

Insights

A biweekly publication from the National Office of Audit and Accounting

June 24, 2008

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Accounting

Further Defining Participating Securities in EPS Calculations

FASB Statement No. 128, *Earnings per Share*, requires the use of the two-class method of computing basic earnings per share (EPS) for those enterprises with participating securities or multiple classes of common stock. Participating securities are described in Statement No. 128 as securities that may participate in dividends with common stocks according to a predetermined formula with, at times, an upper limit on the extent of participation. This description was explained further in Emerging Issues Task Force (EITF) Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128," to include a security that may participate in undistributed earnings with common stock in its current form, whether that participation is conditioned upon the occurrence of a specified event or not. However, neither Statement No. 128 nor Issue No. 03-6 provides guidance about whether unvested instruments granted as share-based compensation are participating securities. To address this, on June 16, 2008 the Financial Accounting Standards Board issued FASB Staff Position (FSP) No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*, to clarify that instruments granted in share-based payment transactions can be participating securities prior to the requisite service having been rendered. A basic principle of the FSP is that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of EPS pursuant to the two-class method. Following is a summary of the guidance in the FSP:

- The holder of a share-based payment award that includes nonforfeitable rights to dividends or dividend equivalents receives a noncontingent transfer of value each time an entity declares a dividend or dividend equivalent during the contractual period of the share-based payment award. As a result, the award meets the definition of a participating security in its current form, that is, prior to the requisite service having been rendered for the award. However, the right to receive dividends or dividend equivalents that the holder will forfeit if the award does not vest is not a participation right.
- Dividends or dividend equivalents also may be transferred to the holder of a share-based payment award in the form of a reduction in the exercise price of the award (for example, reduction in the exercise price of an equity share option). Such a feature would not be considered a participation right because the award does not represent a nonforfeitable right to participate in undistributed earnings absent the exercise of the award.
- Dividends or dividend equivalents that are actually paid and are accounted for as compensation cost because the unvested share-based payment award is not expected to vest (or does not vest) would not be included in the earnings allocation in computing EPS.

The provisions of this FSP are effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented (including interim financial statements, summaries of earnings, and selected financial data) are required to be adjusted retrospectively to conform with the provisions of the FSP. Early application is not permitted. The complete text of this FSP is available at http://www.fasb.org/pdf/fsp_eitf03-6-1.pdf.

Revised Disclosures of Certain Loss Contingencies Proposed

Investors and other users of financial information have expressed concerns that current disclosures required by FASB Statement No. 5, *Accounting for Contingencies*, do not provide sufficient information in a timely manner to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies. Therefore, the Financial Accounting Standards Board (FASB) has issued an Exposure Draft of a proposed Statement, *Disclosure of Certain Loss Contingencies - an amendment of FASB Statements No. 5 and 141(R)*, which would expand disclosures about certain loss contingencies in the scope of FASB Statement No. 5 or FASB Statement No. 141 (revised 2007), *Business Combinations*.

This proposed Statement would replace the disclosure requirements in Statement No. 5 for loss contingencies that are recognized as liabilities in a statement of financial position and for unrecognized loss contingencies that would be recognized as liabilities if the criteria for recognition in Statement No. 5 were met (i.e., it is probable that a liability has been incurred and the amount of loss can be reasonably estimated). This proposed Statement also would apply to loss contingencies recognized in a business combination accounted for under Statement No. 141(R). It would not change the disclosure requirements for loss contingencies that are or would be recognized as asset impairments.

The disclosure objective of the proposed Statement is that an entity is to provide disclosures to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies that are, or would be, recognized as liabilities in a balance sheet. Those disclosures should include information about the risks those loss contingencies pose to the entity and their potential and actual effects on the entity's financial position, results of operations, and cash flows. To achieve this objective, an entity must disclose:

- a. Quantitative information about the entity's exposure to loss from the contingency, excluding any potential recoveries (i.e., the amount of the claim or assessment against the entity or, if there is no claim or assessment amount, the entity's best estimate of the maximum exposure to loss).
- b. Qualitative information about the contingency sufficient to enable users to understand the risks posed to the entity. This information must include a description of the contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution; a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome; the entity's qualitative assessment of the most likely outcome of the contingency; and significant assumptions made by the entity in estimating the amounts disclosed in paragraph a. above and in assessing the most likely outcome.
- c. A qualitative and quantitative description of the terms of relevant insurance or indemnification arrangements that could lead to a recovery of some or all of the possible loss.

The proposed Statement provides certain relief from the disclosures in those rare instances where disclosures about the contingency may be prejudicial to an entity's position.

