1999

Selected Current Developments in Financial Accounting and Reporting

David W. LaRue

Repository Citation
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FASB Exposure Draft on Business Combinations and Intangible Assets

I. Introduction and Background

A. Recent increases in merger and acquisition activity have focused greater attention to the actual and perceived problems with APB Opinions 16 and 17, especially those regarding the usefulness, relevance, and comparability of the financial information resulting from their application.

1. The Securities and Exchange Commission (SEC) staff spends a substantial amount of time on inquiries related to those APB Opinions, particularly APB Opinion 16, and urged the FASB to reconsider APB Opinions 16 and 17.

2. The FASB's Financial Accounting Standards Advisory Council (FASAC) also supported reconsideration of APB Opinions 16 and 17 with an eye to achieving convergence between the U.S. and the international standards of accounting for business combinations.

B. APB Opinion No. 16, Business Combinations, provides for two methods of accounting for business combinations, the pooling-of-interests method and the purchase method.

1. The proposed Statement would amend APB Opinion 16 by eliminating the pooling-of-interests method and by requiring all business combinations to be accounted for using the purchase method.

2. Under the “pooling-of-interests” method:
a) The book value of all assets and liabilities recorded on the books of the amalgamating companies are carried forward to the financial statements of the combined enterprise.

b) No new assets or liabilities are recognized as a result of the combination.

c) The excess of the purchase price over the book value of the net assets acquired is not recognized.

d) The income statements of the combined enterprise for the year of combination is presented as if the enterprises had been combined for the full year.

e) All comparative financial statements are presented as if the enterprises had always been combined.

3. Under the "purchase" method:

a) The acquiring enterprise recognizes the assets acquired and liabilities assumed based on their fair values, including assets and liabilities that may not have been recorded on the financial statements of the acquired enterprise.

b) The purchase premium is recognized as goodwill.

c) The income statement of the acquiring enterprise does not include the results of operations of the acquired enterprise prior to the acquisition date.

4. The pooling and purchase methods are not alternatives or substitutes for one another.

a) A business combination that meets all of the 12 conditions specified in APB Opinion 16 must be accounted for using the pooling method.

b) A business combination that does not meet all of those conditions must be accounted for using the purchase method.

5. The 12 conditions specified in APB Opinion 16 were intended to limit the use of the pooling method, however use of that method has increased substantially in recent years.

a) Enterprises frequently structure transactions to qualify for the pooling method in an attempt to avoid the earnings charges related to recording goodwill and other acquired intangible assets, as well as those related to the step-up in the basis of the other acquired net assets.

C. APB Opinion No. 17, Intangible Assets, addresses the accounting for intangible assets, including those acquired in a business combination.

1. It requires that the costs recorded for goodwill and other intangibles be amortized over the expected period of benefit, not to exceed a period of 40 years.

2. Under the Exposure Draft,
a) The 40-year maximum amortization period would be changed to 20 years.

b) The financial presentation requirements for goodwill charges (including amortization) would also change

(1) These charges would be preceded by a subtotal and would be presented on a net-of-tax basis as a separate line item on the income statement.

3. The Exposure Draft also provides guidance for identifying intangible assets.

D. The proposed Statement would not change:

1. The provisions of APB Opinion 17 that pertain to internally developed intangible assets, or

2. The accounting guidance in APB Opinion 16 and its amendments and interpretations which pertain to the purchase method of accounting for business combinations, or the status of the EITF issues that provide guidance on applying the purchase method.

II. Business Combinations

A. Scope

1. Under the Exposure Draft, a “business combination” generally occurs when:

   a) An enterprise, whether or not incorporated and regardless of the form of the consideration used to effect the acquisition, acquires–

      (1) All or a portion of the net assets that constitutes a business or

      (2) Equity interests of one or more enterprises which is sufficient to give the acquirer control over the enterprise or enterprises,

   b) One or more enterprises are merged or become subsidiaries,

   c) One enterprise transfers its net assets or equity interests to another (including all or a portion of the net assets that constitutes a business or equity interests of the enterprise),

   d) Each enterprise transfers its net assets or equity interests to a newly formed enterprise in exchange for equity in the new enterprise.

   e) An exchange of a business for a business also constitutes a business combination.

