

Insights

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Accounting

Disclosures Required for All Non-Public Employers Electing Delayed Adoption of FASB Statement No. 158

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. The main provision of Statement No. 158 requires a sponsor (this includes both for-profit and not-for-profit employers) of one or more single-employer defined benefit plans to recognize the funded status of a benefit plan (measured as the difference between plan assets at fair value and the benefit obligation) in its balance sheet. For an employer without publicly traded equity securities (a nonpublic employer) this requirement is not effective until the end of the fiscal year ending after June 15, 2007. However, a nonpublic employer is required by Statement No. 158 to disclose the following information in financial statements for a fiscal year ending after December 15, 2006, but before June 16, 2007, unless it has elected the early application of the recognition provisions of Statement No. 158 in preparing those financial statements:

- A brief description of the provisions of Statement No. 158;
- The date that adoption is required; and
- The date the employer plans to adopt the recognition provisions of the Statement, if earlier.

Statement No.158 is available in full at <http://www.fasb.org/pdf/fas158.pdf>.

Guidance Proposed for Quantifying Misstatements

Financial Accounting Standards Board (FASB) Statement No. 154, *Accounting Changes and Error Corrections*, provides guidance for reporting the correction of an error in previously issued financial statements. However, Statement No. 154 does not specify the appropriate method to quantify the misstatement as a basis for evaluating materiality. On March 13, 2007, the FASB released proposed FASB Staff Position (FSP) No. FAS 154-a, *Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements*. This FSP describes the consideration of the effects of prior-year uncorrected misstatements when quantifying misstatements in current-year financial statements of privately held entities and not-for-profit organizations. If finalized, the FSP would extend the guidance in SEC Staff Accounting Bulletin (SAB) No. 108 that is applicable to SEC registrants to all other nongovernmental entities that are not subject to the requirements of SAB 108, thereby conforming the reporting of error corrections between SEC registrants and all other nongovernmental entities.

This proposed FSP does not address whether misstatements are material as that is a matter of professional judgment. The proposed FSP does, however, require that the assessment of materiality should be based on both quantitative and qualitative considerations. Because of the interaction of

quantitative and qualitative considerations, misstatements of a relatively small amount could have a material effect on the current financial statements as well as financial statements of future periods.

In current practice, there is diversity amongst privately held entities and amongst not-for-profit organizations as to how to quantify the effects of prior-year misstatements in current-year financial statements. There have been two common approaches used to quantify such misstatements:

- The rollover approach quantifies a misstatement based on the amount of the error originating in the current-year income statement.
- The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement's year(s) of origination.

The proposed FSP states that for purposes of evaluating the materiality of a misstatement, an entity must quantify the effect of the misstatement in its current-year balance sheet and income statement using both the rollover approach and the iron curtain approach. If a misstatement using either the rollover approach or the iron curtain approach is material to the current-year financial statements, the entity must correct its current-year financial statements. If a misstatement relating to prior-year misstatements exists after the current-year financial statements are corrected and is material to the current-year financial statements, the entity must correct the previously issued financial statements. This correction is required even if the prior-year misstatements were and continue to be immaterial to the previously issued financial statements.

If finalized, the FSP would be effective for financial statements issued for fiscal years ending after June 15, 2007. Earlier application would be permitted. To assist entities in adopting the requirements of the FSP, the FASB would allow entities to elect not to restate prior-period financial statements, assuming management properly applied its prior approach (either rollover or iron curtain), including properly evaluating all qualitative materiality considerations. In adopting the FSP, entities may report the cumulative effect of the initial application of the FSP as an adjustment to the opening balance of retained earnings. The nature and amount of each individual error being corrected in the cumulative adjustment must be disclosed. The disclosure also should include when and how each error being corrected arose and the fact that the errors had previously been considered immaterial.

The proposed FSP is available for comment until April 30, 2007 at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas154-a.pdf.

Upsetting the Myth on Trade-In Accounting

Companies often trade in assets for different or newer models or even different types of assets. Accounting for such trade-ins is dependent on several factors, including among others:

- How much cash (boot) was paid/received in the transaction?
- Is fair value of the assets being traded able to be determined within reasonable limits?
- Is there commercial substance to the transaction?

The first question is important as the answer determines whether the transaction is considered a monetary or nonmonetary exchange. Generally if monetary consideration is 25 percent or more of an exchange transaction, it is considered to be a monetary transaction. Conversely if monetary consideration is under 25 percent, the transaction is considered to be nonmonetary. This determination drives the accounting.

