss be charged retroactively to that period when it can be reasonably estimated in a subsequent period? Does the loss accrue to the earlier period, when it was probable that an asset had been impaired or a liability had been incurred, or to the later period, when the amount of loss can be reasonably estimated? The Board believes that the requirement under *APB Opinion No. 9* that certain losses, when they can be reasonably estimated in a later period, be charged retroactively to an earlier period is inconsistent with the intent of *FASB Statement No. 5* in prohibiting accrual of an estimated loss when the amount of loss cannot be reasonably estimated, even though it is probable that an asset has been impaired or a liability has been incurred. The Board concluded that all estimated losses for loss contingencies should be charged to income rather than charging some to income and others to retained earnings as prior period adjustments.

Consideration of Specific Types of Adjustments

38. A number of respondents questioned the appropriateness of a rate-regulated utility's reporting refunds in the period in which the refunds are ordered if the refunded amounts were originally collected subject to refund. Upon request, several of those respondents furnished additional data that further explained the effect of those refunds. The Board is aware that there are differing views about the reporting of both the contingently refundable revenue when it is billed and the subsequent refunds. Determining the reporting that would be appropriate for the contingently refundable revenue when it is billed is outside the scope of this Statement. Except for the possible effect of the rate-making process, the Board does not believe that the reporting of any adjustment at the time that a subsequent refund is determined is sufficiently different from the reporting of other adjustments that result from previous uncertainties to justify special treatment in this Statement. However, the Board did not consider whether the effect of the rate-making process might permit or require special treatment for those refunds. (See also paragraphs 46, concerning adjustments related to prior interim periods of the current fiscal year, and 55, concerning the Addendum to *APB Opinion No. 2*.)

39. A number of respondents recommended that this Statement be modified to provide that specific types of adjustments, such as renegotiation, continue to be reported as prior period adjustments. The Board rejected this recommendation because none of the items cited is sufficiently different from other adjustments that are included in the determination of net income of the current period to justify special treatment. (However, see paragraph 46 concerning adjustments related to prior interim periods of the current fiscal year.)

Prior Period Adjustments That Are Not Affected by This Statement

40. The Board reviewed other kinds of items reported as prior period adjustments, described in paragraphs 41-45. In each case, the Board concluded that the accounting for these items should not be modified at this time.

Correction of an error

41. Paragraph 13 of *APB Opinion No. 20* states:

> Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgment. Thus, an error is distinguishable from a change in estimate. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error for purposes of applying this Opinion.

A major distinguishing feature of a correction of an error is that the financial statements of the affected prior period, when originally issued, should have reflected the adjustment. In contrast, a prior period adjustment that meets the criteria of paragraph 23 of *APB Opinion No. 9* could not have been determined when the financial statements were originally issued. The Board concluded that a correction of an error, as defined above, should continue to be reflected by restating the financial statements of the affected prior period.

42. Some respondents contended that the distinction between a correction of an error and a change in estimate is too vague to be a basis for different accounting. The Board noted that *APB Opinion No. 20* used that same distinction as the basis for different accounting for corrections of errors and changes in estimates that did not meet the criteria of Opinion No. 9 for prior period adjustments. No problems of application resulting from that requirement of Opinion No. 20 have been brought to the Board's attention.

43. Several respondents stated that an exception to permit the reporting of corrections of errors as prior period adjustments is not justified. The Board concluded that the normal procedures of revising and reissuing financial statements promptly when an error is discovered or otherwise advising users that the financial statements contain erroneous data appear to satisfy the interest of financial statement users. Those procedures also permit enterprises to disclose the inaccuracies on as timely a basis as is practicable in the circumstances.

Income tax benefits of pre-acquisition operating loss carryforwards of purchased subsidiaries

44. Paragraph 88 of *APB Opinion No. 16* states that "an acquiring corporation should reduce the acquired goodwill retroactively for the realized tax benefits of loss carry-forwards of an acquired company not previously recorded by the acquiring corporation." The corresponding reduction in the amount of goodwill amortization in prior years is reported as a prior period adjustment as described in paragraph 49 of *APB Opinion No. 11*. The FASB presently has on its technical agenda a project entitled "Accounting for Business Combinations and Purchased Intangibles" that includes a reconsideration of *APB Opinion No. 16*. The Board believes that because it is reconsidering *APB Opinion No. 16* the requirements of that Opinion should continue in effect so as to maintain the status quo during the Board's reconsideration.