2. A “business combination” does not occur when:

   a) An enterprise transfers some or all of its net assets to a newly formed substitute enterprise chartered by the transferor enterprise, or
b) Upon the transfer of net assets or exchanges of shares between enterprises under common control (such as between a parent corporation and its subsidiary or between two subsidiary corporations of the same parent).

B. Recording acquired assets and assumed liabilities

1. The acquiring enterprise should follow the guidance set forth in paragraph 68 of APB Opinion 16 in allocating the cost of an acquired enterprise to the assets acquired and liabilities assumed. Prior to the allocation, the acquiring enterprise must:
   a) Review the purchase consideration (if other than cash) to ensure that it has been valued in accordance with the requirements in paragraphs 72–76 of APB Opinion 16, and
   b) Identify all of the assets acquired and liabilities assumed, including intangible assets.

C. Acquired R&D assets

1. The proposed Statement would not change FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.

2. This Interpretation requires the acquirer to expense, on the date the combination is completed, any amounts assigned to tangible and intangible assets that are to be used in a particular research and development project and which have no alternative future use.

D. Excess of cost over the fair value of acquired net assets

1. The excess of the cost of the acquired enterprise over the difference between identifiable assets acquired and liabilities assumed must be recognized and recorded as goodwill.

2. Identifiable intangible assets that cannot be reliably measured should also be included in goodwill.

E. Disclosures

1. In the period in which a material business combination is completed, or for which a material business combination is completed after the balance sheet date, but before the financial statements are issued, the notes to the financial statements of the acquiring enterprise must include the following information:
   a) The name and brief description of the acquired enterprise and the percentage of voting shares acquired,
   b) The period for which the results of operations of the acquired enterprise are included in the income statement of the acquiring enterprise,
   c) The cost of the acquired enterprise,
   d) The number of shares of stock issued or issuable (together with the value assigned to those shares and the basis upon which the value was determined [if applicable]),
e) Contingent payments, options, or commitments specified in the acquisition agreement and the accounting treatment that will be followed should any such contingency occur,

f) A condensed balance sheet disclosing the following for each major asset and liability caption of the acquired enterprise:

(1) The book value as reflected in the acquired enterprise's financial records at the date of acquisition not including fair value adjustments and

(2) The fair values assigned at the date of acquisition,

g) For any purchase price allocation that has not been finalized, that fact and the reasons therefore and, in subsequent periods, the nature and amount of any material adjustments made to the initial allocation of the purchase price,

h) Additional information if the amount assigned to acquired goodwill or to other acquired intangible assets is significant in relation to the total cost of the acquired enterprise.

2. The notes to the financial statements of an acquiring enterprise must disclose the following information in the period in which individually immaterial business combinations have been completed if those combinations are material in the aggregate:

a) The number of enterprises acquired and a brief description of those enterprises,

b) The aggregate cost of the acquired enterprises, the number of shares of stock issued or issuable, and the value assigned to those shares,

c) The aggregate amount of any contingent payments, options, or commitments and the accounting treatment that will be followed should any such contingency occur if potentially significant in relation to the aggregate cost of the acquired enterprises,

d) Additional information if the aggregate amount assigned to goodwill or to other intangible assets acquired is significant in relation to the aggregate cost of the acquired enterprises.

F. Intangible Assets

1. Scope

a) Part II of the proposed Statement applies to the accounting for both identifiable and unidentifiable intangible assets that an enterprise acquires and recognizes as assets, including those acquired in a business combination.
b) It also covers the accounting for costs of developing goodwill and other unidentifiable intangible assets having indeterminate lives.

c) It does not apply to intangible assets whose accounting is prescribed by:

(1) *FASB Statement No. 2, Accounting for Research and Development Costs*

(2) *FASB Statement No. 61, Accounting for Title Plant*

(3) *FASB Statement No. 63, Financial Reporting by Broadcasters* license agreements for program material, paragraphs 2–7

(4) *FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* (paragraph 7)


2. Definitions

   a) "Intangible assets"— Noncurrent assets (not including financial instruments) that lack physical substance.

   b) "Goodwill"— Unidentified intangible asset[s] and identifiable intangible asset[s] that are not reliably measurable.

   c) "Observable Market"— One in which intangible assets are separately bought and sold. From those purchases and sales, a market price can be observed and used in estimating the fair value of similar intangibles.