Let's assume the transaction is considered monetary. Monetary transactions are recorded at fair value. The use of fair value is, however, predicated on the ability to satisfactorily measure fair value of the assets being exchanged, the second question above. If it is not possible to measure the fair value, then the asset being received would be recorded at the amount of boot paid plus the depreciated cost of the asset traded in.

Now let's assume the transaction is considered nonmonetary. Nonmonetary transactions have been accounted for under Accounting Principles Board (APB) Opinion No. 29, *Accounting for Nonmonetary Transactions*, which has been amended by FASB Statement No. 153, *Exchanges of Nonmonetary Assets - an amendment of APB Opinion No. 29*. Statement No. 153 was issued by the Financial Accounting Standards Board (FASB) in 2004 and is effective for nonmonetary asset exchanges occurring in periods beginning after June 15, 2005.

Statement No. 153 changed the accounting for nonmonetary transactions by requiring that they be measured using fair value of the assets being exchanged. However Statement No. 153 does provide exceptions to this measurement at fair value. If any of the following three items are present, fair value accounting does not apply:

- If the fair value of neither the assets received nor the assets relinquished is determinable within reasonable limits.
- When the transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.
- When the transaction lacks commercial substance.

If a transaction meets one of the exceptions, the transaction is recorded based on recorded amounts and no gain is recognized, but a loss would be recognized for an indicated impairment of value.

The first two bullets did not change from APB Opinion No. 29. However the third bullet introduces a new concept - "commercial substance." The challenge in applying Statement No. 153 is assessing whether the exchange has commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The entity's future cash flows are expected to significantly change if either of the following criteria is met:

- The risk, timing or amount of the future cash flows, collectively referred to as the configuration of the future cash flows, of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred. (A change in any one of those elements would be a change in configuration.)
- The entity-specific value of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the asset(s) exchanged. An entity-specific value attempts to capture the value in the context of a particular entity and is different from a fair value measurement.

In many ways the change in future cash flows can be qualitatively determined. In these cases, detailed calculations would not need to be made. Consider the following example:

A company trades in its five-year-old delivery truck for a brand-new model, and the boot exchanged was less than 25%. (For purposes of this illustration, assume that fair value of both models can be determined and the exchange is not being done to facilitate sales to customers.) To determine commercial substance, the company would compare what cash flows the old truck would have

generated to what cash flows the new truck will generate. These cash flows would include repair/maintenance costs, gas, and any sales directly attributable to the truck, and would also be affected by the useful life of the asset (which isn't necessarily the same as the life assigned for tax depreciation). It is intuitive to assume the new model will eventually experience the same repair/maintenance issues as the older model, however because it is expected to have a longer useful life to the company, it will generate more "sale" cash flows. Therefore the cash flows on the new truck will be different. If the amount of sale cash flows is significant, then the commercial substance test is met, and the new truck is recorded on the financial statements at its current fair value rather than the recorded amount of the old truck plus boot paid.

Previously, under Opinion No. 29 this transaction would have been considered an "exchange of similar productive assets" and been recognized at recorded amounts.

As shown in this example, the resulting impact of Statement No. 153 is that more nonmonetary asset exchanges will be recorded at fair value rather than at their recorded amounts, and gains and losses will be recognized compared to previously existing GAAP. Keep in mind that this change in accounting will affect how deferred taxes on these transactions are computed.

Director Options: Which GAAP Applies?

When considering which generally accepted accounting principle (GAAP) to apply in the accounting for stock options granted to members of a board of directors, each set of facts and circumstances must be analyzed carefully. In deciding how to account for these stock options, the first guidance to consider is FASB Statement No. 123 (revised 2004), *Share-Based Payment*. Statement No. 123(R) generally applies to all stock option grants. However, as provided in paragraphs A230-A232 of Statement No. 123(R) and related FASB Staff Position No. FAS 123R-1, unless the grant was to an employee, Statement No. 123(R) does not apply to grants once they are vested. The question to then ask is: Are directors considered to be employees under Statement No. 123(R)?

