Statement of Financial Accounting Standards No. 7

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FAS7 Summary

Accounting and Reporting by Development Stage Enterprises

June 1975

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 7: Accounting and Reporting by Development Stage Enterprises

INTRODUCTION

1. This Statement specifies the guidelines for identifying an enterprise in the development stage and the standards of financial accounting and reporting applicable to such an enterprise. The transition requirements of this Statement are also applicable to certain established operating enterprises.[1]

2. Some development stage enterprises have adopted special financial accounting and reporting practices, including special forms of financial statement presentation or types of disclosure, that are different from those used by established operating enterprises. Some of the special practices have resulted from applying regulations of the Securities and Exchange Commission; other practices appear simply to have evolved. Special accounting practices have included (a) deferral of all types of costs without regard to their recoverability, (b) nonassignment of dollar amounts to shares of stock issued for consideration other than cash, and (c) offset of revenue against deferred costs. Special reporting formats have included statements of (a) assets and unrecovered preoperating costs, (b) liabilities, (c) capital shares, and (d) cash receipts and disbursements. Sometimes, a balance sheet or a statement of operations is presented in conjunction with one or more special formats. Other development stage enterprises issue financial statements like those of established operating enterprises that present financial position, changes in financial position, and results of operations in conformity with generally accepted accounting principles.

3. No special standards of financial accounting and reporting were established for development stage enterprises by the AICPA Accounting Principles Board or its predecessor, the Committee on Accounting Procedure. In 1973, the AICPA Committee on Companies in the Development Stage issued an exposure draft of a proposed Audit Guide recommending special financial statements and accounting methods, but no action was taken on the exposure draft and the matter was referred to the FASB. *FASB Statement No. 2,* "Accounting for Research and Development Costs," issued in October 1974, has been interpreted by the FASB to apply to "the accounting for research and development costs of development stage enterprises whose financial statements present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles." [2] However, pending the issuance of a Statement on the subject of accounting and reporting by development stage enterprises, the FASB Interpretation stated that "a development stage enterprise that issues financial statements that do not purport to present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles need not apply *Statement No. 2* in accounting for its research and development costs." [3]

4. The standards of financial accounting and reporting set forth in this Statement apply to any separate financial statements of a development stage subsidiary or other investee [4] of an established operating enterprise, as well as to the financial statements of a separate development stage enterprise (or of a group of companies that, as a whole, is considered to be in the development stage). Hereinafter, the term "development stage enterprise" is used to include a development stage subsidiary or other investee that is issuing separate financial statements.

5. This Statement applies to development stage enterprises in all industries. This Statement applies to development stage enterprises in regulated industries in accordance with the provisions of the Addendum to *APB Opinion No. 2,* "Accounting for the 'Investment Credit.'" However, paragraphs 11-12 of this Statement, which require disclosure of additional information, apply to development stage enterprises in regulated industries in all cases.

6. This Statement supersedes *FASB Interpretation No. 5,* "Applicability of FASB Statement No. 2 to Development Stage Enterprises." It does not supersede, alter, or amend any other present requirement in an Accounting Research Bulletin (ARB), Accounting Principles Board (APB) Opinion, or FASB Statement or Interpretation. Neither does this Statement change generally accepted accounting principles that are currently applicable to established operating enterprises but that are not explicitly stated in an ARB, APB Opinion, or FASB Statement or Interpretation. For example, this Statement does not change generally accepted accounting principles applicable to (a) established operating enterprises generally in expanding their existing businesses, (b) established operating enterprises in the extractive industries in their exploration and development activities, and (c) established operating enterprises in the real estate industry in developing their properties.

7. Standards of financial accounting and reporting for development stage enterprises are set forth in paragraphs 8-16. Appendix B sets forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others. Appendix A provides background information.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Guidelines for Identifying a Development Stage Enterprise

8. For purposes of this Statement, an enterprise shall be considered to be in the development stage if it is devoting substantially all of its efforts to establishing a new business and either of the following conditions exists:

a. Planned principal operations have not commenced.
b. Planned principal operations have commenced, but there has been no significant revenue therefrom.