3. Acquisition of intangible assets

   a) The fair value of any intangible assets acquired from other enterprises or individuals must be measured and recognized whether those assets are acquired singly, in groups, or as part of a business combination.

4. Amortization of intangible assets other than goodwill.

   a) Reliably measurable identifiable intangible assets (other than those intangible assets that meet the criteria for nonamortization) must be amortized over their useful economic lives.

      (1) The useful economic life of an intangible asset is presumed to be 20 years or less.

      (2) The amount to be amortized is the amount assigned less any residual value.
(3) A residual value of zero is assumed unless the useful life to the acquiring enterprise is shorter than the asset's useful economic life and

(a) The acquiring enterprise has a commitment from a third party to purchase the asset at the end of its useful life or

(b) The residual value can be determined by reference to an observable market that is expected to exist at the end of the asset's useful life.

b) The 20 year amortization periods may be extended if

(1) The intangible asset generates clearly identifiable cash flows that are expected to continue for more than 20 years and

(2) Either the asset is exchangeable or control over the future economic benefits of the asset is obtained through contractual or other legal rights that extend for more than 20 years.

(3) Such assets should not be amortized until their life is determined to be finite.

5. Amortization of goodwill

a) All goodwill must generally be amortized over its useful economic life and not more than 20 years.

b) The useful economic lives of the underlying elements of goodwill must be considered in determining the amortization period for these respective underlying elements

6. Determining the useful economic life

a) The useful economic life of an intangible asset is the period over which the asset is expected to generate identifiable cash flows.

b) The following factors are to be considered when estimating the useful economic life of an intangible asset:

(1) The legal, regulatory, or contractual provisions that may enable renewal or extension of a specified limit on the asset's legal or contractual life (provided there is evidence to support renewal or extension without substantial cost);

(2) The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, the rate of technological change, and expected changes in distribution channels);

(3) The expected useful life of assets or groups of assets of the enterprise or of individuals or groups of
employees to which the useful life of the asset may parallel (such as mineral rights to depleting assets);

(4) The expected use of the intangible asset by the enterprise;

(5) The level of maintenance expenditure required to obtain the expected future economic benefits from the asset (for example, if the level of required maintenance is material in relation to the carrying value of the asset, that may suggest a very limited useful life).

c) The remaining periods of amortization should be examined every reporting period to determine whether events and circumstances dictate revision of estimates of useful economic lives.

   (1) If estimates are changed, the unamortized cost must be allocated to the number of remaining periods in the revised life.

7. Financial statement presentation

   a) All goodwill must be aggregated and presented as a separate line item in the statement of financial position.

   b) All other intangible assets must be aggregated and presented as a separate line item in the statement of financial position, but can be presented individually or by classes.

   c) Goodwill amortization expense and impairment losses (collectively referred to as “goodwill charges”) must be presented net-of-tax as a separate line item in the income statement.

   d) All enterprises reporting goodwill charges must display a subtotal, after income taxes but before goodwill charges, that is descriptive of the items that follow (e.g., income before goodwill charges and extraordinary item or income before goodwill charges and discontinued operations).

      (1) The next line item is the aggregate goodwill charge followed by a subtotal that is descriptive of the other items that follow (e.g., income before extraordinary item or income before discontinued operations).

      (2) If there are no other items that follow, the goodwill line item must be followed by the total net income.

   e) Goodwill charges associated with a discontinued segment must be included net-of-tax within the results of discontinued operations.

   f) If goodwill impairment losses are associated with extraordinary items or changes in accounting principle, those
losses must be included as part of those line items in the income statement as appropriate.

g) The amortization expense and impairment losses for intangible assets other than goodwill must be presented in income statement line items as deemed appropriate for each enterprise.

(1) Those charges may not be presented on net-of-tax and should be included in the income subtotal that precedes the goodwill charges.

8. Income Tax Allocation

a) FASB Statement No. 109, Accounting for Income Taxes, provides guidance on allocating income tax expense or benefit for the period among continuing operations, discontinued operations, and extraordinary items.

(1) It specifies the amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of four specified items.

(2) For purposes of applying that provision in periods in which goodwill charges have been recognized, pretax income or loss from continuing operations includes goodwill charges on a pretax basis.

b) The portion of income tax expense or benefit attributable to pretax income or loss from continuing operations allocable to goodwill charges must be determined by measuring the tax effect of goodwill charges at the highest marginal tax rate or rates.