Statement No. 123(R) permits nonemployee directors acting in their role as members of the board of directors to be "treated as employees if those directors were (a) elected by the employer's shareholders or (b) appointed to a board position that will be filled by shareholder elections when the existing term expires." In addition, paragraph A76 states that this guidance applies only to (a) nonemployee directors acting in their role as members of the *parent entity's* board of directors and (b) nonemployee members of a consolidated subsidiary's board of directors to the extent that those members are elected by shareholders that are not controlled directly or indirectly by the parent or another member of the consolidated group.

The most common scenario involves options granted to board of directors of company, whether it is a stand-alone company or a parent company of a consolidated group. Under Statement No. 123(R), these directors are generally considered employees with the assumption that they have been elected by the shareholders of the company. (It should be noted that the scenarios provided assume the options have been granted for services as a director. There are many factors that go into that determination, and a full discussion is beyond the scope of this article.)

However another situation that arises is when the board members serve as directors of a company that is a wholly owned subsidiary. Consider, for example, this situation:

A parent company has six wholly owned consolidated subsidiaries. Each of these subsidiaries has its own board of directors. The parent company has elected to grant stock options under its established

stock option plan to the subsidiaries' directors for their services as directors. The grants were fully vested upon issuance.

Are these directors considered to be employees under Statement No. 123(R)? The answer to the question is "No." Because the parent company owns 100% of each subsidiary, there are no noncontrolling shareholders that can elect the directors.

Why is the answer to this question important? As stated previously, Statement No. 123(R) does not apply to vested grants to nonemployees. Because these directors are not considered to be employees, this raises another question: What accounting guidance should be followed once the grant is vested?

Once the grant is vested, the accounting for these grants is covered by Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and related Emerging Issues Task Force (EITF) Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*. These standards affect classification of the grant as equity or as a liability and whether the grant should be marked to market each period.

Now let's throw a wrinkle in the example above. Instead of being fully vested upon issuance, change the assumption so that the grants have graded vesting, in which 25% vest every year over a period of four years. In this situation, the unvested portion of the grants will be accounted for under Statement No. 123(R), while the vested grants will be covered under Statement No. 133 and EITF Issue No. 00-19.

It should be noted that the conclusions reached above do not change when/if the subsidiary issues stand-alone financial statements.

This example demonstrates the need to consider all of the facts before deciding which accounting principles apply to the granting of stock options to directors.

Did the Accounting Change for Your Registration Rights Agreement?

An entity may issue financial instruments such as equity shares, warrants or convertible debt instruments that are subject to registration payment arrangements. These arrangements can take many forms. Some are mandatory registrations, some are considered "best efforts", which means the company only has to make their best effort or use commercially reasonable efforts to effect a registration, and others may be a combination of both. Generally, the arrangements require the issuer to file a registration statement for the resale of the shares underlying these instruments, which must be declared effective by the SEC within a specified period. Some will also require the issuer to maintain the effectiveness of the registration statement for a period of time or into perpetuity. If the issuer fails to fulfill these requirements, the issuer may need to transfer some type of consideration to the counterparty. The form of the registration rights may be included as a provision of a financial instrument or other agreement or may be issued as a separate agreement.

These types of payment arrangements can affect the classification of the instrument subject to the arrangement. Under Emerging Issues Task Force (EITF) Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, certain types of registration payment arrangements cause the affected instrument to be recorded as a liability versus equity in the financial statements. In the application of EITF Issue No. 00-19, many questions arose as to how to apply the guidance therein to these types of arrangements. The questions involved complex issues, such as determining the unit of account, i.e. whether to consider the registration rights agreement as a separate instrument requiring separate accounting or combining the agreement with the related instrument, whether

a payment under the registration rights agreement constitutes a settlement, as described in EITF Issue No. 00-19, of the related instrument, etc.

In December 2006, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. EITF 00-19-2, *Accounting for Registration Payment Arrangements*, which answered many of these questions. Therefore this FSP may have changed the impact these registration rights arrangements have on the classification of the affected instrument. The FSP also may require the registration rights arrangement to be recorded separately. The FSP is effective immediately for registration payment arrangements and the financial instruments subject to those arrangements that are entered into or modified subsequent to December 21, 2006. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to December 21, 2006, the guidance is effective for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years.

What Is Covered by this FSP?

This FSP covers only certain types of registration rights arrangements. The arrangements must:

- Specify that the issuer will endeavor (1) to file a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration to be declared effective by the SEC, and/or (2) to maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity); AND
- Require the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if the effectiveness of the registration statement is not maintained.