9. A development stage enterprise will typically be devoting most of its efforts to activities such as financial

planning; raising capital; exploring for natural resources; developing natural resources; research and development;[5] establishing sources of supply; acquiring property, plant, equipment, or other operating assets, such as mineral rights; recruiting and training personnel; developing markets; and starting up production.

Financial Accounting and Reporting

10. Financial statements issued by a development stage enterprise shall present financial position, changes in financial position, and results of operations in conformity with the generally accepted accounting principles that apply to established operating enterprises and shall include the additional information required by paragraphs 11-12. Special accounting practices and reporting formats, such as those described in paragraph 2 of this Statement, that are based on a distinctive accounting for development stage enterprises are no longer acceptable. Generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred. Accordingly, capitalization or deferral of costs shall be subject to the same assessment of recoverability that would be applicable in an established operating enterprise. For a development stage subsidiary or other investee, the recoverability of costs shall be assessed within the entity for which separate financial statements are being presented.

11. In issuing the same basic financial statements as an established operating enterprise, a development stage enterprise shall disclose therein certain additional information. The basic financial statements to be presented [6] and the additional information shall include the following:

a. A balance sheet, including any cumulative net losses reported with a descriptive caption such as "deficit accumulated during the development stage" in the stockholders' equity section.
b. An income statement, showing amounts of revenue and expenses for each period covered by the income statement and, in addition, cumulative amounts from the enterprise's inception.[7]
c. A statement of changes in financial position, showing the sources and uses of financial resources for each period for which an income statement is presented [8] and, in addition, cumulative amounts from the enterprise's inception.
d. A statement of stockholders' equity, showing from the enterprise's inception:[9]
    1. For each issuance, the date and number of shares of stock, warrants, rights, or other equity securities issued for cash and for other consideration.
    2. For each issuance, the dollar amounts (per share or other equity unit and in total) assigned to the consideration received for shares of stock, warrants, rights, or other equity securities. Dollar amounts shall be assigned to any noncash consideration received.
    3. For each issuance involving noncash consideration, the nature of the noncash consideration and the basis for assigning amounts.

12. The financial statements shall be identified as those of a development stage enterprise and shall include a description of the nature of the development stage activities in which the enterprise is engaged.

13. The financial statements for the first fiscal year in which an enterprise is no longer considered to be in the development stage shall disclose that in prior years it had been in the development stage. If financial statements for prior years are presented for comparative purposes, the cumulative amounts and other additional disclosures required by paragraphs 11-12 need not be shown.

Effective Date and Transition

14. This Statement shall be effective for fiscal periods beginning on or after January 1, 1976, although earlier application is encouraged. Thereafter, when financial statements, or financial summaries or other data derived therefrom, are presented for periods prior to the effective date of this Statement, they shall be restated, where necessary, to conform to the provisions of this Statement. Accordingly, any items that would have been accounted for differently by a development stage enterprise if the provisions of paragraph 10 had then been applicable shall be accounted for by prior period adjustment (described in paragraphs 18 and 26 of *APB Opinion No. 9,* "Reporting the Results of Operations").

15. An established operating enterprise that during its development stage would have accounted for any items differently if the provisions of paragraph 10 had then been applicable shall account for those items by prior period adjustment. In some cases, those items will have been amortized or otherwise included in an income statement in periods prior to the effective date of this Statement. Financial statements, or financial summaries or other data derived therefrom, for those periods shall be restated when they are included for comparative purposes with financial data for periods after the effective date of this Statement.

16. The nature of any adjustment or restatement resulting from application of paragraphs 14-15 and, where appropriate, its effect on income before extraordinary items, net income, and related per share amounts shall be disclosed in the period of change for all periods presented. Any related income tax effects shall be recognized and disclosed.

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

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

Although he agrees with the basic conclusions in this Statement that development stage enterprises should use the same accounting principles and prepare the same basic financial statements as established operating enterprises, Mr. Schuetze dissents because he believes that the Board should have addressed the question of accounting for start-up costs before issuing this Statement. Paragraph 10 states that "capitalization or deferral of costs [in a development stage enterprise] shall be subject to the same assessment of recoverability that would be applicable in an established operating enterprise." A substantial portion of the costs incurred by many development stage enterprises falls into a broad category that most persons would regard as start-up costs. In Mr. Schuetze's view, neither this Statement nor any other authoritative pronouncement furnishes adequate guidance as to how the recoverability of start-up costs should be assessed or as to how those start-up costs that are capitalized or deferred should be accounted for thereafter. Mr. Schuetze believes that until such a pronouncement is issued the accounting practices of development stage enterprise will vary significantly. In this regard, Mr. Schuetze is particularly concerned as to how the recoverability test in paragraph 10 would be applied by development stage enterprises in the extractive industries.

