

Insights

A biweekly publication from the National Office of Audit and Accounting

October 25, 2006

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

Accounting

Jay Hanson Appointed to EITF

Jay Hanson, National Director of Accounting for McGladrey & Pullen, LLP, has been appointed to the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board. The EITF identifies, discusses, and resolves emerging financial accounting issues that can be analyzed within the framework of existing authoritative literature. Task Force members include auditors, preparers, and users of financial statements who are in a position to be aware of such issues.

Mr. Hanson joined McGladrey & Pullen in 1979 and currently is responsible for the Firm's accounting guidance and training on all accounting topics. He provides consultation on complex accounting and SEC issues for McGladrey & Pullen locations and McGladrey Network firms nationwide. Hanson also is a member of the American Institute of Certified Public Accountants' Accounting Standards Executive Committee.

Disclosures about Pronouncements Issued But Not Yet Adopted

With very few exceptions, pronouncements issued by the Financial Accounting Standards Board (e.g., Statements of Financial Accounting Standards and FASB Interpretations) have delayed effective dates and, in some cases, consensus positions of the Emerging Issues Task Force may have a delayed effective date. That is, adoption of the pronouncement is required at some future date after its issuance. Thus, a question arises as to what, if any, disclosures need to be made in financial statements when an authoritative pronouncement has been issued but the enterprise has not adopted, or is not yet required to adopt, the pronouncement.

Several new accounting pronouncements have been released so far in 2006, and some of these are going to affect almost every financial statement issued. For example, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109*, which is effective for fiscal years beginning after December 15, 2006, will require management to evaluate every open tax position that exists on the date of initial adoption in every jurisdiction.

If the adoption of an accounting pronouncement is expected to materially affect the financial statements, disclosure of the pending adoption would be necessary. The objectives of the disclosure should be to notify the financial statement users about the new accounting pronouncement and to assist the financial statement users in assessing the significance of the impact that the pronouncement will have on the financial statements when adopted. Obviously, the level of information that is available to disclose before adoption of a new pronouncement will depend on a variety of circumstances. The disclosure of information should be limited to that which is, or should have been, known. The following disclosures would be appropriate:

- A generalized description of the new pronouncement, and how its requirements differ from those applied in the financial statements;
- The date that adoption is required and the date the company expects to adopt the new pronouncement, if earlier or presently determinable (if not presently determinable, this should be stated);
- A discussion of the methods of adoption allowed by the new pronouncement and the method expected to be followed by the company if presently determinable (if not presently determinable, this should be stated);
- A discussion of the impact that adoption of the new pronouncement is expected to have on the financial statements, unless not known or reasonably estimable (if not known or reasonably estimable, this should be stated); and
- A discussion of other significant matters that the company reasonably believes might result from the adoption of the new pronouncement, if any (e.g., the adoption of the pronouncement might cause a technical violation of a restrictive covenant in a loan agreement).

It should be observed that the FASB, as it did in Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, may specify the disclosures to be made in the circumstances discussed above. In those situations, the specific disclosures required by the FASB should be made.

In those instances where a recently issued pronouncement will impact, but not materially affect, the financial statements, companies are encouraged to disclose that a new pronouncement has been issued, and that its adoption will not have a material effect on the financial position or results of operations.

Is There an Embedded Derivative?

As part of a financing arrangement, a company may issue a financing instrument (that is, debt or preferred stock) with detachable warrants. The existence of detachable warrants requires the debt to be recorded by the issuer at a discount due to the fact that the warrant is a stand-alone instrument with a separate value to the holder (that is, the creditor/investor). Also, the debt arrangement may have a feature allowing the issuing company, at its option, to prepay the debt early. (This type of option is also referred to as a call option.) This feature, as required by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, along with all other features that may affect the cash flows associated with an instrument, must be evaluated to determine if it is an embedded derivative and required to be bifurcated from the instrument. Bifurcation means that the embedded derivative may need to be measured and accounted for separately from the original instrument.

Prepayment features

A prepayment feature in a debt instrument could clearly change the originally expected cash flows of the instrument. For example, assume a company has \$100,000 of debt with interest to be paid annually at 10% over five years with the principle to be paid at maturity. The cash flows expected upon issuance of such debt would be \$10,000 of interest per year for five years and a \$100,000 payment at the end of five years, for a total of \$150,000. If the company elected to pay off this debt at the end of year two the total cash flows would be reduced by \$30,000 (the three years of interest no longer required to be paid). Therefore this prepayment option needs to be analyzed under Statement No. 133.

The good news is that debt issued at par with a prepayment feature exercisable solely at the option of the issuing company, such as the one in the example above, is exempt from Statement No. 133 bifurcation accounting. Many issuers of debt typically fall into this category. However certain types of prepayment features require further analysis:

- If the payoff amount in the prepayment feature is based on something other than just par plus accrued interest, the prepayment feature needs to be evaluated under paragraphs 12, 13 and 61(a) of Statement No. 133. Examples of such provisions include:
 - Debt must be paid off at the greater of par plus accrued interest or the market value of 100,000 shares of company stock
 - Debt must be paid off at par plus an adjustment based on the S&P performance.

