

## **Analysis of the Effects of FAS 154 on the Application of EITF Consensuses**

The purpose of this memo is to address the effects of FASB Statement No. 154, *Accounting Changes and Error Corrections*, on the transition provisions of EITF consensuses. In summary,

1. The Task Force should continue to establish transition provisions for consensuses on an Issue-by-Issue basis by selecting the most appropriate transition for the specific circumstances. However, if no transition guidance is provided, an entity will be required to apply a consensus through retrospective application of that guidance to all prior periods, unless it is impractical to do so.
2. If the Task Force decides that the application of a consensus should be reported as a cumulative effect adjustment, the adjustment should be made to the opening balance of retained earnings (or other appropriate components of equity or net assets) for that period. No longer should a cumulative effect adjustment be included in net income for the period of change.
3. The Task Force is not required to reconsider the transition provisions for any existing consensuses. However, for existing consensuses that may be adopted in periods beginning after December 15, 2005, the FASB staff recommends that the Task Force require that any cumulative effect adjustments be recognized in beginning retained earnings (or other appropriate components of equity or net assets) for that period.
4. The Task Force should consider FAS 154 when deliberating the transition requirements of any future consensuses.

### **Background**

*EITF Abstracts*, Topic No. D-1, "Implications and Implementation of an EITF Consensus," states that, unless an EITF consensus specifies the manner of reporting a change in accounting principle, an entity may apply a consensus prospectively to future transactions or may apply the provisions of APB Opinion No. 20, *Accounting Changes* (generally as a cumulative effect adjustment).<sup>1</sup> As a practical matter, it is very unusual for the Task Force not to provide transition guidance for a consensus and, therefore, an entity rarely is required to consider the "standard" transition provisions in Topic D-1.

In May 2005, the FASB issued FAS 154, which addresses the accounting and reporting for changes in accounting principles. FAS 154 replaces APB 20 and FIN 20. Accordingly, the basis

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<sup>1</sup> FASB Interpretation No. 20, *Reporting Accounting Changes under AICPA Statements of Position*, also includes these transition alternatives for EITF consensuses.

for the "standard" EITF transition has been replaced and Topic D-1 will be modified appropriately.

This memo also addresses the provisions of FAS 154 that may affect the application of EITF consensuses.<sup>2</sup>

### **Changes in accounting principles**

The Task Force should continue to consider transition for consensuses. However, in the unusual instance in which no transition is provided, an entity will be required to apply a consensus through retrospective application<sup>3</sup> of the guidance to all prior periods, unless it is impractical to do so. No longer will an entity have a choice, unless specifically provided for in the consensus, to apply the consensus prospectively or as a cumulative effect adjustment.

Paragraph 7 of FAS 154 states that retrospective application requires the following:

- a. The cumulative effect of the change to the new accounting principle on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.
- b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.
- c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle.

Paragraphs 8 and 9 of FAS 154 provide reporting guidance if it is impractical<sup>4</sup> to determine (a) the period-specific effects of a change in accounting principle on all prior years presented and (b) the cumulative effect of applying a change in accounting principle to any prior period.

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<sup>2</sup> This memo does not address the FAS 154 provisions that provide guidance on voluntary changes in accounting principles, changes in accounting estimates, changes in reporting entities, and corrections of errors in previously issued financial statements.

<sup>3</sup> FAS 154 defines retrospective application, in part, as "the application of a different accounting principle to one or more previously issued financial statements, or to the statement of financial position at the beginning of the current period, as if that principle had always been used."

<sup>4</sup> Paragraph 11 provides guidance as to whether retrospective application is impracticable.

Additionally, FAS 154 requires that an entity include only the direct effects of a change in accounting principle in a retrospective application. Indirect effects should not be included in a retrospective application. If indirect effects are actually incurred and recognized, they should be reported in the period in which the accounting change is made.

### **Preferred Transition**

The Task Force should establish transition provisions for consensuses on an Issue-by-Issue basis by selecting the most appropriate requirements for the specific circumstances. FAS 154 does not require the Task Force to select a specific transition method, nor does it provide specific criteria that must be considered when evaluating transition alternatives. However, the Task Force should note that when selecting retrospective application as the "default" transition for new accounting pronouncements and the required transition for voluntary changes in accounting principles, the Board emphasized the importance of the period-to-period comparability of financial statements over the concern expressed in APB 20 that restatement of financial information may dilute public confidence in financial reporting.

