

Insights

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Accounting

Proper Adoption of 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)*, which applies to employers that sponsor single-employer defined benefit pension and other postretirement plans who are either business enterprises or nongovernmental not-for-profit organizations. Among other provisions, this Statement requires employers to fully recognize the overfunded or underfunded positions (the difference between the fair value of plan assets and the benefit obligation) of defined benefit pension, retiree healthcare and other postretirement plans in their balance sheets. Under past accounting standards, information about the current funded status of such plans was reported in the notes to the financial statements, and generally only a portion of the over/under funding was reported on the balance sheet.

The requirement to recognize the funded status of a benefit plan for entities with publicly traded equity securities was effective as of the end of the fiscal year ending after December 15, 2006; for all other entities that requirement is effective at the end of the fiscal year ending after June 15, 2007. However, an employer without publicly traded equity securities is required to disclose certain information in financial statements for a fiscal year ending after December 15, 2006, but before June 16, 2007, unless it has applied the recognition provisions of Statement No. 158 in preparing those financial statements.

It is important to note the proper method of adopting Statement No. 158 is to record the entry directly to the current-year ending balance of accumulated other comprehensive income (OCI), rather than through the current-year OCI.

Revenue Recognition Project

In 2002, the Financial Accounting Standards Board (FASB) added to its technical agenda a project to develop a single comprehensive accounting standard on revenue recognition and to amend the related guidance on revenues and liabilities in certain of the FASB Concepts Statements. The project consisted of two interrelated "parts" - the "top-down" approach and the "bottom-up" approach. The bottom-up approach involved analyzing existing authoritative guidance to gain an understanding of the existing revenue recognition models in that guidance. The bottom-up approach concluded in 2003 after an extensive examination of the existing authoritative revenue recognition literature and the transactions to which that literature is applied.

The top-down approach is currently in progress and involves developing the conceptual guidance and the comprehensive standard pertaining to recognition and measurement of revenues. Since 2004, the development of such guidance has been a joint project of the FASB and the International Accounting Standards Board, with the intent of converging U.S. and international revenue recognition standards.

The comprehensive standard that is expected to result from this project is planned to apply to all business entities; however, the Boards may conclude that certain transactions or industries requiring additional study should be excluded from the scope of that standard and addressed separately. The Boards currently are developing two different models for revenue recognition to compare and evaluate:

- The fair value model would measure assets and liabilities at fair value. Under this model, the fair values of performance obligations would be measured at the legal layoff price - the price that the reporting entity would have to pay an unrelated party to assume legal responsibility for performing all of its remaining obligations.
- The customer consideration model would measure performance obligations using an allocation of the customer consideration amount rather than at the fair value of the obligation.

An initial discussion paper covering both concepts-level and standards-level revenue recognition guidance is expected to be issued by the end of 2007. It will explain, illustrate, and compare the fair value and customer consideration models. The Boards will then work to coordinate the eventual issuance of an Exposure Draft and a comprehensive final Statement.

Complete details about the project are available at http://www.fasb.org/project/revenue_recognition.shtml.

How Does the Fair Value Option Differ from Hedge Accounting?

In February 2007, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159). The objective of this Standard was to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. FAS 159 allows entities to account for most financial instruments at fair value rather than under other applicable generally accepted accounting principles (GAAP). The accounting results in the instrument being marked to fair value every reporting period with the gain/loss from a change in fair value recorded in the income statement. This accounting treatment is an election made by the entity, on an instrument-by-instrument basis, when the financial instrument first becomes eligible for the election. However, once the election is made, it is irrevocable.

The fair value option in FAS 159 may be appealing to companies that want to offset changes in the fair values of related assets and liabilities without having to deal with the complexities of hedge accounting provisions under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities, as amended and interpreted*, (FAS 133.) Electing the fair value option would enable companies to avoid the time, effort and development of systems needed to document fair value hedging relationships and demonstrate their effectiveness to qualify for continued hedge accounting. Rather than designating a fair value hedging relationship under FAS 133, companies could elect to apply the fair value option to the hedge item at its inception.

So how will the accounting under FAS 159 differ from fair value hedge accounting under FAS 133?

Under FAS 133 a company may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability attributable to a particular risk. In a qualifying fair value hedge, the gain or loss on the hedging instrument is recognized in earnings, and the gain or loss (change in fair value) on the hedge item to the extent attributable to the hedged risk adjusts the carrying amount of the hedge item and is recognized in earnings. A fair value hedge under FAS 133 results in a partial markup to fair value as only fair value changes attributable to selected risks are recognized. Consider that FAS 133

permits the use of a designated benchmark interest rate which results in a partial mark-to-market of the hedged debt (for the change in fair value attributable to changes in the designated benchmark interest rate) by excluding the impact of changes in the debtor's creditworthiness.

