

Insights

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Accounting

Guidance Issued for the Application of Investment Company Accounting

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA) has issued Statement of Position (SOP) 07-01, *Clarification of the Scope of the Audit and Accounting Guide "Investment Companies" and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. SOP 07-01 provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide). For purposes of the separate financial statements of an entity, the Guide is applicable to entities regulated by the Investment Company Act of 1940 or similar requirements and to separate legal entities whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies. Entities that are investment companies are required to apply the provisions of the Guide in presenting their financial statements, and entities that are not investment companies should not apply the provisions of the Guide.

For those entities that are investment companies under SOP 07-01, the SOP also provides guidance for determining whether the specialized industry accounting principles of the Guide (investment company accounting) should be retained by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity. If the application of that guidance leads to the conclusion that investment company accounting should not be retained in the financial statements of the parent company or equity method investor, the financial information of the investment company should be adjusted as if investment company accounting had not been applied by the subsidiary or equity method investee for purposes of the consolidated financial statements of the parent company or the application of the equity method of accounting by an equity method investor.

In addition, the SOP includes certain disclosure requirements for parent companies and equity method investors in investment companies that retain investment company accounting in the parent company's consolidated financial statements or the financial statements of an equity method investor.

The provisions of the SOP are effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged. Entities that previously applied the provisions of the Guide but that do not meet the provisions of the SOP to be an investment company within the scope of the Guide (or that previously retained investment company accounting in the financial statements of a parent company or equity method investor, but do not meet the provisions of the SOP to retain investment company accounting in the financial statements of a parent company or equity method investor), should report the effects of adopting SOP 07-01 prospectively by accounting for their investments in conformity with applicable generally accepted accounting principles (GAAP) other than investment company accounting, beginning as of the date of the adoption using fair value in conformity with investment company accounting

at the date of adoption as the carrying amount of investments at the date of adoption. Entities that are investment companies within the scope of the Guide (or meet the provisions of the SOP to retain investment company accounting in the financial statements of a parent company or equity method investor), but that previously had not followed the provisions of the Guide (or previously did not retain investment company accounting in the financial statements of a parent company or equity method investor), should report the cumulative effect of adopting the SOP as an adjustment to opening retained earnings as of the beginning of the year that the SOP is adopted.

It should be noted that on May 11, 2007 the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FIN 46(R)-7, *Application of FASB Interpretation No. 46(R) to Investment Companies*. The FSP was issued to address the application of FASB Interpretation (FIN) No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, by an entity that accounts for its investments in accordance with the specialized accounting guidance in the Guide. As a result, when an entity initially adopts SOP 07-01, it may be required to consolidate an entity that was previously not consolidated or to apply the specialized accounting in the Guide if it had previously consolidated an investment under FIN 46(R). For more information, see "Application of FIN 46(R) to Investment Companies" in the May 30, 2007 edition of *Insights*.

Look for Participating Securities

A participating security is a security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not. The form of participation, however, does not have to be a dividend – that is, any form of participation in undistributed earnings that would otherwise be available to common shareholders would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend. The following securities, for example, are considered to be participating securities:

- Securities that may participate in dividends with common stocks according to a predetermined formula. The right to dividends must be based on objective criteria, not an arbitrary amount at the discretion of a company's board of directors.
- A class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights.
- Potential common shares, that is, securities or other contracts that may entitle their holders to obtain common stock (such as options, warrants, forwards, or other contracts to issue common stock), if they meet the definition of a participating security in their current form (that is, prior to exercise or settlement) for example, by participating in dividends if declared. This applies only to the "vested" portion of options and restricted stock grants.
- Debt instruments that receive a dividend based on a formula of earnings.

The reason it is important to understand the definition of a participating security and to be able to recognize a security as such is that the existence of a participating security affects the calculation of earnings per share. Entities must exclude from earnings available to common stockholders any claim on undistributed earnings from a participating security, irrespective of whether the securities are convertible, non-convertible, or potential common stock securities, in basic earnings per share using the "two-class" method. The "two-class" method is an earnings allocation formula "as if" all earnings for the period were distributed in accordance with the terms of the participating securities. Only the earnings that "would be" distributed to

the common shareholders are presented in basic and diluted earnings per share. There is no requirement for the presentation of basic and diluted earnings per share for securities other than common stock.

