Insights

February 25, 2009

A biweekly audit and accounting publication

Accounting

Which Disclosure Requirements Are Applicable for Financial Instruments?

FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires all entities (except those entities that meet certain criteria as discussed below) to disclose the fair value of financial instruments, including derivative financial instruments. Regardless of whether the financial instrument is recognized or not recognized on the entity's balance sheet, Statement No. 107 requires entities to disclose the fair value of the financial instruments, and the methods and significant assumptions used to estimate the fair value of financial instruments.

Statement No. 157, *Financial Value Measurements*, defines fair value and establishes a framework for measuring fair value. Therefore, the framework in Statement No. 157 is used to estimate the fair value of financial instruments to be disclosed under Statement No. 107. Statement No. 157 also expanded disclosures about fair value measurements, but such disclosures only apply under other accounting pronouncements that require or permit fair value measurements. The expanded disclosures about fair value measurements required under Statement No. 157 therefore only apply to financial instruments if the financial instruments are required to be recognized at fair value on the balance sheet.

It should also be noted that disclosures about the fair value of financial instruments prescribed in Statement No. 107 are optional for an entity that meets all of the following criteria:

- The entity is nonpublic;
- The entity's total assets are less than $100 million on the date of the financial statements; and
- The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, other than commitments related to the origination of mortgage loans to be held for sale, during the reporting period.

Under professional standards, auditors are required to design audit procedures to obtain sufficient, competent audit evidence to provide reasonable assurance that the disclosures about the fair value of financial instruments are in conformity with generally accepted accounting principles.

What Is a Financial Instrument?

FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires entities to disclose the fair value of all financial instruments, including derivative financial instruments, as defined. A financial instrument is defined as:

- Cash;

- Evidence of an ownership interest in an entity; or
- A contract that both:
  - Imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity, or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity; and
  - Conveys to that second entity a contractual right (a) to receive cash or another financial instrument from the first entity, or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

A contractual obligation and a contractual right include both those conditioned on the occurrence of a specified event, and those that are not. A contractual obligation or a contractual right may be recognized in the balance sheet or they may not be recognized because they fail to meet a criterion for recognition. Also, a contractual obligation may be owed to a group of entities and a contractual right may be due from a group of entities instead of, in either case, a single entity.

Examples of financial instruments include, but are not limited to:

- Certificates of deposit
- Accounts receivable and accounts payable
- Accrued liabilities
- Short-term borrowings and long-term debt
- Common and preferred stock and warrants or options to subscribe to or purchase stock
- An interest in a partnership
- Foreign currency contracts

It should be noted that paragraph 8 of Statement No. 107 specifically excludes certain financial instruments from its disclosure requirements.

Acceleration of Vesting of Deep Out-of-the-Money Share Options

Recent declines in stock values have led many companies to contemplate accelerating the vesting of out-of-the-money stock options. Considering the extent of market decline, companies may have concluded that past awards of stock options containing exercise prices significantly higher than current stock prices (i.e., out-of-the-money) provide the employee and the company with little value. Given the lack of future benefit, as there is little incentive for an employee to remain with the company and complete the service period required for vesting, some companies are considering modifications to the award which would immediately vest it and expect the accounting result to be immediate recognition of the remaining compensation expense. This is viewed by some as preferable to recognizing the compensation expense over the remaining original vesting period.

Acceleration of the vesting of out-of-the-money options raises some accounting issues under FASB Statement No. 123R, *Share-Based Payments*. Under Statement No. 123R, the compensation cost for an award of share-based employee compensation is recognized over the requisite service period. The requisite service period is the period during which an employee is required to provide service in exchange for an award, which often is the vesting period. The requisite service period is estimated based on an analysis of the terms of the share-based payment award.

Requisite service periods may be explicit, implicit, or derived from certain valuation techniques, depending on the terms of the share-based payment award.

Statement No. 123R specifies that the estimate of requisite service period should ignore nonsubstantive vesting conditions. For example, the grant of a deep out-of-the money share option award without an explicit service condition will have a derived service period. Likewise, if an award with an explicit service condition that was at-the-money when granted is subsequently modified to accelerate vesting at a time when the award is deep out-of-the-money, that modification is not substantive because the explicit service condition is replaced by a derived service condition.

Considering the guidance provided by Statement No. 123R and based on discussions with the SEC staff, the following conclusions on issues relating to acceleration of vesting of deep out-of-the-money options were reached:

Issue 1: Does the acceleration of the vesting of a deep out-of-the-money option result in the acceleration of compensation cost?

No. If the acceleration of the vesting of the award is determined to be nonsubstantive, it would not be appropriate to accelerate recognition of the remaining compensation expense. The SEC staff emphasized that it is inappropriate to give accounting recognition to a nonsubstantive modification.