Paragraph 6 of FAS 154 states that an accounting pronouncement (including consensuses reached by the EITF) normally will provide specific transition requirements. Additionally, paragraph B6 of FAS 154 states that:

...the Board noted that this Statement does not preclude the Board or other standard setters from establishing specific transition provisions in future pronouncements that may differ from the provisions of this Statement. The Board expects to establish transition guidance on a standard-by-standard basis by selecting the transition requirements appropriate for those specific circumstances.

Accordingly, the FASB staff believes that the Task Force should continue to provide transition guidance on an Issue-by-Issue basis.

In future meeting materials and minutes, the FASB staff will use terms that are consistent with FAS 154—specifically, retrospective application will be used instead of restatement.

### **Cumulative Effect**

If the Task Force decides that the application of a consensus should be reported as a cumulative effect adjustment, the adjustment should be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period. No longer should a cumulative effect adjustment be included in the net income of the period of change.

Paragraphs 7 and 8 of FAS 154 require that the cumulative effect of a change in accounting principle be recorded directly in the opening retained earnings balance (or other appropriate components of equity or net assets). Paragraph B12 of FAS 154 states that the Board considered requiring the cumulative effect adjustment to be included in net income of the period in which the change was made, as was required by APB 20. However, the Board rejected that alternative on the basis that the cumulative effect adjustment does not relate to the period in which the change is made and, therefore, should not be included in net income for that period. Accordingly, the Task Force should require that a cumulative effect adjustment be reported as a change in the opening balance of retained earnings (or other appropriate components of equity or net assets).

Additionally, the Task Force may need to provide additional reporting guidance if it permits an entity to adopt a consensus in an interim period through a cumulative effect adjustment. Paragraphs 15 and 16 of FAS 154 provide guidance on the retrospective application of a change in accounting principle when the change is made in an interim period. Additionally, FAS 154 supercedes FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, which provided guidance on reporting cumulative-effect-type accounting changes in interim periods. Accordingly, in the absence of FAS 3, the Task Force may need to provide more explicit guidance for reporting a cumulative effect adjustment in an interim period.

### **FAS 154 Transition**

FAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. FAS 154 does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of FAS 154. Accordingly, the Task Force is not required to reconsider the transition provisions for any

existing consensuses. However, to be consistent with the requirements of FAS 154 for existing consensuses that will be adopted in periods beginning after December 15, 2005, the FASB staff recommends that the Task Force require that any cumulative effect adjustments be recognized in beginning retained earnings (or other appropriate components of equity or net assets). The staff has identified one consensus that may be affected—EITF Issue No. 04-6, "Accounting for Stripping Costs Incurred during Production in the Mining Industry." The FASB staff proposes that the Status Section of Issue 04-6 include an update for FAS 154 to indicate that any cumulative effect adjustment recognized in periods beginning after December 15, 2005, should be reported as a change to beginning retained earnings (or other appropriate components of equity or net assets).

Additionally, the transition alternatives provided in the Issue Summaries for the June 15–16, 2005 EITF meeting do not consider FAS 154. The staff believes that the Task Force should consider FAS 154 when deliberating the transition requirement for any consensus reached at the June meeting and, at a minimum, require any cumulative effect adjustment reported for fiscal periods after December 15, 2005, to be reported in retained earnings (or other appropriate components of equity or net assets), instead of through net income. In particular, the Task Force should consider the guidance in FAS 154 when deliberating Issues that include a cumulative effect adjustment alternative in the related Issue Summary. Those Issues include:

- a. EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights" (Transition Method A)
- b. EITF Issue No. 05-2, "The Meaning of "Conventional Convertible Debt Instrument" in EITF Issue 00-19, 'Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock'"
- c. EITF Issue No. 05-4, "The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19"
- d. EITF Issue No. 05-5, "Accounting for the Altersteilzeit Early Retirement Programs and Similar Type Arrangements."