Members of the Financial Accounting Standards Board:

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

Appendix A: BACKGROUND INFORMATION

17. In April 1973, the FASB placed on its technical agenda a project on "Accounting for Research and Development and Similar Costs." The scope of the project also encompassed accounting and reporting by development stage enterprises, the subject of this Statement.

18. A task force of sixteen persons from industry, government, public accounting, the financial community, and academe was appointed in July 1973 to provide counsel to the Board in preparing a Discussion Memorandum analyzing issues related to the project.

19. The FASB did not undertake a major research effort in connection with the project but rather relied primarily on published research studies and articles that are cited in the Discussion Memorandum. Especially important in this regard was *Accounting for Companies in the Development Stage,* an exposure draft of an Audit Guide originally issued for comment in 1973 by the Committee on Companies in the Development Stage of the American Institute of Certified Public Accountants.

20. The Discussion Memorandum was issued by the Board on December 28, 1973, and a public hearing on the subject was held on March 15, 1974. Seventy-four position papers, letters of comment, and outlines of oral presentations were received by the Board in response to the Discussion Memorandum. Thirty-nine of those responses included recommendations about development stage enterprises. Fourteen oral presentations were made at the public hearing.

21. In the course of its deliberations following the hearing, the Board concluded that accounting and reporting by development stage enterprises should be addressed in a separate Statement of Financial Accounting Standards. An Exposure Draft of a proposed Statement on "Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components" was issued on July 19, 1974. The Board received

138 letters of comment on the Exposure Draft. In November 1974, the Board announced that "because of questions raised in many of the comment letters received during exposure of the proposed Statement on development stage companies, the Standards Board is continuing its consideration of that subject and a final Statement is not expected to be issued before April or May of 1975." [10]

Appendix B: BASIS FOR CONCLUSIONS

22. This Appendix discusses 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.

SCOPE OF THIS STATEMENT

23. As indicated by the title, the Exposure Draft, "Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components," explicitly encompassed a development stage subsidiary, division, or other component of an established operating enterprise as well as a separate development stage enterprise. A number of respondents to the Exposure Draft interpreted the inclusion of subsidiaries, divisions, or other components of an established operating enterprise to mean that new financial accounting standards were being proposed for the costs incurred by established operating enterprises in expanding their existing businesses. Those respondents suggested that any changes called for by the proposed new standards in that regard were unclear. They further suggested that the proposed new standards for financial statement presentation and disclosure were inapplicable to components of established operating enterprises except as they might apply to separate financial statements occasionally issued by subsidiaries in the development stage.

24. In addition to accounting for research and development costs and accounting for development stage enterprises, the Discussion Memorandum comprehended accounting for start-up costs and other costs that are similar to research and development costs in the sense that they share certain distinguishing characteristics.[11] In issuing the Exposure Draft, however, the Board did not intend to propose new financial accounting standards for start-up costs and those other "similar costs" incurred by established operating enterprises. To eliminate that possible source of confusion and to deal more directly with the financial accounting and reporting matters affecting development stage enterprises, the scope of this Statement is restricted to the financial statements of a development stage enterprise (or of a group of companies that, as a whole, is considered to be in the development stage) and to any separate financial statements of a development stage subsidiary or other investee of an established operating enterprise (see paragraph 4).

Development Stage Enterprises in the Extractive Industries

25. A number of respondents to the Exposure Draft questioned the application of this Statement to development stage enterprises in certain industries (see paragraph 5 of this Statement), especially to development stage enterprises in the extractive industries. The Discussion Memorandum made a distinction for

the extractive industries between (1) costs that are indistinguishable in nature from those costs incurred in other industries and (2) costs that are incurred uniquely in the extractive industries. It stated that "research and development and similar costs that are indistinguishable in nature from the research and development and similar costs incurred in other industries are embraced by this project." The Discussion Memorandum also stated that costs that are incurred uniquely in the extractive industries are generally believed to warrant separate consideration and "are specifically outside the scope of this project." [12] *FASB Statement No. 2,* "Accounting for Research and Development Costs," in paragraph 3, recognized that distinction by indicating that it "does not apply to activities that are unique to enterprises in the extractive industries."

