

Insights

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Accounting

FASB Issues Guidance on Determining the Variability to Be Considered in Applying FIN 46(R)

In applying FASB Interpretation (FIN) No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, the identification of variable interests involves determining which assets, liabilities, or contracts create the entity's variability, and which assets, liabilities, equity, and other contracts absorb or receive that variability. The latter are the entity's variable interests. Currently, there is diversity in practice in determining the variability that should be considered in applying FIN 46(R).

Typically, assets and operations of the entity create the entity's variability (and thus, are not variable interests), and liabilities and equity interests absorb that variability (and thus, are variable interests). Other contracts or arrangements may appear to both create and absorb variability because at times they may represent assets of the entity and at other times liabilities (either recorded or unrecorded). Per the Financial Accounting Standards Board (FASB), it is the role of a contract or arrangement in the design of the entity, regardless of its legal form or accounting classification, which dictates whether that interest should be treated as creating variability for the entity or absorbing variability.

In FASB Staff Position (FSP) No. FIN 46(R)-6, *Determining the Variability to Be Considered In Applying FASB Interpretation No. 46(R)*, the FASB states that the variability to be considered when applying FIN 46(R) should be based on an analysis of the design of the entity. In analyzing the design of the entity, the first step is to analyze the nature of the risks in the entity. Risks to be considered include, but are not limited to, credit risk, interest rate risk, prepayment risk, foreign currency exchange risk, commodity price risk, equity price risk and operations risk.

The second step in analyzing the design of the entity is to determine the purpose for which the entity was created and determine the variability (created by the risks identified in step one) the entity is designed to create and pass along to its potential variable interest holders. In making these determinations, all relevant facts and circumstances should be considered, including, but not limited to, the following:

- The activities of the entity;
- The terms of the contracts the entity has entered into;
- The nature of the entity's interests issued;
- How the entity's interests were marketed to potential investors; and
- Which parties participated significantly in the design or redesign of the entity.

After determining the variability to consider, the reporting enterprise can determine which interests are designed to absorb that variability (that is, which interests are variable interests). The FSP provides several examples illustrating its application, including whether arrangements entered into by the entity

create variability or absorb variability. However, those examples (and this FSP) do not provide guidance on the determination of the primary beneficiary of a variable interest entity.

An enterprise must apply the guidance in this FSP prospectively to all entities (including newly created entities) with which it first becomes involved and to all entities previously analyzed under FIN 46(R) when a reconsideration event has occurred pursuant to FIN 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. Retrospective application to the date of the initial application of FIN 46(R) is permitted, but if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006.

The FSP is available in full at http://www.fasb.org/fasb_staff_positions/fsp_fin46r-6.pdf.

FIN 47 Applies to a Variety of Companies

About a year ago, the Financial Accounting Standards Board published FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations – an Interpretation of FASB Statement No. 143*, (FIN 47) to provide guidance for more consistent recognition of liabilities relating to conditional asset retirement obligations and more information about future cash outflows relating to these obligations. Statement No. 143, *Accounting for Asset Retirement Obligations*, requires entities to record an obligation, when incurred, for the cost of retiring assets. For example, if a company is legally obligated to restore a building site back to a certain condition, it is required to accrue that obligation as the asset is used, as opposed to at the end of the asset's useful life.

FIN 47 was issued to clarify that a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event is within the scope of Statement No. 143. Therefore, an entity would be required to recognize a liability for the fair value of an asset retirement obligation that is conditional on a future event if the liability's fair value can be reasonably estimated. This calls for an entity to record the obligation as soon as it is responsible for it. Uncertainty surrounding the timing and (or) method of settlement that may be conditional on events occurring in the future would be factored into the measurement of the liability rather than the recognition of the liability.

Entities may mistakenly believe that FIN 47 only applies to companies in "dirty" industries, such as mining or nuclear power production, because they need to accrue clean up costs, such as land reclamation or nuclear decommissioning. Actually, neither FIN 47 nor Statement No. 143 is industry specific. Asset retirement obligations exist in substantially all industries. For example, a retailer might be required to record an asset and a corresponding liability for the fair value of the estimated asset retirement obligation associated with store fixtures and leasehold improvements at all store locations. Also, a manufacturer required to remove asbestos incurs this liability. Throughout the United States, the implementation of FIN 47 has resulted in restaurants, financial institutions, shoe stores, coffee houses, breweries, and real estate investment trusts, among others, recognizing asset retirement obligations when none had previously been recognized.