Generally these types of provisions will require bifurcation of the embedded prepayment feature as the payoff is based on something other than changes in interest rates or credit risk.

- If the prepayment feature both (i) involves debt issued at a substantial premium or discount and (ii) is only contingently exercisable, the issuing company should follow the guidance in Issue B16 issued by the Derivatives Implementation Group (DIG) to determine if it must be bifurcated. DIG Issue B16 provides guidance and examples on determining when embedded calls (and puts) in debt instruments should be bifurcated.
 - *Issued at a substantial discount.* This term is often associated with zero-coupon bonds. However, if the debt is issued with a detachable warrant, a portion of the proceeds associated with the issuance must be allocated to the warrant. Therefore, the debt is not recorded on the financial statements at par upon issuance, which means the debt was effectively issued at a discount. The next consideration is whether the discount is “substantial.” There is no guidance in the accounting literature as to what constitutes “substantial,” however a general rule of thumb in the industry is that a 10% discount is presumed to be substantial.
 - *Contingently exercisable.* Examples of contingently exercisable provisions include provisions where the debt is immediately payable if:
 - The S&P increases by X%
 - There is a change of control
 - The stock price of the company changes by X%
 - Interest rates move 200 basis points
 - The company’s credit rating drops below AAA.

What if it should be bifurcated?

The prepayment feature is recognized as a separate instrument on the balance sheet of the issuing company at its fair value. The other side of the initial entry is to debt discount/premium. The prepayment feature is marked to market at each subsequent reporting period with the offset going through the income statement. However, a bifurcated embedded derivative may be designated as a fair value or cash flow hedge instrument. (Of course this election requires all the appropriate hedge documentation prescribed by Statement No. 133.) This election would change how the offset entry is recorded.

What if there are multiple embedded derivatives requiring bifurcation?

Statement No. 133 (specifically DIG Issue B15) requires that if one feature is identified as an embedded derivative that needs to be bifurcated, all other features also requiring bifurcation must be bundled together as a single, compound embedded derivative. This means that the valuation of such an instrument may be very complex. The FASB has recognized this issue and has provided some relief to this in Statement No. 155, *Accounting for Certain Hybrid Financial Instruments - An Amendment of FASB Statements No. 133 and 140*. Statement No. 155 allows the issuing company instead to elect to mark the whole instrument to market. This mark-to-market adjustment and subsequent adjustments to the value are recorded directly to the income statement. Therefore, this election may present consequences considered adverse by the issuing company. Also, if the election is made, it may not be reversed in a future period.

File documentation

Regardless of the type of prepayment feature in a debt instrument, the issuing company's files should include a thorough analysis of the application of Statement No. 133 to the feature.

Modifications of Instruments Originally Issued as Employee Compensation

FASB Statement No. 123 (revised 2004), *Share-Based Payment*, states that a freestanding financial instrument originally subject to that Statement should become subject to the recognition and measurement requirements of other applicable generally accepted accounting principles (GAAP) when the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity. However, because the Financial Accounting Standards Board (FASB) has on its agenda a project to consider the distinction between liabilities and equity, which could significantly change other applicable GAAP, the Board decided in August 2005 to defer the requirements of Statement No. 123(R) that make freestanding financial instruments subject to the recognition and measurement requirements of other GAAP when the rights conveyed by the instrument are no longer dependent on the holder being an employee. At that time, FASB Staff Position (FSP) No. FAS 123(R)-1, *Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)*, was issued.

Per FSP No. FAS 123(R)-1, a freestanding financial instrument issued to an employee in exchange for past or future employee services that is subject to Statement No. 123(R) or was subject to Statement No. 123(R) upon initial adoption of that Statement must continue to be subject to the recognition and measurement provisions of Statement No. 123(R) throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. Following such modification, recognition and measurement of the instrument should be determined through reference to other applicable GAAP.

Questions have been raised about whether an entity that executes an equity restructuring must, in all cases, reassess whether the recognition and measurement of an instrument whose holder is no longer an employee becomes subject to other applicable GAAP. In recently issued FSP No. FAS 123(R)-5, *Amendment of FASB Staff Position FAS 123 (R)-1*, the FASB concluded that for instruments that were originally issued as employee compensation and then modified, and for which such modification is made to the terms of the instrument solely to reflect an equity restructuring that occurs when the holders are no longer employees, no change in the recognition or the measurement (due to a change in classification) of those instruments will result if both of the following conditions are met: (a) either there is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved), or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring; and

(b) all holders of the same class of equity instruments (for example, stock options) are treated in the same manner.

The provisions in FSP No. FAS 123(R)-5 should be applied in the first reporting period beginning after October 10, 2006. If in applying Statement No. 123(R) an entity did so in a manner consistent with the provisions of the FSP, then that entity would continue to apply the provisions in the FSP to prior periods. However, if an entity did not apply Statement No. 123(R) in a manner consistent with the provisions of the FSP, then that entity would be required to retrospectively apply the provisions in the FSP to prior periods when those periods' financial statements are included for comparative purposes with current-period financial statements. Early application of this FSP is permitted in periods for which financial statements have not yet been issued.