Once it is determined that participating securities exist, entities should follow the guidance for the calculation of earnings per share in FASB Statement No. 128, *Earnings Per Share*, and in Emerging Issues Task Force Issue No. 03-06, "Participating Securities and the Two-Class Method under FASB Statement No. 128."

Public Sector

TPAs Released for the Reporting of Fund-Raising Expenses by Not-For-Profit Organizations

The Accounting Standards Team of the American Institute of Certified Public Accountants has released three Technical Practice Aids (TPAs) relating to the reporting of fund-raising expenses by not-for-profit organizations (NPOs), which are summarized as follows:

- TPA 6140.20, *NPOs Reporting No Fund-raising Expenses*. This TPA states that it would be unusual for an NPO to have contributions but have minimal or no fund-raising expense. Examples of circumstances in which an NPO could have contributions but minimal or no fund-raising expense typically include those in which (a) because of name recognition or custom, donors contribute to the NPO without the NPO undertaking fund-raising activities; (b) fund-raising activities related to those contributions are conducted entirely or almost entirely by volunteers whose contributed services do not meet the recognition criteria for contributed services in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*; or (c) other organizations that the NPO does not control contribute to the NPO with the NPO undertaking minimal or no fund-raising activity or other participation in relation to those contributions.
- TPA 6140.21, *Should an NPO Report Amounts Charged to the NPO by a Professional Fund-raiser Gross, as Fund-raising Expenses, or Net, as a Reduction of Contributions*. This TPA concludes that in circumstances in which a professional fund-raiser charges an NPO for soliciting contributions on the NPO's behalf, the NPO should report the amounts charged to the NPO by the professional fund-raiser gross, as a fund-raising expense.
- TPA 6140.22, *In Circumstances in Which the Reporting NPO Undertakes a Transaction in Which Another NPO (Fund-raising NPO) Raises Contributions on Behalf of the Reporting NPO, and the Reporting NPO Compensates the Fundraising NPO for Raising Those Contributions (Compensation Including, but not Limited to, an Administrative Fee), Should the Reporting NPO Report the Fundraising NPO's Compensation Gross, as Fund-raising Expenses, or Net, as a Reduction of Contributions?* This TPA concludes that the reporting NPO should report the amount retained as compensation by the fundraising NPO acting as an agent or intermediary gross as fund-raising expenses and report contributions for the gross amount contributed from the donor to the fund-raising NPO acting as an agent or intermediary for the benefit of the reporting NPO.

These TPAs are available in full at <http://www.aicpa.org/members/div/acctstd/index.htm>.

SEC

SEC Proposes to Amend Eligibility Requirements of Form S-3

Form S-3 is the “short form” used by eligible domestic companies to register securities offerings under the Securities Act of 1933. The form permits these companies to rely on their reports filed under the Securities Exchange Act of 1934 to satisfy the form’s disclosure requirements, which allows for automatic updating of the registration statement. Currently, to use Form S-3, a company must meet the form’s registrant requirements, which generally pertain to reporting history under the Exchange Act, as well as at least one of the form’s transaction requirements. These transaction requirements provide that companies may register primary offerings (that is, securities offered by or on behalf of the registrant for its own account) on Form S-3 only if their non-affiliate equity market capitalization, or “public float,” is at least \$75 million.

The SEC is proposing to amend the eligibility requirements of Form S-3 to allow companies with less than \$75 million in public float to register primary offerings of their securities on Form S-3, provided they:

- Meet the other registrant eligibility conditions for the use of Form S-3;
- Are not shell companies and have not been shell companies for at least 12 calendar months before filing the registration statement; and
- Do not sell more than the equivalent of 20% of their public float in primary offerings pursuant to the new instructions of Form S-3 over any period of 12 calendar months.

The amendments are intended to allow more companies to benefit from the greater flexibility and efficiency in accessing the public securities markets afforded by Form S-3. The SEC also is proposing comparable amendments to Form F-3, the equivalent short-form registration form available for use by foreign private issuers.

The proposed rule is available in full at <http://www.sec.gov/rules/proposed/2007/33-8812.pdf>.

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