If the registration rights arrangement meets both of the above, it is subject to this FSP. It does not matter whether the registration rights were issued in a separate agreement or are included as a provision of a financial instrument or other agreement.

How Does This Change the Accounting?

The FSP defines arrangements meeting the above criteria as *registration payment arrangements*. These registration payment arrangements are now evaluated separately from the instrument(s) subject to it. This means (1) when evaluating the instrument subject to the arrangement under EITF 00-19, if applicable, these registration payment arrangements are ignored and do not impact the classification of the instrument(s) and (2) an entity must determine if the registration payment arrangement itself requires recognition and measurement in the financial statements.

It is possible that when applying this FSP, an instrument that was previously classified as a liability under EITF No. 00-19 may no longer be a liability when ignoring the impact of the registration payment arrangement. Therefore one should review any instrument classified as a liability under EITF No. 00-19 to determine if this FSP would change that conclusion. In addition, it is also possible that although the instrument(s) subject to the registration payment arrangement are no longer considered a liability, the registration payment arrangement would require an amount to be recorded as a liability. Therefore the considerations for determining the recognition and measurement of a registration payment arrangement should be reviewed and documented.

Arrangements meeting the definition of a registration payment arrangement as defined in this FSP are recognized and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of the Loss*.

What Is Not Covered by this FSP?

As indicated above, not all registration rights arrangements are covered by this FSP. The following arrangements are not covered by this FSP:

- Those with no stated payment provisions
- Those wherein the amount of consideration to be transferred is determined by reference to:
 - An observable market, other than the market for the issuer's stock or
 - An observable index
- Those that require registration or listing of convertible debt instruments or convertible preferred stock if the form of consideration that would be transferred to the counterparty is an adjustment to the conversion ratio
- Those in which the financial instrument(s) subject to the arrangement are settled when the consideration is transferred.

Those arrangements not in the scope of the FSP still need to be considered in the evaluation of the instrument(s) subject to the registration rights arrangements under EITF No. 00-19. If these arrangements were not considered in the evaluation of the instrument(s) subject to the arrangement under EITF Issue No. 00-19, then a re-evaluation should be performed as appropriate. This may also change prior accounting.

More Information about this FSP

For more information regarding this FSP, see "Accounting for Registration Payment Arrangements" in the January 9, 2007 edition of *Insights*. The FSP is available in full at http://www.fasb.org/fasb_staff_positions/fsp_eitf00-19-2.pdf.

Derivatives: Reminder No. 1

There is no doubt about it – FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is one of the most complex accounting principles out there. Since it was issued in 1998, there have been many interpretations and clarifications regarding the application of this Statement. There also have been many financial statement restatements due to its misapplication. Although Statement No. 133 is very complicated, many restatements can be traced back to misapplication of three important basic requirements:

- Initially identifying a derivative instrument;
- Documenting a hedged item sufficiently and at inception of the hedging relationship; and
- Measuring hedge effectiveness accurately and periodically.

This article is the first in a three-part series of articles written as reminders of these basic concepts.

Reminder No. 1 - Look for the Derivative

A common source of financial statement restatements is not recognizing that a derivative instrument exists in the first place. Because all derivatives are assets or liabilities that must be recorded on the balance

sheet at fair value, it is important to be able to identify a derivative. A derivative instrument is a financial instrument or other contract with all of the following characteristics:

- It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both.
- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market forces.
- Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. Below are some common derivative contracts with the underlying and notional amounts identified:

<u>Derivative</u>	<u>Underlying</u>	<u>Notional Amount</u>
Stock option	Stock price	Number of shares
Currency forward	Exchange rate	Number of currency units
Interest rate swap	Interest rate	Dollar amount
Commodity future	Commodity price	Number of commodity units

As noted above, certain contracts for the purchase or sale of commodities and/or inventories may meet the definition of a derivative. These contracts need not be accounted for as derivatives, however, if they meet the definition of “normal purchases or sales,” and the company has documented its basis for that conclusion. Failure to comply with the documentation requirements precludes application of the normal purchases and sales exception and will require a company to follow derivative accounting for the contract.

Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments — implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. An embedded derivative instrument must be separated from the host contract and accounted for as a derivative instrument pursuant to Statement No. 133 if certain criteria are met.

Once a contract or financial instrument has been determined to meet the definition of a derivative, it must be recognized as either an asset or liability and measured at fair value. The effect on the income statement is dependent on whether the derivative is designated as a hedge and if so, what type of hedge. The next biweekly article in this series will remind us about the documentation required to elect hedge accounting.