26. Chapter four, "Companies in the Development Stage," of the Discussion Memorandum states that "this Discussion Memorandum excludes from this project only those 'costs that are incurred uniquely in the extractive industries.' Therefore, whether extractive industry companies in the development stage have sufficiently different characteristics to warrant exclusion from or special handling in a definition of a company in the development stage requires consideration." [13]

27. The AICPA Committee on Companies in the Development Stage indicated in its 1973 exposure draft that the proposed provisions should be applicable to any development stage enterprise in any industry. Similarly, the APB Committee on Extractive Industries states, "new companies still in the exploratory and development stage in the oil and gas industry are no different than companies in a similar stage in other industries and probably should not be afforded any special treatment."[14]

28. The Board has concluded that consideration of the accounting for costs incurred in activities that are unique to enterprises in the extractive industries is outside the scope of this Statement. Paragraph 6 explains that this Statement does not change generally accepted accounting principles that are applicable to established operating enterprises but that are not explicitly stated in an ARB, APB Opinion, or FASB Statement or Interpretation, and cites as an example generally accepted accounting principles that are applicable to established operating enterprises in the extractive industries in their exploration and development activities. The effect of this Statement being applicable to development stage enterprises in all industries, therefore, is not to change the generally accepted accounting principles applicable to costs incurred in activities that are unique to enterprises in the extractive industries, but to require those generally accepted accounting principles applicable to established operating enterprises in the extractive industries to be applied to development stage enterprises in the extractive industries as well. This includes presentation of the same basic financial statements.

GUIDELINES FOR IDENTIFYING A DEVELOPMENT STAGE ENTERPRISE

29. The broad guidelines set forth in paragraphs 8-9 for identifying a development stage enterprise are designed to include enterprises engaged in diverse areas of economic activity. The point at which an enterprise ceases to be in the development stage, and, therefore, need not present the cumulative amounts since its inception and other additional disclosures required by paragraphs 11-12, must be evaluated in each case.

ACCOUNTING

30. The Board has concluded that the generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred. The primary reasons for this conclusion are:

a. The kinds of transactions engaged in by development stage enterprises are also common to established operating enterprises in expanding their existing businesses. Accounting treatment should be governed by the nature of the transaction rather than by the degree of maturity of the enterprise. Thus, the determination of whether a particular cost should be charged to expense when incurred or should be capitalized or deferred should be based on the same accounting standards regardless of whether the enterprise incurring the cost is already operating or is in the development stage.
b. Any different standards for a development stage enterprise that would result in deferral of costs that would not be deferred if the generally accepted accounting principles applicable to established operating enterprises had been applied may cause financial statement users to reach unjustified conclusions about the nature of the costs incurred by a development stage enterprise. The Board believes that adequate financial statement disclosures concerning the costs incurred by a development stage enterprise, both for the current period and cumulatively since its inception, will mitigate that possibility and provide useful financial information for decisions about that kind of enterprise.

31. Established operating enterprises incur costs under various circumstances and with varying degrees of uncertainty about future benefits, especially in expanding their existing businesses. Authoritative accounting literature does not contain general criteria or guidelines for determining when costs should be charged to expense as incurred and when costs should be capitalized or deferred,[15] and this Statement does not attempt to specify such criteria or guidelines.

32. The absence of explicit criteria or guidelines, however, does not provide a free choice to defer costs or to charge them to expense when incurred. The scope of generally accepted accounting principles is broader than the authoritative literature and encompass practices that have evolved and gained acceptance with time and experience. Many of those practices are described in *APB Statement No. 4*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises." For example, paragraph 160 of *APB Statement No. 4* describes generally accepted accounting principles as calling for immediate recognition as expense when "(1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose." [16]

33. In concluding that the generally accepted accounting principles applicable to established operating enterprises shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred, the Board is relying primarily on the assessment of recoverability of incurred costs that those principles require. Heretofore, some have felt that generally accepted

accounting principles did not apply to the special accounting practices and special financial reporting formats that have been used by some development stage enterprises. The Board's conclusion that the generally accepted accounting principles applicable to established operating enterprises also apply to development stage enterprises, including presentation of the same basic financial statements, eliminates the special practices and formats and the question about the applicability of generally accepted accounting principles to them.