45. Some respondents recommended that the acquired goodwill be reduced *in the current year* for the realized

tax benefits of loss carryforwards of an acquired company not previously recorded by the acquiring corporation. The adjustment would thus in effect be amortized only prospectively rather than both retroactively, as a prior period adjustment, and prospectively. Accounting for realized tax benefits of loss carryforwards of an acquired company is addressed as Problem 2 of Technical Issue Two at paragraphs 512-520 of the August 19, 1976 FASB Discussion Memorandum, "Accounting for Business Combinations and Purchased Intangibles." As indicated in paragraph 44 above, the Board believes that the status quo should be maintained on that project during the Board's deliberations.

Adjustments Related to Prior Interim Periods of the Current Fiscal Year

46. A number of respondents to the Exposure Draft and to the October 7, 1976 Exposure Draft on "Accounting for Income Taxes in Interim Periods" recommended that this Statement be applied to annual financial statements only, rather than to annual and interim financial statements. Several of those respondents noted that the APB concluded in paragraph 9 of *APB Opinion No. 28* that "the usefulness of such [interim financial] information rests on the relationship that it has to the annual results of operations." In those respondents' view, restatement of interim periods is necessary to make interim data relate in a meaningful way to anticipated annual results. Several other of those respondents observed that the Board has on its technical agenda a project entitled "Interim Financial Reporting" that includes a reconsideration of *APB Opinion No. 28* and contended that, because Opinion No. 28 was issued when the criteria of Opinion No. 9 for prior period adjustments were in effect, the Board should not change interim reporting during its reconsideration of Opinion No. 28 by proscribing adjustments to prior interim periods. While not necessarily agreeing with these arguments, the Board decided to continue the practice of interim period restatements in the current fiscal year on a limited basis for the present. To avoid the interpretation problems that have resulted from the criteria of paragraph 23 of Opinion No. 9, the Board (a) limited such restatements to the specific examples cited in paragraph 23 of Opinion No. 9, (b) required that the adjustments meet the definition of materiality for extraordinary items (paragraph 24 of *APB Opinion No. 30*), and (c) required that the adjustments meet the two criteria of paragraph 23 of Opinion No. 9 that have not created interpretation problems in the past. The Board believes that application of the criteria in paragraph 13 will substantially continue existing practice for interim periods of the current fiscal year. Some Board members believe that this exception is inconsistent with some of the other conclusions of this Statement; however, they are willing to accept the provisions of paragraphs 13-15 during the Board's consideration of its project on interim financial reporting.

Accounting Changes

47. Paragraph 25 of APB Opinion No. 9 addressed the subject of accounting changes as follows:

> A change in the application of accounting principles may create a situation in which retroactive application is appropriate. In such situations *these changes should receive the same treatment as that for prior period adjustments*. [Emphasis added]

While distinguishing a retroactive accounting change from the prior period adjustments covered by paragraph 23 of that Opinion, the APB did prescribe the same accounting treatment for both.

48. Accounting changes (but not prior period adjustments covered by paragraph 23 of *APB Opinion No. 9*) were subsequently dealt with in *APB Opinion No. 20*. Paragraph 5 of Opinion No. 20 states:

> Paragraph 25 of *APB Opinion No. 9* is superseded. Although the conclusion of that paragraph is not modified, this Opinion deals more completely with accounting changes.

49. The Board believes that retroactive accounting changes, whether specified in transition requirements of FASB Statements and Interpretations and APB Opinions or in the requirements of *APB Opinion No. 20,* differ significantly in nature from the prior period adjustments covered by paragraph 23 of *APB Opinion No. 9,* as described in the following paragraph. For that reason, the Board concluded that it should not, in this standard, reexamine existing requirements for retroactive accounting changes or proscribe the use of retroactive accounting changes in future Statements or Interpretations.

50. Requirements for restatements of prior periods to reflect changes in accounting principles address categories of transactions that are usually recurring and pervasive. Those restatements provide useful information for purposes of comparing financial data for periods after initial application of the accounting principles with data presented for earlier periods. In contrast, the criteria of paragraph 23 of *APB Opinion No. 9* address isolated adjustments that are stated to be "rare in modern financial accounting." The purpose of restatement of prior periods for nonrecurring items cannot be to make the affected prior period comparable to subsequent periods because comparability cannot be accomplished by shifting nonrecurring items among periods. Instead, the purpose is to exclude material items directly related to prior periods from the determination of net income in the current period to avoid impairing the significance of net income of the current period (see paragraphs 10-12 of *APB Opinion No. 9*). As previously stated, the Board concluded that purpose is not accomplished by paragraph 23 of *APB Opinion No. 9* (see paragraph 25 above).

