

# Insights

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## Accounting

### FASB Proposes Amendments to EPS Calculations

The Financial Accounting Standards Board (FASB) has issued a revised Exposure Draft of a proposed Statement of Financial Accounting Standards, *Earnings per Share - an amendment of FASB Statement No. 128*. The proposed Statement seeks to clarify and simplify the method of calculating earnings per share (EPS), while promoting the international convergence of accounting standards by eliminating major differences that currently exist between FASB Statement No. 128, *Earnings per Share*, and International Accounting Standard (IAS) 33, *Earnings per Share*. The Exposure Draft is part of a short-term convergence project that the FASB is conducting jointly with the International Accounting Standards Board (IASB). Consequently the IASB has also published an exposure draft to amend IAS 33. (See related article in the "International" section below.)

The FASB's proposed Statement is a revision of an earlier FASB Exposure Draft, *Earnings per Share*, which was issued in September 2005. Following is a summary of the major changes from the 2005 Exposure Draft:

- The following instruments should be included in basic EPS:
  - ♦ An instrument that is currently exercisable for little or no cost to the holder;
  - ♦ Shares that are currently issuable for little or no cost to the holder; and
  - ♦ A mandatorily convertible instrument that is a participating security.
- The denominator of the computation of diluted EPS should no longer be increased by additional common shares resulting from the exercise or conversion of instruments that are freestanding or separately accounted for as a component of a compound instrument and that are measured at fair value with changes in fair value recognized in earnings for the period. Additionally, an entity should not increase the denominator of the computation of diluted EPS by additional common shares resulting from the exercise of a financial instrument or contract subject to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, that is recognized (or will be recognized) as a liability and measured under that Statement's fair-value-based measurement approach.
- The treasury stock method has been modified for all instruments subject to the treasury stock method that are not remeasured at fair value at each reporting period. The modified treasury stock method includes the end-of-period value of the liability as an assumed proceed (if applicable), and uses the end-of-period market price in computing the number of incremental shares in the determination of diluted EPS.
- Computational guidance on computing diluted EPS under the two-class method was added.

The Exposure Draft does not yet include a specific effective date. The Exposure Draft is available for comment until December 5, 2008 at [http://www.fasb.org/draft/rev\\_ed\\_eps\\_amend\\_st128.pdf](http://www.fasb.org/draft/rev_ed_eps_amend_st128.pdf).

## Auditing

### ASB Clarification and Convergence Project

The Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants, which issues standards for audits of nonissuers in the United States, has undertaken a significant effort to make U.S. generally accepted auditing standards (GAAS) easier to read, understand, and apply. This endeavor is similar to a project of the International Auditing and Assurance Standards Board that aims to clarify its International Standards on Auditing (ISAs). The ASB's plan is to converge U.S. GAAS with the ISAs while avoiding unnecessary conflict with the standards of the Public Company Accounting Oversight Board.

Over the next two to three years, the ASB will redraft all of the auditing sections in the *Codification of Statements on Auditing Standards*, converging the material with the ISAs and applying the following clarity drafting conventions:

Establishing objectives for each of the standards;

- Including a definitions section, where relevant, in each standard;
- Separating requirements from application and other explanatory material;
- Numbering application and other explanatory paragraphs using an "A" prefix and presenting them in a separate section;
- Using formatting techniques, such as bulleted lists, to enhance readability; and
- Including special considerations relevant to audits of governmental audits and audits of smaller, less complex entities.

The ASB proposes that all redrafted standards will be effective on the same date. The effective date is expected to apply to audits of financial statements for periods beginning no earlier than December 15, 2010.

Further information about the ASB's plans with respect to clarity and convergence is available at [http://www.aicpa.org/download/auditstd/ASB\\_Clarify\\_%20and\\_Convergence\\_\(8.5x11\).pdf](http://www.aicpa.org/download/auditstd/ASB_Clarify_%20and_Convergence_(8.5x11).pdf).

