

Insights

A biweekly publication from the National Office of Audit and Accounting

September 18, 2007

By clicking on a heading in the Bookmark section on the left, you will go directly to that subject.

Accounting

Proposed Accounting for Convertible Debt Instruments that May Be Settled in Cash

Emerging Issues Task Force (EITF) Issue No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion," currently provides accounting guidance for certain types of convertible debt instruments that may be settled in cash upon conversion. One of those instruments, referred to as Instrument C in that Issue, requires that, upon conversion, the issuer satisfy the accreted value of the obligation in cash and the conversion spread in either cash or stock. The consensus in Issue 90-19 required that Instrument C be accounted for as convertible debt (i.e., no portion of the proceeds from the issuance of the convertible debt securities should be accounted for as attributable to the conversion feature in accordance with the guidance in paragraph 12 of Accounting Principles Board (APB) Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*). However, Issue 90-19 also prescribed a diluted earnings-per-share methodology that was consistent with debt issued with detachable warrants. As a result, Instrument C generally has had less of a dilutive effect on the calculation of diluted earnings per share than a convertible debt instrument that requires application of the if-converted method. Because of the proliferation of such instruments in the marketplace over the past several years, questions were raised as to whether the accounting guidance in Issue 90-19 appropriately reflected the economic effects of those instruments.

The Financial Accounting Standards Board (FASB) believes that the inconsistency between the accounting for such instruments (as convertible debt) and the diluted earnings-per-share treatment (as debt issued with detachable warrants) can provide misleading information to investors. The FASB therefore has issued proposed FASB Staff Position (FSP) No. APB 14-a, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*, to provide guidance on the accounting for certain types of convertible debt instruments that may be settled in cash upon conversion. The proposed FSP would apply to convertible debt instruments that, by their stated terms, may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The proposed FSP would clarify that convertible debt instruments within its scope are not addressed by paragraph 12 of Opinion No. 14.

The initial measurement guidance in the proposed FSP would require issuers to separately account for the liability and equity components of convertible debt instruments within its scope. The issuer would first determine the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded features other than the conversion option) that does not have an associated equity component. The issuer would then determine the carrying amount of the equity component represented by the embedded conversion option by deducting the fair value of the liability component from the initial proceeds ascribed to the convertible debt instrument as a whole.

The subsequent measurement guidance in the proposed FSP would require the application of other U.S. generally accepted accounting principles to the liability and equity components. The excess of the principal amount of the liability component over its initial fair value would be amortized to interest cost using the interest method, as described in APB Opinion No. 21, *Interest on Receivables and Payables*. The equity component (conversion option) is not remeasured as long as it continues to meet the conditions for equity classification in EITF Issue 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

If finalized, the FSP would be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years, and would be applied retrospectively to all periods presented. Early adoption would not be permitted. The proposed FSP is available for comment until October 15, 2007 at http://www.fasb.org/fasb_staff_positions/prop_fsp_apb14-a.pdf.

Proposed Airline Audit and Accounting Guide

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants has issued an exposure draft of a proposed Audit and Accounting Guide, *Airlines*. The proposed Guide addresses many new accounting issues that have emerged over the years. It also includes chapters dedicated specifically to air cargo and regional carriers. The Exposure Draft is available for comment until December 15, 2007 at http://www.aicpa.org/download/exposure/Airline_Guide_ED.pdf.

Pension Accounting a Priority on FASB Agenda

One year ago, the Financial Accounting Standards Board (FASB) issued FASB 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)*. 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. This Statement completed the first phase of the FASB's comprehensive project to improve and ultimately converge employers' accounting for pensions and other postretirement benefits.

The second phase of the project, which will be conducted jointly with the International Accounting Standards Board (IASB), is expected to take several years. At its August 29, 2007 meeting, the FASB discussed how it will conduct the second phase. Initially, the FASB and IASB will work separately, focusing on different aspects of accounting for postretirement benefits. The IASB will focus on the measurement of obligations for certain plans that contain defined return promises (including plans sometimes referred to as cash balance plans). When it completes that work, the FASB will consider whether adopting similar requirements would improve financial reporting in the United States.

The FASB will initially focus on three areas:

- Presentation of the components of periodic benefit cost in conjunction with the financial statement reporting framework being developed by the joint financial statement presentation project. This includes the issue of earnings smoothing (i.e., use of an expected return on plan assets and delayed recognition of gains/losses).
- Reporting an employer's obligations associated with multiemployer plans. An employer's costs associated with multiemployer plans currently are reported on a contribution basis, resulting in obligations that are not reported in the financial statements and not disclosed in the notes. Efforts

will focus on enhancing disclosures as a first step toward improving reporting of an employer's obligations.

- Financial statement footnote disclosures about risks in plan assets (e.g., use of derivatives).

Once the FASB concludes its work, the IASB will consider whether it should adopt similar requirements internationally. After those initial efforts conclude, the Boards will consider how to work together to further improve and converge other aspects of their standards.