51. Paragraph 52 of *APB Opinion No. 16* states that a change in accounting method of one of the combining enterprises in a pooling of interests that is made to conform the accounting methods of the combining enterprises shall be applied retroactively. Like the item discussed in paragraph 44, this provision will be reconsidered as a part of the current FASB technical agenda project entitled "Accounting for Business Combinations and Purchased Intangibles," and the Board believes the status quo should be maintained in the meantime.

Income Statement Classification

52. Some respondents noted that most adjustments that would have been reported as prior period adjustments prior to the issuance of this Statement will not meet the criteria of *APB Opinion No. 30* for classification as extraordinary items. Some of those respondents recommended that this Statement require adjustments to be classified in the future as extraordinary items if they meet the present criteria of paragraph 23 of *APB Opinion No. 9*. Others contended that inclusion of such adjustments in income from continuing operations would obscure current income from ongoing operations. Considerations of income statement classification under Opinion No. 30 are not different for items previously classified as prior period adjustments and for other changes in estimates. The Board concluded that income statement classification is too pervasive to be dealt

with in this project and that it probably should be considered in some phase of the FASB agenda project entitled "Conceptual Framework for Financial Accounting and Reporting."

53. A number of respondents observed that the "average" investor relies primarily on earnings per share data or earnings summaries in the financial press and thus might be misled by the inclusion of adjustments that are related to prior periods in income from continuing operations in the current period. The effect of random, irregular, or unpredictable events may make periodic earnings per share data unrepresentative of an enterprise's earning activities during that period. For example, completed contract accounting for long-term contracts may result in an enterprise's reporting activities of one period in a subsequent period. However, the Board does not believe that investors are served by excluding the effects of such events from reported earnings. Disclosure of the effects of such events is required by certain APB Opinions and FASB Statements. Thus, reliance on a single earnings per share amount or a summary in the financial press may not be a sound basis for investment decisions.

54. Some respondents to the Exposure Draft contended that this Statement substitutes a narrow rule for managements' and auditors' judgments. The Board agrees that judgment is necessary in financial reporting but does not believe that judgment should result in special treatment for some items of profit and loss recognized during a period but not for other similar items unless special treatment is justified by different circumstances. On the other hand, management's judgment may indicate that disclosure should be furnished to allow a user to properly evaluate the enterprise's earnings. For example, *APB Opinion No. 30* requires disclosure of the effect of "unusual" or "infrequently occurring" items. Similar disclosure for items that are not "unusual" or "infrequently occurring," as defined in that Opinion, may also be appropriate if management feels that such disclosure is needed.

Addendum to APB Opinion No. 2

55. A number of respondents requested that the FASB clarify how the Addendum to *APB Opinion No. 2* applies to prior period adjustments. The Board is aware that differing applications of the Addendum exist in practice and has not addressed that issue.

Effective Date and Transition

56. Some respondents recommended that the Statement not apply to certain categories of preexisting contingencies. Those respondents suggested a variety of criteria for determining the preexisting contingencies to be exempted, including prior disclosure of the contingency, prior partial settlements of the same or of a related matter that were reported as prior period adjustments, and qualifications of auditors' earlier reports with respect to the contingency. The Board concluded that there was no equitable basis for exempting certain preexisting contingencies and not others.

57. The Exposure Draft proposed that the Statement be applied to fiscal years beginning on or after December 15, 1976. Several respondents recommended earlier application to avoid an interim period of confusion. Several others recommended a delay in the effective date because management may have disclosed in good faith

that an anticipated adjustment would be reported as a prior period adjustment and might as a result be charged with having misled investors if the adjustment is reported in income of the current period. Following further consideration the Board concluded that it was appropriate to modify the effective date of this Statement to fiscal years beginning after October 15, 1977.

Applicability to Interim Periods

58. Some respondents questioned whether this Statement was intended to apply to interim as well as annual financial statements. As a result the Board added footnote 1 to paragraph 10. In addition, as explained in paragraph 46, paragraphs 13-15 were added.

