

Insights

A biweekly publication from the National Office of Audit and Accounting

May 1, 2007

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Accounting

FAS 159 Status Update

On April 6, 2007, we issued a white paper discussing Financial Accounting Standards Board Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, and related Financial Accounting Standards Board Statement No. 157, *Fair Value Measurements*. These two standards continue to generate questions related to their early adoption and proper application. Therefore we are providing some additional information received after the issuance of the white paper at http://www.mcgladrey.com/Resource_Center/Audit/Articles/FAS159StatusUpdateApril172007.html.

Proposed Accounting for Financial Guarantee Insurance Contracts

Currently, there is diversity in the way financial guarantee insurance contracts are accounted for by insurance enterprises under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. That diversity has resulted in differences in the recognition and measurement of claim liabilities and can lead to different financial statement information for similar transactions. The Financial Accounting Standards Board (FASB) therefore has issued an Exposure Draft, *Accounting and Reporting by Insurance Enterprises- an interpretation of FASB Statement No. 60*, to provide consistency in accounting for financial guarantee insurance contracts.

The Exposure Draft requires that insurance enterprises recognize premium revenue when insured contractual payments (generally principal and interest) are made by the issuer of the insured financial obligation. The proposal presumes that the risk to the insurance enterprise is reduced to the extent of the insured contractual payments made. The proposed Statement also:

- Requires recognition of a claim liability prior to a default (insured event) under certain criteria;
- Requires more consistent claim liability measurement based on the present value of expected cash flows; and
- Requires expanded disclosures about financial guarantee insurance contracts.

If finalized, the proposed Statement would be effective for financial statements issued for fiscal years beginning after December 15, 2007, and all interim periods within those fiscal years. The Exposure Draft is available for comment until June 18, 2007 at http://www.fasb.org/draft/ed_fin_guarantee_ins_contracts.pdf.

It is interesting to note that this Exposure Draft was written in a new format intended to improve the understandability of accounting pronouncements. Notable changes from formats used in previous FASB Statements issued include the use of bold text at the beginning of each section to convey the accounting principle for that section, and the inclusion of examples in the body of the Standard to illustrate some of the guidance.

Determining Whether Options Are Indexed to an Entity's Own Stock

When applying FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, contracts issued or held by a company that are both indexed to its own stock and classified in stockholders' equity in its balance sheet are not considered derivative instruments for purposes of the Statement. To provide further clarification of this scope exception, the Financial Accounting Standards Board (FASB) has issued proposed guidance in Derivatives Implementation Group (DIG) Statement 133 Implementation Issue No. C21, *Scope Exceptions: Whether Options (Including Embedded Conversion Options) Are Indexed to both an Entity's Own Stock and Currency Exchange Rates*. This proposed Implementation Issue clarifies that:

- An option to acquire a fixed number of an issuer's equity shares with an exercise price that is denominated in a currency other than the issuer's functional currency, including a conversion option embedded in a foreign-currency-denominated convertible debt instrument, is considered to be dual indexed to both the issuer's own stock and foreign currency exchange rates and, thus, does not meet the requirement for the scope exception.
- An option to acquire a fixed number of an issuer's equity shares with an exercise price that is denominated in the issuer's functional currency, including a conversion option embedded in a functional-currency-denominated convertible debt instrument, is not considered indexed to currency exchange rates even though the shares issuable upon exercise or conversion are traded only on an exchange or other established marketplace on which trades are not executed in the issuer's functional currency. Since an equity share is not inherently "denominated" in a particular currency, an issuer's analysis of an option, including an embedded conversion option, is not affected by the currencies in which third-party investors transact the issuer's shares.

A comparison of two scenarios that illustrate the guidance in DIG Issue C21 is as follows:

Company A, whose functional currency is the U.S. dollar (US\$), issues convertible notes denominated in Euros (EUR) with a par value of EUR 1,000. The note is convertible at any time into 100 shares of Company A's common stock. This note would fall under the first bullet point above as the note is denominated in a foreign currency and therefore would NOT meet the scope exception.

If the note instead was denominated in US\$ but the stock itself was only traded on a EUR-based exchange, the note would fall under the second bullet point and therefore would meet the scope exception.

Note that If an option is indexed to the issuer's own stock, it is still necessary to evaluate whether it is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument), which is the second criterion for the scope exception noted above.

If finalized, the effective date of the guidance in DIG Issue C21 will be the first day of the first fiscal quarter beginning after the Board-cleared guidance is posted to the FASB Web site. The guidance will be applied to all financial instruments that the reporting entity enters into or modifies on or after that effective date. However, for all financial instruments and other transactions accounted for prior to the first fiscal quarter beginning after the Board-cleared guidance is posted, the effective date of this DIG Issue will be the beginning of the reporting entity's first fiscal year beginning after the Board-cleared guidance is posted.

DIG Issue C21 is available for comment until May 24, 2007 at http://www.fasb.org/derivatives/04-19-07_C21.pdf.

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