Unlike fair value hedge accounting, the offset resulting from the application of FAS 159's fair value option is based on the fair value of the entire financial asset or liability and not selected risks inherent in those financial asset or financial liabilities. Rather than the partial fair value mark up in FAS 133 (limited to the hedged risk), under the fair value option a full markup to fair value occurs at each reporting period.

Consider the following example:

On June 30, 20X1, Company A, a manufacturer with high credit quality, borrows \$10,000,000 of three-year 7.5 percent fixed-rate interest-only nonrepayable debt. It concurrently enters into a three-year interest-rate swap with Bank B to convert the debt's fixed rate to a variable rate. Under the terms of the swap, the Company receives interest at a fixed rate of 7.5 percent and pays interest at a variable rate equal to the six-month U.S. LIBOR, based on a notional amount of \$10,000,000. Both the debt and the swap require that payments be made or received on December 31 and June 30. The six-month U.S. LIBOR rate on each reset date determines the variable portion of the interest-rate swap for the following six-month period. *The period analyzed in this example is from June 30, 20X1 to December 31, 20X1; information and journal entries pertaining to dates beyond this period are not presented. Journal entries to record the issuance of the debt, accrue interest, record interest payments, and record the settlement of the semiannual swap are the same under both FAS 159 and FAS 133 and, therefore, are not presented here.*

Under FAS 133, the accounting would be as follows:

Company A designates the swap as a fair-value hedge of the fixed-rate debt, with changes in the fair value that are due to changes in the benchmark interest rate being the specific risk that is hedged. Both at the inception of the hedge and on an ongoing basis, Company A assumes that there is no ineffectiveness in the hedging relationship involving the interest-bearing debt and the interest-rate swap. Because Company A concludes that the swap will be highly effective in offsetting changes in the fair value of the debt, the change in the fair value of the interest-rate swap is equal to the change in the fair value of the debt due to changes in the benchmark interest rate. Assume the fair value of the swap at December 31, 20X1 is a liability of \$323,000.

Journal Entries

	Debit	Credit
1. Debt	323,000	
Gain on hedge activity		323,000
(To record the change in the debt's fair value that is attributable to changes in interest rates at the end of Company A's first reporting period)		
2. Loss on hedge activity	323,000	
Swap contract		323,000
(To record the change in the fair value of the swap at the end of Company A's first reporting period)		

Under FAS 159, the accounting would be as follows:

Under the fair value option method, changes in the fair value of the interest-rate swap (or other derivative instrument) are no longer necessarily the same as the change in the fair value of the debt. Rather, the fair value of the debt must be determined independently using the guidance provided in FASB Statement No. 157, *Fair Value Measurements*. The fair value of the debt is determined to be \$10,000,000 and \$9,700,000 at June 30, 20X1 and December 31, 20X1, respectively. Note that the difference between the \$300,000 in entry #1 below and the \$323,000 in entry #1 above is due primarily to the impact of changes in the issuer's credit risk.

Journal Entries

	Debit	Credit
1. Debt	300,000	
Gain on hedge activity		300,000
(To record the change in the debt's fair value at the end of Company A's first reporting period)		
2. Loss on hedge activity	323,000	
Swap contract		323,000
(To record the change in the fair value of the swap at the end of Company A's first reporting period)		

Companies contemplating the application of the fair value option to long-term debt should also consider the impact on debt issuance costs. Under the fair value option, issuance costs, previously reported in the balance sheet as a deferred charge, are expensed immediately.

Public Sector

Disclosures of Pension Plans Revised

The Governmental Accounting Standards Board (GASB) has issued GASB Statement No. 50, *Pension Disclosures*. Statement No. 50 amends GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, by requiring:

- Disclosure in the notes to the financial statements of pension plans and certain employer governments of the current funded status of the plan as of the most recent actuarial valuation date. This will require disclosure of the degree to which the actuarial accrued liabilities for benefits are covered by assets that have been set aside to pay the benefits.
- Governments that use the aggregate actuarial cost method to disclose the funded status and present a multi-year schedule of funding progress using the entry-age actuarial cost method as a surrogate; these governments previously were not required to provide this information.
- Disclosure by governments participating in multi-employer cost-sharing pension plans of how the contractually required contribution rate is determined.

The provisions of Statement No. 50 generally are effective for periods beginning after June 15, 2007, with early implementation encouraged. However, the requirements relating to governments using the aggregate actuarial cost method are effective for financial statements and required supplementary information that contains information from actuarial valuations as of June 15, 2007, or later.

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