Disclosure

59. Some respondents recommended that this Statement specify the disclosures that should be made for an adjustment that would previously have been reported as a prior period adjustment under the criteria of *APB Opinion No. 9.* The Board concluded that existing disclosure requirements that have been applied to other similar items included in the determination of current net income also apply to items that would previously have been reported as prior period adjustments. For example, *APB Opinion No. 30* specifies the disclosure requirements for "unusual items," "infrequently occurring items," and "extraordinary items"; *APB Opinion No. 28* specifies the disclosure requirements for various categories of adjustments in interim financial reports; and other pronouncements specify disclosures that apply to certain types of items.

Appendix B: SUMMARY OF FASB STAFF RESEARCH

Other Studies Available

60. A recent survey of the annual reports of 600 industrial and commercial corporations contained the following summary of adjustments to the opening balances of retained earnings during the four fiscal years of those enterprises ended not later than February 2, 1975:[12]

Reasons for adjustment	1974	1973	1972	1971
Poolings of interests	30	56	67	69
Research and development expenditures charged to operations	23	—	—	—
Litigation or income tax settlements	12	29	26	15
Other	18	36	89	87
Total adjustments	83	121	182	171

Investigation revealed that the "other" category consisted principally of accounting changes (adopting tax allocation, adopting recommendations of AICPA Industry Audit Guides that required retroactive application, etc.) and changes in the reporting entity. The items categorized as "litigation or income tax settlements" were prior period adjustments made pursuant to the criteria of paragraph 23 of *APB Opinion No. 9*. Since the adjustments represented by this caption were few in number, the broader study described in the following paragraphs was undertaken. The adjustments in the above table that were determined to have been made pursuant to paragraph 23 of *APB Opinion No. 9* were used as a control to ensure that the selection procedures were adequate to locate substantially all of such adjustments made by enterprises included in the study.

Methodology

61. The research by the FASB staff utilized the National Automated Accounting Research System (NAARS).[13] NAARS includes a file of annual reports of publicly held enterprises. Enterprises reporting or referring to prior period adjustments in either the footnotes or the retained earnings statement were identified. The control group referred to in paragraph 60 was used to provide assurance that no substantial number of items was omitted. Complete reliability of the results of such a search could not be assured because of the variety of ways that enterprises disclose such adjustments. Adjustments were located in approximately 1,200 reports and those adjustments were reviewed in detail, and the adjustments made pursuant to paragraph 23 of *APB Opinion No. 9* were identified. If it was unclear whether the adjustment belonged in this category, it was included, except that in a few instances where there was virtually no disclosure of the nature or circumstances of the adjustment, the adjustment was excluded from the study because no meaningful conclusions could be derived. Subsidiary companies that reported the same prior period adjustment reported in consolidated statements were excluded to avoid duplication. At the time the research was conducted, the NAARS system included:

Year*	Total reports including subsidiaries	Approximate total enterprises
1973	3,617	3,350
1974	3,150	2,800
1975	650	600
Total	7,417	6,750

The detail summaries following are limited to 1974 and 1973; 1975 was reviewed to determine whether significant trends were apparent (none were noted) but the file was considered not sufficiently complete to justify any further conclusions. In addition, later 1975 results, if available, would probably have reflected the effect of the recent SEC staff interpretations.

Overall Results

62. The following table compares 1974 and 1973 identified prior period adjustments:

Category	1974 Number of enterprises reporting adjustments	1974 Percentage of enterprises	1973 Number of enterprises reporting adjustments	1973 Percentage of enterprises
Income taxes	30	1.1%	53	1.6%
Litigation and similar claims	37	1.3%	37	1.1%
Utility rate and similar matters	13	0.5%	13	0.4%
Renegotiation	—	0.0%	6	0.2%
Economic stabilization	1	0.0%	2	0.1%
Other	—	0.0%	5	0.1%
Total*	81		116	
Total enterprises*	79	2.8%	112	3.3%

63. The following table compares the relative size of the identified adjustments reported for 1974 and 1973:

Range of prior period adjustment as a percentage of net income or loss in the year reported: Over	But not over	Number of enterprises reporting adjustments in the range: Income taxes	Litigation and similar claims	Utility rate and similar matters	All other
0%	5%	13	18	7	4
5%	10%	29	7	6	3
10%	20%	17	17	6	3
20%	50%	16	19	4	1
50%	100%	5	8	—	—
100%		2	5	2	3
Not determinable		1	—	1	—
Total		83	74	26	14