SEC Regulations and AICPA Committee Proposal

34. Both the regulations of the Securities and Exchange Commission (SEC) and the proposed Audit Guide issued by the AICPA Committee on Companies in the Development Stage provide for the use by development stage enterprises of certain accounting practices that differ from those appropriate for established operating enterprises.

35. Article 5A of SEC *Regulation S-X* prescribes the form and content of financial statements filed with the SEC by development stage enterprises. It provides for separate statements of (a) assets and unrecovered promotional, exploratory, and development costs; (b) liabilities; (c) capital shares; (d) other securities; and (e) cash receipts and disbursements. Among the types of costs indicated as includible in *unrecovered promotional, exploratory, and development costs* are:

> (a) development expenses, (b) plant and equipment maintenance expenses, (c) rehabilitation expenses, (d) general administrative expenses incurred in a period when there was little or no actual mining and (e) other expenses.... General administrative expenses incurred in connection with subcaptions (a), (b) and (c) should be included therein. Any other general administrative expenses not chargeable to those subcaptions nor written off as costs or other operating charges (including taxes, protection and conservation of property when inactive) shall be included under subcaption (d).[17]

Rule 12-06a of *Regulation S-X* allows for the offset of certain proceeds and other income against promotional, exploratory, and development costs.

36. The AICPA Committee proposed the presentation of cumulative cost outlays, together with assets, liabilities, and investment by stockholders, in a special statement referred to as a "preoperating accountability statement." Cumulative cost outlays would have been deferred and amortized by charges against income when operations commenced. Incidental revenue received during the development stage would have been deducted from the cumulative cost outlays.

37. The AICPA Committee stated the basis for its conclusion as follows:

> A company in the development stage is engaged in building an enterprise, and the expenditures it makes are in the nature of investments for the future. Costs incurred during the development stage are accumulated because they have been incurred in the expectation that they will generate future revenues or otherwise benefit periods after the company reaches the operating stage. Accumulating costs is consistent with the business fact that for many companies a development stage must precede the attainment of ordinary business operations.... The only outlays that

> should not be carried as accumulated costs during the preoperating period are those relating to known losses....
>
> For a company in the development stage there is from inception a presumption that uncertainty as to cost recovery will both exist and persist. (By contrast, the presumption for an operating company is that cost recoverability can be reasonably evaluated.) It would be unrealistic and arbitrary to write off immediately the costs incurred during the development stage simply because of this predictable uncertainty.[18]

38. Both the SEC and AICPA Committee approaches draw attention to the uncertainty about cost recovery surrounding most development stage costs by segregating them in a special category and a special financial statement (or group of statements) similar to the conventional balance sheet. Those costs are not reported as "assets," and they need not be subjected to the assessment of recoverability that is applied to costs incurred by established operating enterprises. The Board believes, however, that the distinction between costs that would be reported as "assets" and costs that would be reported as "unrecovered costs" or "cumulative cost outlays" under the SEC and AICPA Committee approaches is one that is likely to be overlooked by many financial statement users. In addition, as indicated in paragraphs 30-33, the Board believes that all costs of a development stage enterprise should be subjected to the same assessment of recoverability applicable to costs incurred by established operating enterprises. In the Board's view, the nature of development stage activities and their related costs can best be indicated by the additional financial statement disclosures required by paragraphs 11-12, rather than by accumulation or deferral of costs that would be charged to expense when incurred if generally accepted accounting principles applicable to established operating enterprises were applied.

39. Accumulation or deferral of development stage costs requires amortization after operations commence. Article 5A does not address the question of amortization, and the AICPA Committee noted that "while the current practices are anything but uniform, the most prevalent policy noted is to amortize such costs over a short period of time, usually not more than five years." [19] The Board believes that the difficulty in reasonably relating subsequent revenue to accumulated or deferred costs that would not be deferred under generally accepted accounting principles applicable to established operating enterprises limits the usefulness of the data that would result from such accumulation or deferral by a development stage enterprise. Moreover, the initial operating periods of such an enterprise would include both the amortization of those costs incurred during the development stage and the charging to expense of certain costs incurred currently.