9. Per-Share Amounts

a) Enterprises may present basic and diluted earnings per-share amounts on the face of the income statement for the subtotal on the income statement that precedes the goodwill charges and for the goodwill charge line item.

(1) Consult FASB Statement No. 128, Earnings per Share for guidance on the computation.

(2) These EPS amounts must be presented with no greater emphasis than the per-share amounts required to be presented on the face of the income statement in accordance with paragraph 36 of SFAS 128.

b) SFAS 128 states that income from continuing operations is the “control number” to be used in determining whether potential common shares are dilutive or antidilutive for an enterprise with a discontinued operation, an extraordinary item, or the cumulative effect of a change in accounting principle.
For purposes of applying that provision in periods in which goodwill charges have been recognized, income from continuing operations (the control number) refers to the subtotal of income immediately following those goodwill charges.

10. Terminology

a) The phrase "income from continuing operations" is used throughout the accounting literature to refer to the subtotal on the income statement that precedes discontinued operations, extraordinary items, and accounting changes.

(1) However, use of that caption is not required and many enterprises do not use it in their income statements, especially when discontinued operations are not present.

(2) Whenever that phrase is found in accounting pronouncements, it should be considered to refer to the subtotal of income immediately following the goodwill charges.

11. Disclosures

a) The notes to the financial statements in the year of acquisition should include the following information as of the acquisition date:

(1) For each class of intangible asset:
   a) A description of the asset(s) and their recorded amount(s);
   b) The key assumptions and methodologies used to value the intangible assets;
   c) A description of the amortization method; if other than straight-line, the reason;
   d) The weighted-average amortization period;
   e) Any residual value assumed in determining the amount to be amortized (if significant in relation to the carrying amount of the intangible asset class).

(2) A description and the carrying amount of any significant intangible asset presumed to have either a useful economic life longer than 20 years or an indefinite life, the useful life assigned, and the factors supporting that life.

(3) For goodwill:
   a) A description of the elements that underlie goodwill.
(b) The amortization period for goodwill and how it was determined.
(c) The amortization method.

b) The financial statements for subsequent years must disclose the following information.

(1) For each class of intangible asset:
   (a) The gross carrying amount
   (b) The accumulated amortization
   (c) The current-period amortization expense
   (d) The amortization method

(2) A description of any intangible asset not being amortized and a description of the method used to estimate the fair value of that asset

(3) For all goodwill:
   (a) The accumulated amortization
   (b) The amortization method.

12. Effective Date and Transition
   a) The provisions of the proposed Statement would be effective for business combinations initiated and intangible assets acquired after the issuance date of the Statement.
   b) The provisions related to financial statement presentation and disclosure would be applied to previously recognized intangible assets beginning in the first interim or annual period ending after the issuance date of this Statement unless it is not practicable to do so.
   c) If comparative financial statements are provided for earlier periods, those financial statements including interim financial statements, summaries of earnings, and selected financial data must be reclassified to reflect application of the financial statement presentation and disclosure provisions of the Statement.

13. The Statement recommended use of the following list as a reference tool in identifying intangible assets acquired in a business combination:

   a) Customer-based or market-based assets—intangible assets that relate to customer structure or market factors of the business:
      (1) Lists [advertising, customer, dealer, mailing, subscription, and so forth]
      (2) Customer base
(3) Financial institution depositor or borrower relationships
(4) Customer routes
(5) Delivery system, distribution channels
(6) Customer service capability, product or service support
(7) Effective advertising programs
(8) Trademarked brand names
(9) Newspaper mastheads
(10) Presence in geographic locations or markets
(11) Value of insurance-in-force, insurance expirations
(12) Production backlog
(13) Concession stands
(14) Airport gates and slots
(15) Retail shelf space
(16) Files and records [credit, medical]

b) Contract-based assets—intangible assets that have a fixed or definite term:

(1) Agreements [consulting, income, licensing, manufacturing, royalty, standstill]
(2) Contracts [advertising, construction, consulting, customer, employment, insurance, maintenance, management, marketing, mortgage, presold, purchase, service, supply]
(3) Covenants [not to compete]
(4) Easements
(5) Leases [valuable or favorable terms]
(6) Permits [construction]
(7) Rights [broadcasting, development, gas allocation, landing, lease, mineral, mortgage servicing, reacquired franchise, servicing, timber cutting, use, water]

c) Technology-based assets—intangible assets that relate to innovations or technological advances within the business:

(1) Computer software and license, computer programs, information systems, program formats, internet domain names and portals
(2) Secret formulas and processes, recipes
(3) Technical drawings, technical and procedural manuals, blueprints
(4) Databases
(5) Manufacturing processes, procedures, production line
(6) Research and development
(7) Technological know-how.

d) Statutory-based assets—intangible assets with statutorily established useful lives:

(1) Patents
(2) Copyrights [manuscripts, literary works, musical compositions]
(3) Franchises [cable, radio, television]
(4) Trademarks, trade names

e) Workforce-based assets—intangible assets that relate to the value of the established employees or workforce of a company:

(1) Assembled workforce, trained staff
(2) Non-union status, strong labor relations, favorable wage rates
(3) Superior management or other key employees
(4) Technical expertise
(5) Ongoing training programs, recruiting programs.

f) Corporate organizational and financial assets—intangible assets relating to the organizational structure of an entity:

(1) Savings value of escrow fund
(2) Favorable financial arrangements, outstanding credit rating
(3) Fundraising capabilities, access to capital markets
(4) Favorable government relations

14. The following are examples of how different identifiable intangible assets should be accounted for. In each example, the economic and competitive factors that may limit the asset's useful economic life to a period less than its legal life were considered in determining the estimated period of future cash flows.

a) Technological know-how, such as that of plant engineers or research scientists, the fair value of which is not reliably measurable.

(1) Record and amortize as part of goodwill.

b) A customer list of an acquired direct-mail marketing company that is expected to generate future cash flows for 7
years. While there is an observable market for this list, the enterprise has no plans to sell the asset.

1. Amortize over 7-year useful economic life.

c) A patent expiring in 15 years. The patent is expected to be a source of revenue and cash flows for at least 15 years.

1. Amortize over 15-year useful economic life.

d) A newspaper subscriber base that is expected to generate revenues and cash flows for at least 25 years. The projected cash flows are based on an analysis of past subscription renewal patterns that was used to estimate future renewal patterns that also took into account the mortality, relocation, and changing tastes of current subscribers as well as various competitive factors. While the subscription list may be an exchangeable asset, management does not believe the underlying subscriber base is.

1. Amortize over 20 years, the maximum amortization period for intangible assets that are not exchangeable.

e) A trademark that has a remaining legal life of 12 years and is renewable indefinitely at little cost. The trademark protects a leading consumer product brand that has been a market-share leader for the past 8 years. An analysis of product life cycle studies; market, competitive, and environmental trends, and brand extension opportunities provides evidence that the trademark will generate revenue and cash flows for 35 more years.

1. Amortize over 35-year economic useful life.

f) An exclusive right to generate hydroelectric power for 60 years. The costs of generating hydroelectric power are much lower than the costs of obtaining power from alternative sources. It is expected that there will be strong demand for power in the geographical area surrounding the power station for at least 60 years.

1. Amortize over 60-year useful economic life.

III. Acquisition of In-Process Research and Development

A. In March, 1999, the FASB has concluded that all purchased in-process research and development should be recognized as assets and amortized over their useful economic life.

1. This applies whether the purchased in-process research and development is acquired in a business combination or purchased singly or as one part of a group of assets.

B. The Board further decided that in-process research and development should be addressed as a separate component of the business combinations project. A separate standard will eventually be issued.
C. During the research and deliberations portion of the development of the proposed Statement on business combinations, the Board discovered that the subject was extremely complex and more study was needed.

1. The FASB concluded that it was not possible to address purchased R&D costs separate from other R&D costs.

2. In July, the Board announced that it would postpone its consideration of the accounting treatment of purchased R&D until a later date.

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**Exposure Draft: Consolidated Financial Statements**

I. Introduction


B. It states the purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries as if the group were a single company with one or more branches or divisions.

C. There is also a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

D. The proposed Statement would extend that application of the consolidated statement rules to relationships that involve a parent entity and its affiliates, whether they are established as corporations, partnerships, trusts, or other unincorporated entities, and whether they are organized for profit or not.