64. Investigation of the adjustments relating to income taxes and litigation disclosed the following circumstances:

Apparent circumstances of the adjustment, based on financial statement disclosures	Adjustments relating to	
	Income taxes	Litigation and similar claims
Negotiated settlements	56	45 *
Adjudicated settlements	5	14
Combination of negotiated and adjudicated settlements	—	5
Not settled at the date the financial statements were issued	8	7
Negotiated by outside parties without participation by the enterprise	—	1
Change in estimate, with no other party involved	5	—
Not determinable	9	2
Total	83	74

Other Findings

65. Paragraphs 66-70 describe other findings of the survey.

Changes in accounting estimates

66. *APB Opinion No. 20* prohibits restatement of amounts reported in prior periods as a result of changes in accounting estimates except for adjustments that meet all of the criteria of paragraph 23 of *APB Opinion No. 9* (see paragraph 35). Twenty of the 197 identified 1974 and 1973 prior period adjustments were changes in previously recorded accounting estimates. These consisted of seven reversals of income tax accruals, six adjustments of prior year provisions for loss on disposal of discontinued operations, and seven adjustments of prior year provisions for other litigation and similar claims.

Frequency of occurrence

67. Paragraph 23 of *APB Opinion No. 9* stated that prior period adjustments would be "nonrecurring." Paragraph 24 of Opinion No. 9 stated that "treatment as prior period adjustments should not be applied to the normal, recurring corrections...." The term "nonrecurring" is discussed in paragraph 36 above. Many of the identified prior period adjustments appeared to be of a nature that would be reasonably expected to recur in the foreseeable future in the enterprise's operating environment. Nine enterprises reported similar or related prior period adjustments in both 1974 and 1973.

Application of criterion (a)

68. Criterion (a) of paragraph 23 of *APB Opinion No. 9* requires that an item "can be specifically identified with and directly related to the business activities of particular prior periods." Most of the identified prior period adjustments for settlements of litigation were charged to the period in which the underlying event that gave rise to the litigation occurred. Some, however, were charged or credited to a prior period subsequent to the

underlying event, including (a) the period the litigation was initiated, (b) the period of a prior criminal conviction for the alleged acts, or (c) the period that an amount was accrued in excess of the eventual cost of the settlement.

Utility rate and similar matters

69. Utility rate making processes sometimes allow rates to customers to be increased on a provisional basis prior to the regulatory commission's final action on a requested rate increase. If a portion of the requested increase is subsequently disallowed, the utility is required to refund the disallowed portion. Of the 26 identified adjustments relating to utility rate and similar matters, 14 relate to this process.

Income taxes

70. Identified adjustments for income tax matters included 12 settlements for which the underlying basis of the settlement was recorded (e.g., retroactive adjustment of depreciation to reflect longer useful lives). These may have been corrections of errors. As explained in paragraph 61, these adjustments were included because it was unclear whether the adjustments were made pursuant to paragraph 23 of *APB Opinion No. 9.*

Appendix C: EXCERPTS FROM SEC STAFF ACCOUNTING BULLETIN NO. 8

71. On June 4, 1976 the SEC published *Staff Accounting Bulletin No. 8.* This Bulletin included a statement of the SEC staff's interpretation and application of the criteria of *APB Opinion No. 9* for prior period adjustments.

72. Staff Accounting Bulletins contain the following statement concerning their authoritative status:

> The statements in the Bulletin are not rules or interpretations of the Commission nor are they published as bearing the Commission's official approval; they represent interpretations and practices followed by the Division [of Corporation Finance] and the Chief Accountant in administering the disclosure requirements of the federal securities laws.

73. Staff Accounting Bulletin No. 8 included the following:

H. <u>Prior Period Adjustments</u>

<u>Facts:</u>

> Accounting Principles Board Opinion No. 9, paragraph 23, limits treatment as a prior period adjustment "to those material adjustments which (a) can be specifically identified with and directly related to the business activities of particular prior periods, and (b) are not attributable to economic events occurring subsequent to the date of the financial statements for the prior period, and (c) depend primarily on determinations by persons other than management and (d) were not susceptible of reasonable estimation prior to such determination."
>
> It is not uncommon for parties to litigation to reach settlement of the matter at issue in an

out-of-court settlement.

Question:

Do out-of-court settlements meet the criteria for prior period adjustments?