The derived service period must be evaluated to determine whether the employee has received a benefit from the acceleration at the modification date. A service period is inferred from the application of certain valuation techniques used to estimate fair value (typically a lattice model).

The underlying presumption is that, because the option is out-of-the-money at the acceleration of the vesting date, it will take some time for the stock price to recover to the point of becoming in-the-money and, thus, of benefit to the employee. Accordingly, the acceleration of vesting of a deep out-of-the-money award will likely result in a derived service period for the modified awards. Effectively, the exercise price of an out-of-the-money option is considered a market condition because an employee must remain employed until the stock price recovers in order to benefit from the award.

Issue 2: If it is determined that a modification to the vesting period is not substantive, should the derived service period become the requisite service period?

If the acceleration is viewed as nonsubstantive, the remaining unrecognized compensation expense should be recognized over the remaining requisite service period of the original award.

There are no rules of thumb as to when an option is deep out-of-the-money and when a modification is nonsubstantive, and, accordingly, judgment is required. However, in performing an evaluation of the derived service period, a resulting derived service period greater than the remaining original vesting period would be a clear indicator that the acceleration of vesting is nonsubstantive.

Condensed Interim Financial Reporting by Nonissuers

Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*, provides accounting and disclosure guidance relating to recognition and measurement in interim financial information, including condensed interim financial statements. APB Opinion No. 28, however, does not provide a reporting framework for the form and content of condensed interim financial statements. Article 10 of SEC Regulation S-X provides guidance on the form and content of condensed interim financial statements of issuers.

Currently, there is no specific professional guidance with respect to the form and content of condensed interim financial statements prepared by nonissuers. Therefore, the American Institute of Certified Public Accountants has issued Technical Information Service (TIS) 1900.01, *Condensed Interim Financial Reporting by Nonissuers*, which states that in the absence of established accounting principles for form and content in preparing condensed interim financial statements, nonissuers may analogize to the guidance in Article 10 of SEC Regulation S-X. Among other provisions, Article 10 states that the balance sheet and income statement need only include major captions, as defined. Similarly, the statement of cash flows may be abbreviated by starting with a single figure of net cash flows from operating activities and showing cash changes from investing and financing activities individually only when they exceed 10% of the average net cash flows from operating activities for the last three years. A statement of stockholders' equity is not required but may be included. The interim financial information must include disclosures either on the face of the financial statements or in accompanying footnotes sufficient so as to make the interim information presented not misleading.

Preparers should keep in mind that the purpose of condensed interim financial statements is to provide an update to users of the entity's annual financial statements prepared in accordance with generally accepted accounting principles. Therefore, to avoid being considered misleading, such condensed interim financial statements should include a note that the financial information should be read in conjunction with the entity's latest annual financial statements. Also, the entity's latest annual financial statements should either accompany such condensed interim financial statements or be made readily available by the entity. The financial statements are deemed to be readily available if a user can obtain the financial statements without any further action by the entity (for example, financial statements on an entity's Web site may be considered readily available, but being available upon request is not considered readily available).

TIS 1900.01 is available in full at http://www.aicpa.org/download/acctstd/TIS_1900.01.pdf.

It should be noted that new Statement on Auditing Standard (SAS) No. 116, *Interim Financial Information*, applies when interim financial information is intended to provide a periodic update to year-end reporting. For further discussion regarding SAS No. 116, see "Guidance Issued for Interim Reviews of Nonissuers" in the Auditing section below.

Auditing

Guidance Issued for Interim Reviews of Nonissuers

SAS No. 116, Interim Financial Information

A nonissuer may, on a quarterly basis, prepare interim financial statements that conform with the requirements of Article 10 of SEC Regulation S-X. The Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) has issued Statement on Auditing Standards (SAS) No. 116, *Interim Financial Information*, which amends AU Section 722, *Interim Financial Information*, to accommodate reviews of interim financial information of nonissuers, including companies offering securities pursuant to SEC Rule 144A or participating in private equity exchanges. This Statement applies when the interim financial information is intended to provide a periodic update to year-end reporting and:

a. The entity's latest annual financial statements have been audited by the accountant or a predecessor;

b. The accountant has been engaged to audit the entity's current-year financial statements, or the accountant audited the entity's latest annual financial statements and expects to be engaged to audit the current year financial statements;

c. The client prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements; and

d. If the interim financial information is condensed information, all of the following conditions are met:

   i. The condensed interim financial information purports to conform with an appropriate financial reporting framework, which includes appropriate form and content of interim financial statements; for example, Accounting Principles Board Opinion No. 28, *Interim Financial Reporting*, and Article 10 of Regulation S-X with respect to accounting principles generally accepted in the United States of America or International Accounting Standard 34, *Interim Financial Reporting*, with respect to International Financial Reporting Standards issued by the International Accounting Standards Board may be appropriate financial reporting frameworks for interim financial information. See "Condensed Interim Financial Reporting by Nonissuers" in the Accounting section above.

   ii. The condensed interim financial information includes a note that the financial information does not represent complete financial statements and should be read in conjunction with the entity's latest annual audited financial statements.

   iii. The condensed interim financial information accompanies the entity's latest audited annual financial statements or such audited annual financial statements are made readily available by the entity. The financial statements are deemed to be readily available if a user can obtain the financial statements without any further action by the entity (for example, financial statements on an entity's Web site may be considered readily available, but being available upon request is not considered readily available).