Also, for each period for which a statement of income is presented, an entity must provide a reconciliation, in tabular format, of the total amount recognized in the aggregate for loss contingencies in its statement of financial position at the beginning and end of the period. This reconciliation must include increases for loss contingencies recognized during the period, increases resulting from changes in estimates of the amounts of loss contingencies previously recognized, decreases resulting from changes in estimates or derecognition of loss contingencies previously recognized, and decreases resulting from cash payments (or other forms of settlement) for loss contingencies.

The proposed Statement would be effective for fiscal years ending after December 15, 2008, and interim and annual periods in subsequent fiscal years. The Exposure Draft is available for comment until August 8, 2008 at http://www.fasb.org/draft/ed_contingencies.pdf.

Proposed Revisions to Hedge Accounting

The Financial Accounting Standards Board (FASB) has issued a proposed Statement, *Accounting for Hedging Activities - an amendment of FASB Statement No. 133*, which is intended to simplify hedge accounting. Currently, difficulties exist in hedge accounting related to, among other things, quantitatively assessing effectiveness of hedging relationships, measuring ineffectiveness in a cash flow hedge, and measuring the change in value of a hedged item attributable to the hedged risk in a fair value hedge. The proposed Statement would eliminate the multiple methods of hedge accounting, including the shortcut and critical terms matching methods, currently being used for the same transaction under Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

The proposed Statement would establish a fair value approach to hedge accounting, which would eliminate many elements that exist under the current hedge accounting model, including bifurcation-by-risk and the requirement to quantitatively assess effectiveness in order to qualify for hedge accounting. With two exceptions, the proposed Statement also would require an entity to designate all risks as the hedged risk in the hedged item or transaction. The two exceptions are that an entity would be permitted to designate only foreign currency risk if it so desired, and an entity would be permitted to designate only interest rate risk for hedges of its own fixed- or variable-rate debt if hedging at initial recognition of that debt.

Formal, contemporaneous documentation of the hedging instrument and hedged item or forecasted transaction would still be required along with a qualitative assessment of the effectiveness of the hedging relationship. The qualitative assessment must demonstrate that (a) an economic relationship exists between the hedging instrument and hedged item or forecasted transaction and (b) the derivative should be expected to reasonably offset changes in fair value or the variability in the hedged cash flows attributable to the hedged risks. The proposed Statement also notes that in certain situations, a quantitative assessment may be more effective in demonstrating the relationship between the derivative instrument and the hedged risk.

Per the proposed Statement, the measurement of hedge ineffectiveness would be based on a comparison of the change in fair value of the actual derivative designated as the hedging instrument and the present value of the cumulative change in expected future cash flows on the hedged transaction. After inception, an entity would need to reassess effectiveness only if circumstances suggest that the hedging relationship may no longer be reasonably effective. These circumstances would depend on the nature of the hedged item or transaction and hedging instrument and on market developments. The ability to discontinue hedge accounting by simply removing the designation of the hedging relationship would not be permitted. Hedge accounting would be discontinued prospectively for an existing fair value hedge only if certain conditions are met.

The proposed Statement would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years. Early application will not be permitted. The proposed Statement is available for comment until August 15, 2008 at http://www.fasb.org/draft/ed_hedging_amendment_st133.pdf.

Auditing

ESOP Expense Measurement for Purposes of Cost Reimbursement

On May 1, final rules were issued by the U.S. Cost Accounting Standards Board determining the allowable expense government contractors may report for ESOP plans. The expense will look more like the tax expense than the financial statement expense under AICPA Statement of Position No. 93-6, *Employers' Accounting for Employee Stock Ownership Plans*. An "ESOP" is defined to include any defined contribution plan designed to invest primarily in employer stock. The reimbursement will be measured by:

- The market value of the shares at the time a contribution of stock is made;
- The principal and interest paid with respect to a leveraged ESOP; or
- A combination of the above.

The cost is assignable to a cost accounting period only to the extent an allocation is made to participant accounts by the tax return filing date, including any permissible extensions. For leveraged ESOPs, the determination of allowable costs follows Federal Acquisition Regulation Part 31, which permits companies to charge the costs of principal and interest on an ESOP loan provided the stock is acquired at fair market value. No distinction is made in the regulation for internally versus externally financed ESOP loans. Dividends paid on ESOP shares are allowed as a cost for ESOPs of S or C corporations. (For tax purposes, only C corporations are allowed to deduct dividends and only in certain circumstances.)

Companies operating under an existing approved reimbursement procedure can retain that method or renegotiate under the new rules. The new regulations are available in full at <http://edocket.access.gpo.gov/2008/E8-9376.htm>.

SEC

EDGAR Filer Manual Updated

The SEC has adopted revisions to the Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) Filer Manual as of June 4, 2008 to reflect updates to the EDGAR system. The revisions were primarily made to address the removal of rescinded EDGAR submission types, the addition of XBRL Standard Taxonomies, and the inclusion of new links for USGAAP XBRL Taxonomies.

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