1. It would supersede the provisions of paragraphs 1-3 and 5 of *Accounting Research Bulletin No. 51*, as previously amended by *FASB Statement No. 94*, and would amend *ARB 51* to extend its provisions to not-for-profit organizations.

2. The Statement would be effective for financial statements for annual period ending after December 15, 1999 and all interim periods in the year of adoption.

3. This Statement would be applied by restatement of comparative financial statements for earlier periods.

   a) However, retroactive restatement would not be required for entities for which control was relinquished or for entities where management has agreed to a plan to relinquish control and that relinquishment is likely to occur within one year of
the fiscal year-end in which this proposed Statement is first applied.

II. Background

A. The Board is addressing consolidation policy as part of a multiphase project started in 1982 and intended to cover all aspects of accounting for affiliations between entities. In October 1995, upon completing its deliberations on the Discussion Memorandum and the Preliminary Views, the Board issued an Exposure Draft, Consolidated Financial Statements: Policy and Procedures. Following the review of written comments to that Exposure Draft, meetings with members of its Consolidations Task Force, the Emerging Issues Task Force (EITF), and two of the EITF's working groups that had been considering related issues, and its advisory council, the Exposure Draft was revised and issued for comment in February of 1999.

III. Scope

A. The requirements of the proposed Statement are applicable to business enterprises and not-for-profit organizations.

B. The requirements of the proposed Statement do not apply to:

1. Financial statements of reporting entities which, in accordance with GAAP, carry substantially all of their assets (including investments in controlled entities) at fair value with all changes in value reported in a statement of net income or financial performance.
   
a) Examples include defined benefit pension plans that apply the provisions of FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, mutual funds and other investment companies that apply the provisions of the AICPA Audit and Accounting Guide, Audits of Investment Companies, and report all changes in value in a statement of operations.

2. Reporting interests in employee benefit trusts subject to the provisions of FASB Statement No. 87, Employers' Accounting for Pensions, No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, or No. 112, Employers' Accounting for Postemployment Benefits.

C. Definitions

1. "Control"—The ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities. For purposes of consolidated financial statements, control involves decision-making ability that is not shared with others.

2. "Parent"—An entity that controls one or more subsidiaries.

3. "Subsidiary"—An entity that is controlled by another entity.

4. "Affiliate"—An entity that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common
control with another entity. A parent and its subsidiary are affiliates, and subsidiaries of a common parent are affiliates.

D. Consolidation policy

1. 1. Under the *Exposure Draft*, a parent must consolidate each entity over which it has permanent control.

2. 2. Once a subsidiary is consolidated, it will continue to be included in the consolidated financial statements until the parent ceases to control it.

E. Temporary control of a new subsidiary

1. Investment in a temporarily controlled subsidiary is measured at fair value less the cost to sell at the date it is acquired. *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, provides standards for measuring the fair value less cost to sell of an asset held for sale.

2. Control is considered temporary if, at the acquisition date, the parent either
   a) Has committed to give up control of that subsidiary at a later date or
   b) Has an obligation to do so and it is likely that loss of control will occur within one year.

3. Control is also considered temporary if, at the acquisition date, circumstances beyond management’s control are likely to require more time to complete the ultimate change in control. For example, existing contractual obligations with unrelated parties or laws and regulations that may cause the change in control to take longer than one year to complete.

4. The notes to the financial statements must disclose a description of the temporarily controlled subsidiary, the facts and circumstances leading to the expected disposal, the expected disposal date, and the carrying amount of the investment in the subsidiary.

F. Control of a subsidiary

1. "Control" is evidenced by two essential characteristics.
   a) A parent’s decision-making ability must be nonshared and must allow the parent to guide the ongoing activities of its subsidiary. That decision-making ability must further enable the parent to:
      (1) Direct the use of and access to the subsidiary’s assets usually by being able to set the policies that dictate how those assets are used in ongoing activities, and
      (2) Hold the subsidiary’s management accountable for the conduct of its ongoing activities usually by being
able to hire, fire, and select the salary of the management responsible for carrying out the guidance of the parent.

b) Parent's ability to use its decision-making power to increase the profits earned and limit the losses incurred from the subsidiary's activities.

2. These two characteristics usually stem from a single source, but may stem from multiple sources.

a) For example, a parent's decision-making powers may be stated in the subsidiary's articles of incorporation, while its ability to derive benefits may come from a holding of nonvoting equity shares.