## Public Sector

### Guidance Issued for Net Asset Classification of Donor-Restricted Endowment Funds

In July 2006, the National Conference of Commissioners on Uniform State Laws approved the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA). This Act is a modernized version of the Uniform Management of Institutional Funds Act of 1972 (UMIFA), the model act on which most states have based their laws governing the investment and management of donor-restricted endowment funds by not-for-profit organizations. Because the UPMIFA prescribes new guidelines for expenditure of donor-restricted endowment funds, questions have arisen as to the appropriate net asset classification of such funds. To provide guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of the UPMIFA, the Financial Accounting Standards Board (FASB) has issued FASB Staff Position (FSP) No. FAS 117-1, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds*. The FSP addresses the following accounting issues resulting from new guidelines in the UPMIFA:

- The UPMIFA shifts its focus from the prudent spending of the net appreciation of the fund to the entirety of a donor-restricted retirement fund. The UPMIFA eliminates UMIFA's historic-dollar-value threshold, an amount below which an organization could not spend from the fund, in favor of a more robust set of guidelines about what constitutes prudent spending, explicitly requiring consideration of the duration and preservation of the fund. The FSP therefore requires a not-for-profit organization that is subject to an enacted version of the UPMIFA to classify a portion of a donor-restricted endowment fund of perpetual duration as permanently restricted net assets. The amount classified as permanently restricted is the amount of the fund (a) that must be retained permanently in accordance

with explicit donor stipulations, or (b) that in the absence of such stipulations, the organization's governing board determines must be retained permanently under the relevant law.

- Subsection 4(a) of the UPMIFA provides that “unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution.” The FSP states that for each donor-restricted endowment fund for which the restriction described in subsection 4(a) of the UPMIFA is applicable, a not-for-profit organization must classify the portion of the fund that is not classified as permanently restricted net assets as temporarily restricted net assets (time restricted) until appropriated for expenditure by the organization.

The FSP also requires improved disclosures about an organization's endowment (both donor-restricted and board-designated funds), whether or not the organization is subject to the UPMIFA. The FSP requires a not-for-profit organization to disclose information to enable financial statement users to understand the net asset classification, net asset composition, changes in net asset composition, spending policies, and related investment policies of its endowment funds (both donor-restricted and board-designated).

The provisions of the FSP are effective for fiscal years ending after December 15, 2008. Early application is permitted, as long as the organization has not previously issued annual financial statements for that fiscal year.

The FSP is available in full at [http://www.fasb.org/pdf/fsp\\_fas117-1.pdf](http://www.fasb.org/pdf/fsp_fas117-1.pdf).

### **GASB Seeks Input on Reporting of Performance Information**

The Governmental Accounting Standards Board (GASB) is in the early stage of a project of developing guidelines to assist state and local governments that voluntarily choose to report on their service efforts and accomplishments (SEA). To obtain feedback regarding these guidelines, the GASB has issued a *Request for Response on Suggested Guidelines for Voluntary Reporting of SEA Performance Information*. The proposed suggested guidelines identify six qualitative characteristics of SEA performance information as set forth in Concepts Statement No. 2, *Service Efforts and Accomplishments Reporting*, - relevance, understandability, comparability, timeliness, consistency, and reliability. The proposed suggested guidelines also include what the GASB has identified as the four essential components of an effective SEA report:

- Purpose and scope;
- Major goals and objectives; Key measures of SEA performance; and
- Discussion and analysis of results and challenges

The Request for Comments seeks comments prior to October 31, 2008 and is available in full at [http://www.gasb.org/exp/SEA\\_Request\\_for\\_Response.pdf](http://www.gasb.org/exp/SEA_Request_for_Response.pdf).

## **SEC**

### **SEC Issues Guidance on Use of Corporate Web Sites**

The Internet has changed significantly since 2000 when the SEC last published extensive guidance on the use of Web sites and electronic media. Therefore, the SEC has issued an interpretive release to provide updated guidance regarding compliance with the federal securities laws when using company Web sites to provide investors with summary information, interactive content, or links to third-party information on their Web sites. Among its many provisions, the SEC's guidance clarifies:

- How information posted on a company Web site can be considered “public,” and provides guidance to help companies comply with the public disclosure requirements under Regulation FD.
- The liability framework for certain types of electronic disclosure, including how companies can provide access to historical or archived data without it being considered reissued or republished every time it is accessed.

- That the antifraud provisions apply to statements made by the company (or by a person acting on behalf of the company) in blogs and electronic shareholder forums.
- That companies cannot require investors to waive protections under the federal securities laws as a condition to enter or participate in a blog or electronic shareholder forum.

The full text of the interpretive release is available at <http://www.sec.gov/rules/interp/2008/34-58288.pdf>.