40. Some respondents to the Discussion Memorandum and to the Exposure Draft supported the SEC approach, the proposed approach of the AICPA Committee, or similar approaches. The reasons offered were generally similar to those stated by the AICPA Committee (see paragraph 37). A number of respondents to the Discussion Memorandum and to the Exposure Draft recommended that development stage enterprises follow the same accounting standards as established operating enterprises. The reasons given by the respondents were generally similar to those specified in paragraph 30.

Relationship to "Similar Costs"

41. The Exposure Draft stated that the Board was considering an additional pronouncement on the "similar

costs" identified in the Discussion Memorandum. A number of respondents to the Exposure Draft indicated that because, in their view, many costs incurred by development stage enterprises are within a broader category of costs that include start-up costs generally, the Board should address accounting for those "similar costs" before issuing a final Statement on development stage enterprises. The Board considered those suggestions, but concluded that it could reach an informed decision on the issues covered in this Statement without first addressing the more pervasive issues associated with accounting for "similar costs." In the Board's view, this Statement will significantly improve financial accounting and reporting for development stage enterprises.

FINANCIAL STATEMENT PRESENTATION AND ADDITIONAL DISCLOSURES

42. The Board believes that a development stage enterprise should present the same basic financial statements as any other enterprise. The conventional balance sheet, income statement, statement of changes in financial position, and statement of stockholders' equity are sufficiently adaptable to provide the distinctive information that might be considered useful for development stage enterprises. Unique financial statements for development stage enterprises might imply that the nature and results of the transactions entered into by those enterprises are unique, but many established operating enterprises have similar transactions. Further, unique financial statements would not be readily comparable with financial statements issued after an enterprise has emerged from the development stage. Also, the conclusion that the same accounting principles are appropriate for the transactions of development stage enterprises suggests that conventional basic financial statements should be presented.

43. A development stage enterprise typically will be incurring substantial costs in connection with development stage activities and will not have significant revenue. Development stage activities are likely to extend into two or more financial reporting periods. To reflect the significance of development stage activities, the Board believes that the basic financial statements presented by a development stage enterprise should be expanded to provide cumulative financial information since its inception, as well as current information. The Board concluded that disclosure of cumulative revenue and expenses and cumulative amounts of funds obtained from various sources to finance the development effort and initial operations will provide useful information about the activities of development stage enterprises without sacrificing the advantages of retaining the familiar format and content of the basic financial statements of established operating enterprises. Those additional disclosures are specified in paragraphs 11-12.

44. Some respondents to the Discussion Memorandum and Exposure Draft suggested that the differences between established operating enterprises and development stage enterprises are so fundamental as to require unique financial statements for development stage enterprises. The AICPA Committee concluded that, because of the absence of revenue, a conventional income statement would be inappropriate for a development stage enterprise; unique financial statements were deemed necessary to emphasize accountability for financial resources received and expended and to direct attention to accumulated costs rather than to measurement of performance. To accomplish those objectives, the Committee recommended the following special statements:

Preoperating accountability statement—to show the assets and cumulative cost outlays, the liabilities, and the investment by stockholders.

Statement of preoperating financial activities—to show the sources and uses of financial resources, preferably cumulative since an enterprise's inception along with data for the current period.

Statement of investment by stockholders—to show the classes and numbers of shares authorized, issued, and outstanding and the types of amounts of consideration received for the shares issued.

45. The AICPA Committee proposed extensive disclosures emphasizing that the enterprise is in the development stage, calling attention to the uncertainties that surround the enterprise and making clear that the financial statements do not purport to present financial position and results of operations.

46. Other respondents to the Discussion Memorandum and to the Exposure Draft took the position that different basic financial statements or additional disclosures are not necessary for a development stage enterprise. Still others asserted that the same basic financial statements are appropriate but should be supplemented by additional disclosures relevant to the distinctive features of a development stage enterprise.