Auditing

Reporting on Uncertainties in a Review or Compilation

The AICPA’s Accounting and Review Services Committee recently released Interpretation No. 29 of AR Section 100, *Compilation and Review of Financial Statements*, to provide guidance about reporting on an uncertainty, including an uncertainty about an entity’s ability to continue as a going concern. Per the

Interpretation, if the accountant determines that the disclosure of an uncertainty (for example, an uncertainty regarding pending or threatened litigation) is not in accordance with generally accepted accounting principles, the applicable reporting guidance in AR section 100 with respect to departures from generally accepted accounting principles should be followed. If the accountant concludes that management's disclosure of the uncertainty is in accordance with generally accepted accounting principles, the accountant may further decide to include an emphasis of a matter paragraph with respect to the uncertainty in the accountant's compilation or review report.

If, during the performance of compilation or review procedures, evidence or information comes to the accountant's attention that there may be an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being compiled or reviewed, the accountant should consider the adequacy of management's disclosure of the uncertainty. If management has not disclosed the matter or the accountant is concerned about the adequacy of management's disclosure, the accountant should consider whether there is a reasonable possibility that third-party users or other readers of the compiled or reviewed financial statements would be misled into assuming the continuation of the entity. If the accountant determines that the disclosure of the uncertainty regarding the entity's ability to continue as a going concern is not adequate, the applicable reporting guidance in AR section 100 with respect to departures from generally accepted accounting principles should be followed. If the accountant concludes that management's disclosure of the uncertainty regarding the entity's ability to continue as a going concern is adequate, the accountant may further decide to include an emphasis of a matter paragraph with respect to the uncertainty in the accountant's compilation or review report.

If the accountant compiles financial statements that omit substantially all of the disclosures required by generally accepted accounting principles, if the report clearly indicates the omission, and if the client's decision to omit the disclosures was not, to the accountant's knowledge, undertaken with the intention of misleading users of the statements, the disclosure of an uncertainty may be omitted because the user is adequately warned of the limitations of the financial statements by the report language.

Interpretation No. 29 is available in full at http://www.aicpa.org/download/auditstd/Interpretation_No_29-Reporting_on_Uncertainties.pdf.

International

Proposal to Clarify Auditor's Responsibilities with Respect to Related Parties

In December 2005, the International Auditing and Assurance Standards Board (IAASB) published an exposure draft of proposed International Standard on Auditing (ISA) 550 (Revised and Redrafted), *Related Parties*, which deals with the auditor's responsibilities regarding related-party relationships and transactions when performing an audit of financial statements. Recently, the IAASB concluded that re-exposure of this proposed ISA is necessary because of the significance of changes made in response to comments received. The exposure draft includes a new definition of a "related party" to serve as a minimum level for the purposes of the audit of the financial statements. It also improves the delineation between the auditor's procedures to identify relevant risks of material misstatement and his or her responses to the assessed risks. The proposed standard also emphasizes the need for the auditor to be aware of related parties and the extent to which they affect the financial statements, even where the financial reporting framework applied in preparing the financial statements does not establish requirements for related parties (or does so inadequately).

The revised exposure draft is available for comment until June 30, 2007 at <http://www.ifac.org/Guidance/EXD-Download.php?EDFID=00215>.

Exposure Draft to Clarify Use of the Going Concern Assumption

In striving to improve the clarity of its standards, the International Auditing and Assurance Standards Board (IAASB) plans to redraft existing standards and to develop new and revised standards following new drafting conventions. Key elements of the new drafting conventions include: basing each standard on the objective of the auditor with respect to the subject matter of the standard; separating the requirements that the auditor is required to follow from guidance on their application; eliminating the present tense to describe actions by the auditor, which raised ambiguity about whether such actions were required; and other structural and drafting improvements to enhance the overall readability and understandability of the standards. Standards redrafted in this way are described as "redrafted." If further revision has been undertaken, a standard is described as "revised and redrafted."

Recently, the IAASB issued an exposure draft of proposed International Standard on Auditing (ISA) 570 (Redrafted), *Going Concern*, which was redrafted under this initiative. This ISA deals with the auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements. While the final common effective date for all redrafted ISAs will be determined as the IAASB's agenda progresses, it will not be earlier than December 15, 2008.

The exposure draft is available for comment until May 31, 2007 at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0078>.

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