### **SEC Reporting and FASB Forum for Mid-sized and Smaller Public Companies**

McGladrey & Pullen, LLP has assisted in the development of a two-day forum for the SEC Institute, *SEC Reporting and FASB Forum for Mid-sized and Smaller Public Companies*, which will be held September 22 and 23 in Las Vegas. This forum will include complete updates by the Financial Accounting Standards Board, the SEC's Division of Corporation Finance, and the Office of the Chief Accountant. There will also be a discussion of the current political environment and new and proposed SEC rules by the Chair of the SEC's Advisory Committee on Smaller Public Companies. Other topics that will be covered during the Forum include:

- Significant implications of the fair value accounting standards
- Major changes in accounting for business combinations and minority interests
- What you need to know and do to get ready for XBRL
- Smaller company SEC comment letters
- How companies will be affected by IFRS

To register for the Forum, visit the SEC Institute's Web site at [http://www.secinstitute.com/sched/menu\\_srf.html](http://www.secinstitute.com/sched/menu_srf.html) or call 305.529.1550.

## **International**

### **Additional Guidance Issued for Hedge Accounting**

As a result of requests for additional guidance on what International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, permits to be designated as a hedged item, the International Accounting Standards Board (IASB) has issued *Eligible Hedged Items*, an amendment to IAS 39. The amendment clarifies how the existing principles underlying hedge accounting should be applied in the designation of:

- A one-sided risk in a hedged item; and
- Inflation in a financial hedged item.

Entities are required to apply the amendment retrospectively for annual periods beginning on or after July 1, 2009, with earlier application permitted. The IASB also is undertaking research that will ultimately lead to the replacement of IAS 39; however that work is at an early stage.

### **IASB Proposes Amendments to EPS Calculations**

The International Accounting Standards Board (IASB) has published for public comment an Exposure Draft, *Simplifying Earnings per Share - Proposed Amendments to IAS 33*. The proposed Statement seeks to clarify and simplify the method of calculating earnings per share (EPS), while promoting the international convergence of accounting standards by eliminating major differences that currently exist between International Accounting Standard (IAS) 33, *Earnings per Share*, and FASB Statement No. 128, *Earnings per Share*. The Exposure Draft is part of a short-term convergence project that the IASB is conducting jointly with the Financial Accounting Standards Board (FASB). Consequently the FASB has also published an exposure draft to amend FASB Statement No. 128. (See related article in the "Accounting" section above.)

The IASB's Exposure Draft aims to achieve convergence by:

- Establishing a clear principle to determine which shares and other instruments should be included in the calculation of basic EPS. According to this principle, the weighted average number of ordinary shares includes only those instruments that give (or are deemed to give) their holder the right to share currently in the profit or loss of the period.
- Clarifying the EPS calculation for the treatment of contracts that involve the entity receiving its own ordinary shares for cash or other financial assets. The Exposure Draft treats those contracts as if the entity had already repurchased the shares. Therefore, the entity excludes those shares from the denominator of the EPS calculation.
- Clarifying that the principles for contracts to repurchase an entity's own shares for cash or other financial assets should also apply to mandatorily redeemable ordinary shares.
- Amending the calculation of diluted EPS for participating instruments and two-class ordinary shares.

To clarify and simplify the calculation of EPS, the Exposure Draft proposes that:

- For an instrument (or the derivative component of a compound financial instrument) that is measured at fair value through profit or loss, an entity should not adjust the numerator or denominator of the diluted EPS calculation.
- In calculating diluted EPS, an entity should regard the ordinary shares that are assumed to be purchased (using the proceeds from the exercise of options, warrants and their equivalents that are not measured at fair value through profit or loss) as issued at the end-of-period market price, rather than at their average market price during the period. In calculating diluted EPS, an entity should assume that ordinary shares relating to forward contracts to sell an entity's own shares are sold and the effect is dilutive, unless they are measured at fair value through profit or loss.

The Exposure Draft does not yet include a specific effective date. The Exposure Draft is available for comment until December 5, 2008 at <http://www.iasb.org/NR/rdonlyres/B7DA045C-F0EF-4D3B-9DF3-19C8E1C3A002/0/EDIAS33.pdf>.

