

# FASB Interpretation No. 7

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Applying FASB Statement No. 7 in Financial  
Statements of Established Operating Enterprises

an interpretation of FASB Statement No. 7

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Financial Accounting Standards Board  
of the Financial Accounting Foundation  
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# FIN 7: Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises

## an interpretation of FASB Statement No. 7

### INTRODUCTION

1. The FASB has been asked to explain the applicability of *FASB Statement No. 7*, "Accounting and Reporting by Development Stage Enterprises," to an established operating enterprise's financial statements that include the financial statements of a development stage subsidiary or other investee either by consolidation or by the equity method,<sup>1</sup> in terms of the following questions:

- a. Must the effect of a change in accounting principle adopted in the separate financial statements of a development stage subsidiary to conform to the provisions of *Statement No. 7* be reflected in the consolidated financial statements of an established operating enterprise that include the financial statements of that subsidiary?
- b. If it is appropriate that the established operating enterprise's consolidated financial statements reflect the effect of its development stage subsidiary's change to a new principle of accounting adopted to conform to the provisions of *Statement No. 7*, how should the effect of the change be reported in the established operating enterprise's financial statements?

2. Paragraph 10 of *Statement No. 7* states:

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. . . . 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.

3. Paragraph 14 of *Statement No. 7* provides for initial application of the Statement as follows:

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").

Further, paragraph 1 of *Statement No. 7* states, in part, that "the transition requirements of this Statement are also applicable to certain established operating enterprises" and makes specific reference to paragraphs 14–16 of *Statement No. 7* by footnote.

## INTERPRETATION

4. *Statement No. 7* does not address and does not alter generally accepted accounting principles for the preparation of consolidated financial statements. Therefore, *Statement No. 7* does not address the question of whether the effect of a change in accounting principle adopted in the separate financial statements of a development stage subsidiary to conform to the provisions of that Statement must be reflected in an established operating enterprise's consolidated financial statements that include the financial statements of the subsidiary. However, paragraph 10 of the Statement specifies that "capitalization or deferral of costs shall be subject to the same assessment of recoverability that would be applicable in an established operating enterprise" and further specifies that "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." In specifying that the same assessment of recoverability be made, the Statement does not require that the results of that assessment must necessarily be the same. Further, the Statement does not affect any accepted practice in consolidation of financial statements where the results of an assessment of recoverability of a cost may be different (a) in the broader context of a consolidated enterprise and (b) in the context of a development stage subsidiary standing alone. Under any such accepted practice, a cost incurred by a development stage subsidiary could be assessed as recoverable within the consolidated enterprise and be capitalized or deferred in consolidated financial statements even

though that cost is assessed as not being recoverable within a development stage subsidiary and, therefore, charged to expense in the separate financial statements of the development stage subsidiary.

5. Except in the circumstances described in the preceding paragraph, the effect of a development stage subsidiary's change in accounting principle to conform its accounting to the requirements of *Statement No. 7* generally would be reflected in an established operating enterprise's consolidated financial statements that include that subsidiary. When a development stage subsidiary adopts a new accounting principle to conform its accounting to the requirements of *Statement No. 7* and the effect of that subsidiary's accounting change is also reflected in an established operating enterprise's consolidated financial statements that include that subsidiary, the provisions of paragraph 14 of *Statement No. 7* apply. In that situation, the established operating enterprise's consolidated financial statements for periods prior to the period in which the subsidiary's accounting change is made and financial summaries and other data derived therefrom shall be restated by prior period adjustment. It should be noted that *Statement No. 7* does not address the question of how an established operating enterprise should report accounting changes adopted with respect to the revenue and costs related to activities of the parent company or any subsidiaries that are not in the development stage; that question is covered by *APB Opinion No. 20*, "Accounting Changes."

## **EFFECTIVE DATE**

6. This Interpretation shall be effective for fiscal periods beginning on or after January 1, 1976, although earlier application is encouraged, except that it shall not be applied prior to initial application of *Statement No. 7*.

*This Interpretation was adopted by the affirmative votes of five members of the Financial Accounting Standards Board following submission to the members of the Financial Accounting Standards Advisory Council. Mr. Mays and Mr. Schuetze dissented.*

Mr. Mays and Mr. Schuetze dissent because, in their view, the response to the first of the two questions addressed is ambiguous and serves to create additional uncertainty as to the substance of paragraph 10 of *FASB Statement No. 7*.

If different conclusions as to recoverability can be justified on the basis that the two entities are making their assessments within different "contexts," as paragraph 4 attempts to rationalize, would not a development stage enterprise and an established operating enterprise always have different contexts for such assessments? How, then, they ask, is the development stage enterprise subject to "the same assessment of recoverability that would be applicable in an established operating enterprise" as required by paragraph 10 of the Statement? They find equivocal the explanation that although the assessments must be the same the conclusions may be different.

In their opinion, the only appropriate response to the question in paragraph 1(a) is to require that the effect of the change in principle and the assessment of recoverability in the development stage subsidiary be preserved and reflected in the consolidated financial statements in the same manner as in the subsidiary's financial statements.

*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

## Footnotes

FIN7, Footnote 1--Hereinafter, in this Interpretation, the term *subsidiary* comprehends all *investees* that are accounted for by the equity method as described in *APB Opinion No. 18*, "The Equity Method of Accounting for Investments in Common Stock." Likewise, the term *consolidated financial statements* hereinafter comprehends the *equity method of accounting*.