This Statement also clarifies that if the conditions in a. and b. above are not met, reviews of interim financial information of nonissuers should be performed in accordance with Statements on Standards for Accounting and Review Services (SSARS). The Statement also removes the guidance for reviews of interim financial information of issuers since such guidance resides in the auditing standards of the Public Company Accounting Oversight Board. SAS No. 116 is effective for reviews of interim financial information for interim periods beginning after December 15, 2009, with early application permitted.

SSARS No. 18, Applicability of Statements on Standards for Accounting and Review Services

The AICPA has also issued SSARS No. 18, *Applicability of Statements on Standards for Accounting and Review Services*, which revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of SAS No. 116 apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted.

International

Impairment of Non-financial Assets: IFRS vs. U.S. GAAP

This article is the thirteenth 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. In this article, we provide an overview of some of the most significant differences between IFRS and U.S. generally accepted accounting principles (GAAP) with regard to impairment of non-financial assets. Actual differences in the accounting treatment between the two frameworks depend on specific circumstances.

The analysis of impairment of non-financial assets is an area of significant differences between IFRS and U.S. GAAP, which can result in significant adjustments when converting from one framework to the other. Under IFRS,

International Accounting Standard (IAS) 36, *Impairment of Assets*, contemplates a one-step approach for the analysis of impairment, which is applicable to all non-financial assets within its scope. Financial statement preparers are required to compare the carrying amount of the asset with its recoverable amount. If the recoverable amount is lower than the carrying amount, the asset must be adjusted to its recoverable amount. The recoverable amount is the greater of (a) the fair value less cost to sell of the asset and (b) its value in use (VIU).

VIU is the present value of the future cash flows expected to be derived from an asset or cash-generating unit (CGU) and is normally determined using a discounted cash flow analysis. Under IFRS, the impairment test of an asset is always performed at the CGU level. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. This definition is substantially the same as the one included in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Theoretically, a CGU can span from an individual asset to the enterprise as a whole. Moreover, in certain circumstances, CGUs can be aggregated for impairment test purposes.

Under U.S. GAAP, the impairment approach varies depending on the type of asset. Per Statement No. 144, the impairment test for long-lived assets and finite-lived intangibles is performed in a two-step approach at the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. Under FASB Statement No. 142, *Goodwill and Other Intangible Assets*, the impairment test is performed in a two-step approach at the reporting-unit level for goodwill, and in a one-step approach at the individual-asset level for indefinite-lived intangibles. Statement No. 142 defines “reporting unit” as the same level as or one level below an operating segment. In general, a CGU is not larger than a reporting unit, but a reporting unit can incorporate more than one CGU.

According to IAS 36, except for goodwill, impairment losses can be reversed when there is an indication that an impairment loss recognized in prior periods no longer exists or may have decreased. Reversal of impairment is not allowed under U.S. GAAP in any circumstances.

The above summary of differences above is not exhaustive. Specific facts and circumstances combined with the interaction with other standards can lead to further differences.

Insights is a biweekly publication of Keegan, Linscott & Kenon, P.C. 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. Please contact Carolyn Mallonee at (520) 884-0176, fax (520) 884-8767, or e-mail cmallonee@klkcpa.com.

Keegan, Linscott & Kenon, P.C. is an independently owned member of the RSM McGladrey Network. RSM McGladrey Network is the premier affiliation of independent accounting and consulting firms in the United States that leverages the resources of RSM McGladrey. RSM McGladrey is a leading provider of financially focused business services to midsized companies. The RSM McGladrey group of companies offers accounting, tax services, business consulting, retirement resources, employer services, corporate finance, wealth management and financial process outsourcing.

RSM McGladrey and McGladrey & Pullen, a CPA firm, have an alternative practice structure. Though separate and independent legal entities, RSM McGladrey and McGladrey & Pullen work together to serve clients’ business needs. They are members of RSM International, an affiliation of separate and independent legal entities.

Information provided in this publication has been obtained by Keegan, Linscott & Kenon, P.C. and McGladrey & Pullen from sources believed to be reliable. However, Keegan, Linscott & Kenon, P.C. and McGladrey & Pullen guarantee neither the accuracy nor completeness of any information and are not responsible for any errors or omissions or for results obtained by others as a result of reliance upon such information. This publication does not, and is not intended to, provide legal, tax or accounting advice.