SFAS 157 Application Issues: Your Input Needed

Announced earlier, the Financial Accounting Standards Board (FASB) has formed a resource group that will provide input on potential clarifying guidance for issues relating to the application of FASB Statement No. 157, *Fair Value Measurements*, to fair value information required or permitted under U.S. generally accepted accounting principles. The resource group will contribute information regarding the diversity in practice that impacts valuations performed for financial reporting purposes. As a member of this group, Jolene Hart, a partner in the National Office of Audit & Accounting of McGladrey & Pullen, is soliciting input from auditors and financial statement preparers as to accounting and computational issues noted in the application of Statement No. 157. Such issues could include, for example, needed clarification of terminology in the standard, areas where additional guidance is needed, and situations where there is a perceived conflict between Statement No. 157 and other standards. Your input can be forwarded to Ms. Hart at jolene.hart@rsmi.com.

SEC

Small Business Capital Formation Forum

Since 1982, the SEC has hosted an annual Forum on Small Business Capital Formation to provide a platform for small business to highlight perceived unnecessary impediments to the capital-raising process. In 2007, the SEC will hold this forum on September 24 at its Washington, D.C. headquarters. This year's forum will focus on recent SEC rule proposals addressing securities registration and disclosure requirements for smaller companies.

The morning agenda for the forum will feature two roundtable discussions. The first roundtable will focus on recent SEC rule proposals relating primarily to private companies, and the second will consider the SEC's recent proposals concerning smaller public companies. The afternoon schedule will consist of breakout group sessions, including a session on private placement broker-dealers and finders. Participants in the breakout groups will help formulate specific recommendations for the SEC to consider in its efforts to improve small business capital formation.

All forum attendees must pre-register with the SEC prior to September 19, 2007. Registration and more information about the forum are available at <http://www.sec.gov/cgi-bin/registration-form>.

Employee Benefit Plans

IRS Proposes Regulations for Cafeteria Plans

In August, the Internal Revenue Service proposed a new set of regulations that will provide guidance for cafeteria plans (i.e., flexible spending or IRS Code Section 125 plans). These new regulations will reflect the change in the definition of *dependent* and the addition of several qualified benefits, including adoption assistance, health savings accounts (HSAs), and qualified HSA distributions from health flexible spending

arrangements. They also will include many new rules, such as detailed nondiscrimination requirements based on the rules for qualified retirement plans, requirements for the terms of the written plan document and the time the plan must be adopted, and several anti-abuse rules. Most of the regulations are proposed to be effective January 1, 2009, but employers are permitted to rely on the regulations at this time.

As a result of these new regulations, employers will need to pay more attention to their cafeteria plan documentation, administration and nondiscrimination testing than they may have in the past. For detailed information about the proposed regulations, consult with your tax advisor.

International

IAS 1 Revised

The International Accounting Standards Board (IASB) has issued a revised version of International Accounting Standard (IAS) 1, *Presentation of Financial Statements*. The revised standard results from the first stage of the IASB's project on performance reporting. The second stage is being undertaken jointly with the Financial Accounting Standards Board and includes a reconsideration of the presentation and display of information in the financial statements.

Under the revised standard, an entity must present all income and expenses separately from changes in its equity that arise from transactions with its owners. This will enable readers to analyze changes in a company's equity resulting from transactions with owners in their capacity as owners (such as dividends and share repurchases) separately from non-owner changes (such as transactions with third parties). Entities have a choice of presenting items of income and expense and components of other comprehensive income either in a single statement of comprehensive income with subtotals, or in two separate statements - a separate income statement followed by a statement of comprehensive income.

The revisions to the standard also include changes in the titles of some of the financial statements to reflect their function more clearly. For example, the balance sheet is renamed a statement of financial position. The new titles will be used in accounting standards; however, they are not mandatory for use in financial statements.

The revised standard is effective for annual periods beginning on or after January 1, 2009. Early adoption is permitted.

Additional Guidance Proposed for Hedge Accounting

The International Accounting Standards Board (IASB) has published for public comment an exposure draft of proposed amendments to International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*. The amendments are intended to clarify what can be designated as a hedged item in a hedge accounting relationship. The exposure draft specifies the risks that qualify for designation as hedged risks when an entity hedges its exposure to a financial instrument. In addition, it clarifies when an entity may designate a portion of the cash flows of a financial instrument as a hedged item.

The proposed guidance was issued as a result of requests for additional guidance on what IAS 39 permits to be designated as a hedged item. The IASB also is undertaking research that will ultimately lead to the replacement of IAS 39; however that work is at an early stage. The exposure draft of proposed amendments to IAS 39 will be open for comment at www.iasb.org until January 11, 2008.

Insights is a biweekly publication of McGladrey & Pullen, LLP and should not be construed as accounting, auditing, consulting, or legal advice on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult your McGladrey & Pullen, LLP service provider concerning your situation and any specific questions you may have. You may call 1.888.214.1416 for a contact person in your area.

For further information about McGladrey & Pullen or to retrieve archived issues of *Insights*, visit our Web site: <http://www.mcgladrey.com/>. If you do not wish to continue receiving *Insights*, or if you wish to place another person on the distribution list, please contact mpinsights@rsmi.com.