Other Suggestions

47. The Board considered other presentation and disclosure possibilities for a development stage enterprise (including forecasts, disclosure of liquidation priorities and values, and a description of the business environment) and concluded that they should not be required solely for development stage enterprises. The Board also considered the possibility of a statement of cash receipts and disbursements and concluded that the statement of changes in financial position including amounts on a cumulative basis required by paragraph 11(c) would fulfill that need.

POTENTIAL ECONOMIC IMPACT

48. Some respondents to the Exposure Draft expressed concern that requiring development stage enterprises to present the same basic financial statements and to apply the same generally accepted accounting principles as established operating enterprises might make it difficult, if not impossible, for development stage enterprises to obtain capital. They suggested that those requirements would likely cause many development stage enterprises to report periodic losses in an income statement and a cumulative deficit in a balance sheet. Because those results would not be fully understood, suppliers of capital would be disinclined to invest in those enterprises.

49. During the course of developing the Discussion Memorandum and preparing the Exposure Draft, the FASB solicited information about the potential economic impact of applying to development stage enterprises the same generally accepted accounting principles that apply to established operating enterprises. Responses of financial statement users to the Discussion Memorandum and to the Exposure Draft provided only limited information about the potential economic impact. To obtain additional information, the FASB arranged for discussions with officers of fifteen venture capital enterprises. The consensus of those officers was that whether a development stage enterprise defers or expenses preoperating costs has little effect on (a) the amount of any

venture capital to be provided to that enterprise and (b) the terms under which any venture capital is provided. According to those officers, the venture capital investor typically relies on an investigation of the technological, marketing, management, and financial aspects of an enterprise. That investigation provides a basis for estimating potential cash flows and the probabilities of achieving them. Whether a development stage enterprise defers or expenses its preoperating costs does not affect those estimates. Based on their experience, those officers also expressed the opinion that the accounting treatment of preoperating costs would have minimal impact on the availability of short-term credit from commercial banks, but might have impact on the investment and credit decisions of unsophisticated investors.

50. In January 1975, the U.S. Department of Commerce issued a report of a study entitled "Impact of FASB's Rule Two Accounting for Research and Development Costs on Small/Developing Stage Firms." The study involved interviews with forty lenders and investors, eleven small, high-technology firms, eleven accountants, and selected government agencies. It focused primarily on the impact on investment and credit decisions concerning development stage enterprises if they were required to charge research and development costs to expense when incurred. That issue is related to the issue at hand—that is, the potential economic impact on development stage enterprises of requiring certain costs to be expensed when incurred rather than deferred. The conclusions of the Department of Commerce study were generally consistent with the FASB findings described in paragraph 49 of this Statement. Specifically, the study concluded that "FASB's Statement Two should not have a significant impact on those firms who have heretofore capitalized R&D." [20]

51. In summary, the Board has concluded that the cumulative income statement information and the cumulative information about changes in financial position required in paragraph 11 of this Statement will provide the cumulative information about preoperating costs that is typically provided by development stage enterprises currently when using special reporting formats and special accounting practices, such as those cited in paragraph 2. In addition, this Statement requires such information to be presented in financial statements whose formats are familiar and, therefore, less likely to be misinterpreted. As for the concerns of some respondents, the results of FASB discussions and the Department of Commerce study suggest that this Statement will have no significant adverse effect on the ability of development stage enterprises to obtain capital.

ISSUANCE OF SHARES OF STOCK OTHER THAN FOR CASH

52. Under the provisions of Article 5A of SEC *Regulation S-X*, dollar amounts are not assigned to shares of stock issued by a development stage enterprise for noncash consideration, or to the consideration received, unless the noncash consideration has a "fixed or objectively determinable value."

53. The proposed AICPA Audit Guide would have required assignment of dollar amounts to shares of stock issued for noncash consideration, and to the consideration received, at the time of issuance.

54. The Board agrees with the conclusion of the AICPA Committee, and of a number of respondents to the Discussion Memorandum and Exposure Draft who addressed this question, that those transactions should be

accounted for when the shares are issued in accordance with the guidelines applicable to acquisition of assets or issuance of shares in general. The transactions are not unique to development stage enterprises and should not be accounted for differently by those enterprises, even if estimates and judgments are required to determine their values.