Proposed M&A Accounting by Not-for-Profit Organizations

Currently, there is limited accounting guidance for mergers and acquisitions (M&A) by not-for-profit organizations, which has resulted in different accounting treatments for similar economic transactions. The Financial Accounting Standards Board therefore has issued the following two Exposure Drafts, which propose M&A accounting guidance for not-for-profit organizations that is similar to existing guidance for business combinations in the for-profit sector:

- The first proposed Statement, *Not-for-Profit Organizations: Mergers and Acquisitions*, would eliminate the use of the pooling-of-interests method of accounting by not-for-profit organizations, in which assets acquired and liabilities assumed are recorded at "carryover" amounts recorded on the books of acquired organizations. This proposal would instead require the application of the acquisition method to all mergers and acquisitions by a not-for-profit organization. In applying that method, the proposal generally would require that not-for-profit organizations:
 - Recognize the identifiable assets acquired and liabilities assumed that compose the business or nonprofit activity acquired in a merger or acquisition;
 - Measure those assets and liabilities at their fair values as of the acquisition date;
 - Recognize either goodwill of the acquired business or nonprofit activity or the contribution inherent in the merger or acquisition as a residual based on the value of the identifiable assets acquired, liabilities assumed, and the consideration transferred (if any); and
 - Disclose information to enable users of the financial statements to evaluate the nature and financial effects of the merger or acquisition.
- The second proposal, *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*, would provide accounting guidance for those intangible assets after a merger or acquisition. The proposed guidance is consistent with the accounting for all other acquired intangible assets - whether purchased or donated, or whether acquired individually or as part of a group. Under this proposal, not-for-profit organizations would be required to provide consistent and comparable information about identifiable intangible assets acquired by not-for-profit organizations in a merger or acquisition, and more faithfully representative and relevant information about events resulting in impairments of goodwill that a not-for-profit organization has acquired.

A not-for-profit organization would be required to apply the provisions in both of the proposed Statements prospectively in its fiscal year that begins approximately six months after the issuance of a final Statement. The proposed M&A standard will be applicable to new acquisitions occurring after the beginning of the first applicable fiscal year. A not-for-profit organization would be required to apply certain transition provisions to intangible assets that were acquired before the adoption of the proposed Statement regarding intangible assets and were accounted for using the purchase method.

The proposed Statements are available for comment until January 29, 2007 at http://www.fasb.org/draft/major_standards_projects_ed.shtml.

Tentative Guidance Related to Certain Cash Flow Hedges

In a cash flow hedge of a variable-rate financial asset or liability (either existing or forecasted), the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on an index that cannot qualify as the benchmark rate. Financial Accounting Standards Board (FASB) Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, further states that the only rates that can be designated as benchmark interest rates in the U.S. for purposes of applying the definition of interest rate risk are the rates on direct Treasury obligations of the U.S. government and the interest rate swap rates based on the London Interbank Offered Rate (LIBOR). These stipulations raise questions in accounting for a cash flow hedge of a variable-rate financial asset or liability for which the interest rate is not based solely on an index, including situations in which an interest rate is reset through an auction process.

The FASB therefore has issued tentative guidance in Derivatives Implementation Group Statement 133 Implementation Issue No. G26 (DIG Issue No. G26), *Cash Flow Hedges: Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That Are Not Based on a Benchmark Interest Rate*. This tentative guidance makes the following two conclusions related to a cash flow hedge of a variable-rate financial asset or liability for which the interest rate is not based solely on an index, including situations in which an interest rate is reset through an auction process:

- Provided all of the other cash flow hedging criteria in Statement No. 133 are met, an entity may hedge the variability in cash flows (for example, in auction rate notes) by designating the hedged risk as the risk of overall changes in cash flows.
- In a cash flow hedge of a variable-rate financial asset or liability, the risk being hedged cannot be designated as interest rate risk (that is, the risk of changes in cash flows attributable to changes in the designated benchmark interest rate) unless the cash flows of the hedged transaction are explicitly based on that same benchmark interest rate. This conclusion is based on the premise that the auction process does not clearly separate interest rate risk from credit risk. Accordingly, the designated risk being hedged in an auction rate note cannot be interest rate risk.

The above conclusions represent a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB and incorporated in an FASB staff implementation guide, which is contingent upon an amendment of Statement No. 133 being issued. The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after the date that the Board-cleared guidance is posted on the FASB website. When this guidance is cleared by the FASB, entities that have previously designated an otherwise qualifying hedging

relationship that no longer qualifies for hedge accounting based on the guidance in this Issue, must dedesignate the hedging relationships prospectively as of the effective date of the Issue.

DIG Issue No. G26 may be viewed in its entirety on the FASB Website at <http://www.fasb.org/derivatives/10-10-06.pdf>. The comment deadline for this proposal is Nov. 14, 2006.

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.