The fair value of a liability for the conditional asset retirement obligation should be recognized when incurred—generally upon acquisition, construction, or development and (or) through the normal operation of the asset. If, however, there is insufficient information to estimate the fair value of an asset retirement obligation, the liability would be initially recognized in the period in which sufficient information is available to make a reasonable estimate of the liability's fair value. Interpretation 47 provides guidance about when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation.

Interpretation 47 was effective no later than the end of fiscal years ending after December 15, 2005. The full text of the Interpretation is available at http://www.fasb.org/pdf/fin_47.pdf.

Financial Reporting Alert: Employee Stock Option Accounting

The AICPA has issued *Employee Stock Option Accounting*, a Financial Reporting Alert that summarizes FASB Statement No. 123(R), *Share-Based Payment*, SEC Staff Accounting Bulletin No. 107, *Share-Based Payment*, and other recent authoritative developments. Although this Alert has no authoritative standing, it does explore the following questions:

- What are employee stock options?
- What is the controversy behind stock option expensing?
- What are the likely effects of FASB Statement No. 123(R)?
- What is the value of a stock option?
- How can stock option expense be minimized?

This Alert is available for purchase at <https://www.cpa2biz.com/default.htm>.

Susan Phillips Appointed to FAF Board of Trustees

Dr. Susan M. Phillips has been appointed to the Financial Accounting Foundation (FAF) Board of Trustees. Dr. Phillips currently is Dean of The George Washington University School of Business, where she also is a professor of finance. She formerly was a member of the Board of Governors of the Federal Reserve System and chair of the Commodities Futures Trading Commission.

The FAF is responsible for the oversight, administration, and finances of both the Financial Accounting Standards Board and the Governmental Accounting Standards Board. The Foundation also is responsible for selecting the members of both Boards and their respective Advisory Councils.

SEC

More Guidance for Presentation of Discontinued Operations in the Cash Flow Statement

Earlier this year, the SEC staff stated concerns about certain presentations of discontinued operations in the statement of cash flows that were inconsistent with FASB Statement No. 95, *Statement of Cash Flows*. The SEC staff communicated that issuers using an incorrect cash flow statement format should revise the presentation by restating prior periods so that cash flows from discontinued operations are either:

- Combined with cash flows from continuing operations within each category (operating, investing, or financing activities);
- Identified within each category; or
- Identified for each category and presented separately.

The SEC staff advised the AICPA Center for Public Company Audit Firms that it would not object to issuers retrospectively modifying their presentation similar to a change in accounting method, without referring to the correction of an error. Registrants were advised that they need to make these changes in the next periodic report filed subsequent to February 15, 2006, and they must clearly inform readers that the cash flow presentation has been modified.

Calendar year end companies that filed annual reports with revised statements of cash flows should present the 2005 fiscal year cash flow information on a corrected basis, but such basis may be inconsistent with how quarterly cash flow information throughout 2005 was reported in the company's Form 10-Qs. At the April 4, 2006 joint meeting with the AICPA SEC Regulations Committee, the SEC staff advised that for

quarterly reports on Form 10-Q that will be filed throughout 2006, the prior-year comparative period column should be labeled "revised" or "restated" since those periods will be reported on a revised basis for the first time in each Form 10-Q.

At the April meeting, the SEC staff also provided transitional guidance regarding this issue as it applies to non-calendar year end companies. In its first periodic report filed after February 15, 2006 (generally a Form 10-Q), a company with a fiscal year end other than December 31, 2005 should:

- Present the year-to-date information using the proper cash flow presentation;
- Revise the comparative prior-year condensed statement of cash flows to reflect the proper cash flow presentation and label information "revised" or "restated"; and
- Disclose its intent to revise its previously issued annual statements of cash flows in its next annual report, the reasons for the revisions, and the quantitative effect of the revision on the three latest fiscal years.

The disclosure should be transparent and provide sufficient information for the reader to understand the nature and quantified effect of the future revisions. The disclosure may take the form of an unaudited revised condensed statement of cash flows. Where a single line item below financing cash flows was previously used to present cash flows related to discontinued operations, quantitative disclosure may be limited to expansion of that line into operating, investing and financing categories.

If a non-calendar year end company does not file a registration or proxy statement before its next annual report on Form 10-K is due, the company is not required to provide audited revised statements of cash flows for previously filed annual periods until it files its 2006 Form 10-K. Revised statements of cash flows for prior years included in the 2006 Form 10-K would be labeled "revised" or "restated".

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