3. The decision-making ability that enables a parent to control a subsidiary is exclusionary: If A controls B, no other entity can control B.

G. Assessing whether a relationship involves control

1. A. The surrounding facts of a relationship should be assessed if:

a) There is a change in ownership of voting shares or rights to elect or appoint the members of a corporation's governing body,

b) There is an increase or decrease in ownership of securities (e.g., convertible debt, convertible preferred stock, stock options, warrants) that enable the holder to obtain a significant ownership of voting shares or rights to elect or appoint the members of a corporation's governing body,

c) The entity has significant involvement in the formation of an entity (e.g., establishing significant portions of its articles of incorporation, partnership agreement) or provides a significant amount of its capital,

d) The entity obtains or transfers a right to cause an entity to cease its operations,

e) The entity obtains or transfers a right to participate in a distribution of an entity's assets (or net assets) in the event of its liquidation.

2. Corporations

a) The guidance for corporations suggests that control is marked by an entity that has sufficient voting rights or appointment rights that allows them to dominate another corporation's governing board.

b) In the absence of other evidence, the existence of control of a corporation is presumed if an entity (including its subsidiaries) has:
(1) A majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body

(2) A large minority voting interest in the election of a corporation's governing body and no other party or organized group of parties has a significant voting interest

(3) A unilateral ability to

(a) Obtain a majority voting interest in the election of a corporation's governing body or

(b) Obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost.

c) If a corporation is established without an elected or appointed governing body, the facts and circumstances surrounding the establishment of that corporation should be considered when determining control.

3. Partnerships

a) Partnerships are usually controlled by general partners. In the case of a limited partnership, control is presumed if an entity is the only general partner in a limited partnership and no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner.

4. Trusts and Other Arrangements

a) Relationships with trusts, unincorporated associations, and similar structures rarely involve a parent-subsidiary relationship, but usually resemble general partnerships with activities that continue only if the associates continue to work cooperatively.

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SEC Staff Accounting Bulletin No. 99- Materiality

I. Background and Purpose

A. In September 1998, SEC Chairman Arthur Levitt spoke to the NYU Center for Law and Business.

1. In his speech, "The Numbers Game," Levitt suggested that some companies intentionally record errors within a defined percentage ceiling to reach Wall Street earnings predictions.
For example, if the combined misstatements result in a 4% overstatement of net income and a 4% overstatement of earnings per share, then, because no item in the registrant's consolidated financial statements is misstated by more than 5%, the deviation from generally accepted accounting principles ("GAAP") is immaterial and that this accounting is technically permissible.

2. He noted that in many cases, management is managing the numbers as opposed to managing the business and letting the numbers fall where they should.

B. As a result of the discussion triggered by this speech, in August the Securities and Exchange Commission issued Staff Accounting Bulletin No. 99 on materiality.

1. The bulletin expresses the views of the staff that exclusive reliance on certain quantitative benchmarks to determine materiality in preparing financial statements and performing audits of those financial statements is inappropriate: Misstatements are not immaterial simply because they fall below a numerical threshold.

C. Lynn Turner, Chief Accountant of the SEC said the bulletin was created to serve as a tool kit that would provide basic guidance.

1. The SAB was not issued to change law or guidance in the accounting or auditing literature, or to require that misstatements arising from insignificant errors and omission inherent in the normal accounting closing duties always be corrected, even if the error is identified during the audit and known to management.

2. Instead, the purpose was to encourage management and auditors to consider the various factors discussed and assess whether such misstatements are material, need to be corrected, or trigger further procedures under Section 10A of the Exchange Act of 1934.

II. Definition of Materiality

A. As defined in FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, omission or misstatement of an item in a financial report is "material" if there is the substantial likelihood that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

B. The Supreme Court has held that a fact is material if there is a substantial likelihood that the fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

C. The "total mix" includes the size in numerical or percentage terms of the misstatement and the factual context in which the user of financial statements would view the financial statement item.

D. In the SEC staff's view, a registrant or the auditor of its financial statements must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.