EFFECTIVE DATE AND TRANSITION

55. The Board adopted the restatement provisions set forth in paragraphs 14-16 because, in its view, this approach provides the most useful information about development stage enterprises and about those previously in the development stage in comparing financial data for periods after the effective date of this Statement with data presented for earlier periods.

Footnotes

FAS7, Footnote 1--See paragraphs 14-16.

FAS7, Footnote 2--*FASB Interpretation No. 5,* "Applicability of FASB Statement No. 2 to Development Stage Enterprises," para. 6.

FAS7, Footnote 3--Ibid., para. 7.

FAS7, Footnote 4--The terms *subsidiary* and *investee* are defined in paragraph 3 of *APB Opinion No. 18,* "The Equity Method of Accounting for Investments in Common Stock."

FAS7, Footnote 5--*Research and development* is defined in paragraph 8 of *FASB Statement No. 2,* "Accounting and Research and Development Costs."

FAS7, Footnote 6--Under some circumstances, an established operating enterprise may issue less than a full set of financial statements, for example, only a balance sheet. This Statement does not preclude that possibility for development stage enterprises. Also, different titles or formats used by some established operating enterprises may be used provided that the prescribed information is included.

FAS7, Footnote 7--For a dormant enterprise that is reactivated to undertake development stage activities, the disclosure of cumulative amounts required by this paragraph shall be from inception of the development stage.

FAS7, Footnote 8--Subject to the exceptions described in paragraphs 7 and 16 of *APB Opinion No. 19,* "Reporting Changes in Financial Position."

FAS7, Footnote 9--Separate issuances of equity securities within the same fiscal year for the same type of consideration and for the same amount per equity unit may be combined in the statement of stockholders' equity. Appropriate modification of the statement of stockholders' equity may be required for (a) a combined group of companies that, as a whole, is considered to be in the development stage and (b) in unincorporated development stage enterprise.

FAS7, Appendix A, Footnote 10--*FASB Status Report,* No. 19, November 16, 1974.

FAS7, Appendix B, Footnote 11--*FASB Discussion Memorandum,* "Accounting for Research and Development and Similar Costs," pp. 2-5.

FAS7, Appendix B, Footnote 12--Ibid., pp. 8-9.

FAS7, Appendix B, Footnote 13--Ibid., p. 55.

FAS7, Appendix B, Footnote 14--American Institute of Certified Public Accountants, Accounting Principles

Board Committee on Extractive Industries, *Accounting and Reporting Practices in the Oil and Gas Industry* (New York: AICPA, May 31, 1973), p. 24.

FAS7, Appendix B, Footnote 15--Guidance is provided for some specific situations. For example, *FASB Statement No. 2* prescribes that the research and development costs encompassed by that Statement shall be charged to expense when incurred and describes the considerations that led to that conclusion. Also, AICPA Industry Audit Guides provide guidance about accounting for costs incurred by enterprises in particular industries. Although Audit Guides do not constitute authoritative accounting literature, those issued in recent years state that members of the AICPA may be called upon to justify departures from the recommendations contained therein.

FAS7, Appendix B, Footnote 16--*APB Statement No. 4,* in paragraph 4, describes its status as follows: "The accounting principles described are those that the [Accounting Principles] Board believes are generally accepted today. The Board has not evaluated or approved present generally accepted accounting principles except to the extent that principles have been adopted in Board Opinions. Publication of this Statement does not constitute approval by the Board of accounting principles that are not covered in its Opinions."

FAS7, Appendix B, Footnote 17--U.S., Securities and Exchange Commission, *Regulation S-X,* Rule 5a-02, "Statement of Assets and Unrecovered Promotional, Exploratory, and Development Costs," item 14.

FAS7, Appendix B, Footnote 18--American Institute of Certified Public Accountants, Committee on Companies in the Development Stage, *Accounting for Companies in the Development Stage,* an exposure draft of an Audit Guide (New York: AICPA, March 1973), pp. 25-26, 28.

FAS7, Appendix B, Footnote 19--Ibid., p. 11.

FAS7, Appendix B, Footnote 20--U.S., Department of Commerce, "Impact of FASB's Rule Two Accounting for Research and Development Costs on Small/Developing Stage Firms" (Washington, D.C.: U.S., Department of Commerce, January 20, 1975), p. 3.