Interpretative Response:

The staff has been extremely reluctant to permit registrants to charge items to retained earnings as prior period adjustments in the light of the clear intent expressed in APB 9 to limit such charges severely. That opinion effectively adopted an all-inclusive approach to the measurement of periodic income. While such an approach may not result in the best matching of costs and revenues, it does provide assurance that all items will at some time be accounted for as elements of income and it prevents the abuses which were noted prior to the adoption of APB 9 whereby adverse circumstances could be at least partially obscured through the vehicle of a direct charge to retained earnings. If unusual items and items related to matters arising in prior years are properly isolated and described in the income statement, we believe that investors will be able to interpret results in an intelligent fashion. Were the Financial Accounting Standards Board to revise the basic accounting philosophy of the all-inclusive income statement, the staff would, of course, review its position in the light of that revision.

In the meantime, however, the staff intends to continue to apply the four restrictive tests set forth in paragraph 23 of Accounting Principles Board Opinion No. 9 strictly. In this connection, the issue which has arisen most frequently is the treatment of litigation settlements. It is the staff's view that when litigation is settled, the management must make a number of significant judgments and, hence, the test that the amounts must "depend primarily on determinations by persons other than management" (criterion (c) above) has not been met. In addition, in a business world increasingly characterized by litigation to an extent far in excess of that when Accounting Principles Board Opinion No. 9 was adopted (1966), it seems that litigation is inevitably an "economic event" and that settlements would constitute "economic events" of the period in which they occur. Accordingly, it would seem that charges or credits relating to settlements would also not meet the second test (criterion (b) above) set forth in paragraph 23 of Opinion 9 that they not be "attributable to economic events occurring subsequent to the date of the financial statements for the prior period."

Footnotes

FAS16, Footnote 1--As used in this Statement, the term "period" refers to both annual and interim reporting periods.

FAS16, Footnote 2--Many items that would previously have been reported as prior period adjustments will be subject to existing disclosure requirements when that type of item is included in the determination of current net income. For example, *APB Opinion No. 28,* "Interim Financial Reporting," specifies certain disclosures for interim reporting periods and *APB Opinion No. 30,* "Reporting the Results of Operations," specifies disclosures for certain types of items discussed by that Opinion.

FAS16, Footnote 3--The reporting of prior period adjustments is described in paragraph 18 of *APB Opinion No. 9,* as modified by paragraph 16 of this Statement, and in paragraph 26 of *APB Opinion No. 9*.

FAS16, Footnote 4—As defined in paragraph 13 of *APB Opinion No. 20*. That paragraph also describes the distinction between a correction of an error and a change in accounting estimate.

FAS16, Footnote 5--See paragraph 49 of *APB Opinion No. 11*, "Accounting for Income Taxes," and paragraph 88 of *APB Opinion No. 16,* "Business Combinations."

FAS16, Footnote 6--In addition to transition requirements of these pronouncements, accounting changes resulting in restatement of previously issued financial statements of prior periods include a change in accounting method permitted by paragraph 52 of *APB Opinion No. 16*, a change in the reporting entity described in paragraph 34 of *APB Opinion No. 20*, and special changes in accounting principle described in paragraphs 27 and 29 of *APB Opinion No. 20*. See also footnote 5 to *APB Opinion No. 20*.

FAS16, Appendix A, Footnote 7--Criterion (b) of paragraph 23 of *APB Opinion No. 9* requires that the adjustments "are not attributable to economic events occurring subsequent to the date of the financial statements for the prior period."

FAS16, Appendix A, Footnote 8--Criterion (c) of paragraph 23 of *APB Opinion No. 9* requires that the adjustment "depend primarily on determinations by persons other than management."

FAS16, Appendix A, Footnote 9--See footnote 7.

FAS16, Appendix A, Footnote 10--See footnote 8.

FAS16, Appendix A, Footnote 11--See footnote 7.

FAS16, Appendix B, Footnote 12--American Institute of Certified Public Accountants, *Accounting Trends & Techniques--1975,* 29th ed. (New York: AICPA, 1975), p. 363.

FAS16, Appendix A, Footnote 13--NAARS is a computer-assisted accounting retrieval system developed by the American Institute of Certified Public Accountants in conjunction with Mead Data Central Inc.

FAS16, Appendix B, Par. 61, Footnote *--The NAARS system classifies fiscal year-ends from July through June as a "year" (e.g., 1974 includes fiscal years ended July 1974 through June 1975).

FAS16, Appendix B, Par. 62, Footnote *—Individual categories add to more than the total enterprises shown because some enterprises reported prior period adjustments in more than one category.

FAS16, Appendix B, Par. 64, Footnote *--17 required court approval.