### **Amendments Proposed for Eight International Standards**

The International Accounting Standards Board (IASB) has published for public comment an exposure draft of proposed amendments to eight International Financial Reporting Standards (IFRS) under its annual improvements project whereby it makes necessary, but non-urgent, amendments to IFRS. The amendments focus on areas of inconsistency in IFRSs or where clarification of wording is required. Following is a brief summary of the topics addressed by the proposed amendments:

- IFRS 2, *Share-based Payment* - scope of IFRS 2 and revised IFRS 3, *Business Combinations*
- IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* - disclosures of non-current assets (or disposal groups) classified as held for sale or discontinued operations
- IFRS 8, *Operating Segments* - disclosure of information about segment assets
- International Accounting Standard (IAS) 7, *Statement of Cash Flows* - classification of expenditures on unrecognized assets
- IAS 18, *Revenue* - determining whether an entity is acting as a principal or as an agent
- IAS 36, *Impairment of Assets* - unit of accounting for goodwill impairment test IAS 38, *Intangible Assets* - amendments arising from revised IFRS 3 and measuring the fair value of an intangible asset acquired in a business combination

- IAS 39, *Financial Instruments: Recognition and Measurement* - scope exemption for business combination contracts; application of the fair value option; cash flow hedge accounting; and bifurcation of an embedded foreign currency derivative

Unless otherwise specified, the proposed effective date for the amendments is for annual periods beginning on or after January 1, 2010, although entities are permitted to adopt them earlier. The proposed effective date for those amendments arising from revised IFRS 3 is for annual periods beginning on or after July 1, 2009.

The exposure draft is available for comment until November 7, 2008 at [http://www.iasb.org/NR/rdonlyres/2142FFF6-4843-4952-A2B3-A57F9941DFDB/0/ED\\_ImprovementstoIFRS.pdf](http://www.iasb.org/NR/rdonlyres/2142FFF6-4843-4952-A2B3-A57F9941DFDB/0/ED_ImprovementstoIFRS.pdf).

## Principles vs. Rules

*This article is the second in a series of articles that takes our readers on a journey through International Financial Reporting Standards (IFRS) with a special focus on the standards' quintessential feature: they are principles-based. This article provides an overview of the concept of a principles-based set of standards (IFRS) as opposed to a rules-based set of standards (U.S. generally accepted accounting principles or GAAP).*

The debate regarding whether U.S. issuers will be allowed to prepare their financial statements using IFRS has been around for a few years. Regulators in the United States want to make sure that all potential impacts have been analyzed thoughtfully before a final decision is made. To better understand the debate between a principles-based set of standards and a rules-based set of standards, it might be useful to first analyze what are commonly identified as some of the benefits of each of these approaches:

Principles-based Set of Standards	Rules-based Set of Standards
Better able to cope with speed of change of business environment	More workable in large, complex economies and countries
Less voluminous	Less room for interpretation
Encourages use of professional judgment with a focus on what is right	Provides more guidance for practical implementation
Seen as possibly discouraging financial engineering.	Less need for explanation in financial statements.

In the United States, many people believe that U.S. GAAP has served the most successful, dynamic and growing economy of the modern era, and wonder why it should be replaced. Many who support a rules-based set of standards believe that a large and complex economy like that of the United States needs rules, whereas principles are workable only in smaller countries. They think that with so many cultures and business environments, it is a real challenge to develop principles that are robust and workable in all jurisdictions. Their view is that a rules-based system where there is less room for interpretation could actually result in less complex and more transparent financial statements, as there would be less need for explanation. With the United States characterized by a pervasive litigious environment dominated by a prescriptive and very legalistic regulatory framework, moving toward a more principle-based approach for accounting standards might represent a leap with difficult-to-predict consequences.

In general it appears that, at least outside the United States, a strong consensus has emerged in favor of principles and the use of judgment versus rules. Supporters of a principles-based set of standards believe that principles are about common sense and what is right. They think that, by definition, business decisions are judgmental and such a judgmental component cannot be eliminated. In their view, the purpose of accounting should be to fairly depict economic reality and the judgmental component is an integral part of the economic reality. Those who support a principles-based approach believe that failing to emphasize and appropriately bring to the surface the judgmental component of financial reporting can result in misleading information for the users of financial information. In a principles-based context, the tenacious desire for "bright lines" tends to be seen as a search for artificial borders that might result in an illusory one-size-fits-all answer to the inherent economic uncertainty.

We would like to point out that possibly the debate is not about whether we should have principles only or rules only. IFRS include guidance and in some cases are closer to a set of rules than a set of principles.

Also, it might not be entirely accurate to refer to U.S. GAAP as a rules-based set of standards. After all, the “P” in “GAAP” stands for “principles.” U.S. GAAP was born as a set of principles; however, over the years, a rules-driven approach has prevailed and as a result, it fairly depicts where U.S. GAAP stands along the principles vs. rules continuum. Hence, in practice, when visualizing the principles vs. rules continuum, it might be more appropriate to focus the discussion on how close to the “pure principles approach” extreme IFRS should be positioned.

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