   1. Registrants may not assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements.

   2. Exclusive reliance on any percentage or numerical threshold has no basis in the accounting literature or the law.

III. Assessment of Materiality

A. The staff believes that the use of a percentage as a numerical threshold is an initial step in assessing materiality. However, there are numerous circumstances in which misstatements below a quantitatively small amount could be material because of the qualitative factors surrounding the misstatement.

B. Qualitative factors

   1. Several considerations that may cause a quantitatively small misstatement of a financial statement to be a material item are whether the misstatement:

      a) Arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate

      b) Masks a change in earnings or other trends

      c) Hides a failure to meet analysts' consensus expectations for the enterprise

      d) Changes a loss into income or vice versa

      e) Concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability

      f) Affects the registrant's compliance with regulatory requirements, loan covenants, or other contractual requirements

      g) Increases management's compensation

      h) Involves concealment of an unlawful transaction.

C. Other Factors

   1. Response to the market

      a) The price volatility of registrant's securities in response to certain types of disclosures may provide guidance as to
whether investors regard quantitatively small misstatements as material.

b) When management or the independent auditor expects that a misstatement may result in a significant market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.

2. Intent of management
a) Management intent may provide significant evidence of materiality, especially if management has intentionally misstated financial statement items believing that the resulting amounts and trends would be significant to statement users.

3. Significance of segment information
a) Auditors should consider the size of the misstatement and the significance of the segment information to the financial statements taken as a whole.

(1) AU Section 326.33 states, "A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity" is more likely to be material to investors than a misstatement in a segment that has not identified as important.

4. Aggregating and netting misstatements
a) Registrants and the auditors of their financial statements should consider each misstatement separately as well as the total effect of all misstatements. According to AU Section 508.36, this requires consideration of:

(1) The significance of an item to the entire entity (e.g., inventories to a manufacturing company),
(2) The pervasiveness of the misstatement (does it affect the presentation of numerous financial statement items?), and
(3) The effect of the misstatement on the financial statements taken as a whole.

b) If the misstatement of any individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by any other misstatements whose effect may be to lessen the impact of the misstatement on other financial statement items.

(1) For example, if an entity's revenues are a material financial statement item and they are materially overstated, the financial statements taken as a whole will be materially misleading even if the effect on
earnings is completely offset by an equivalent overstatement of expenses.

(2) Even though the misstatement of an individual amount may not cause the financial statements to be materially misstated, when aggregated with other misstatements, the financial statements taken as a whole may be misleading.

(a) Registrants and auditors should also track prior period misstatements and monitor their effects on the current financial statements, especially when immaterial misstatements are noted in more than one year and the cumulative effect becomes material in the current year.

D. Immaterial misstatements that are intentional

1. The SEC requires that registrants comply with Sections 13(b)(2)-7 of the Securities Exchange Act of 1934 and prohibits intentional immaterial misstatements in financial statements.

2. The Act requires SEC registrants to make and keep records and accounts that accurately and fairly record its transactions and assets.

   a) Registrants must also maintain sufficient internal accounting controls to provide reasonable assurances that the transactions are recorded in conformity with GAAP and to ensure that financial statements can be prepared accordingly.

3. In assessing whether a misstatement results in a violation of a registrant's obligations under Section 13(b)(2)-7 several factors must be considered:

   a) How significant is the misstatement?

      (1) Misstatements that clearly have noticeable effects on the financial statements should be treated differently than those that are less significant.

   b) How did the misstatement arise?

      (1) Known misstatements should be corrected as a part of the ongoing business process and management function.

      (2) Therefore, those misstatements that are known and that nevertheless go unchanged in an effort to manage earnings should be handled differently than those that are undetected in the normal course of business.

   c) What is the cost to correct the misstatement?

      (1) Major costs should not be incurred to correct small misstatements.
However, where there is little cost or delay involved in correcting a misstatement, failing to do so is unacceptable.

d) How clear is the authoritative accounting guidance with respect to the misstatement?

(1) If the appropriate accounting treatment of a financial statement item is addressed in the accounting literature, management is obligated to follow such literature, as authoritative literature takes precedence over industry practice.

E. The auditor's response to intentional misstatements

   1. Section 10A(b) of the Securities Exchange Act of 1934 requires specific action from auditors that discover an illegal act whether or not the act materially affects the financial statements.

   2. Statement on Auditing Standards No. 82, Consideration of Fraud in a Financial Statement Audit, requires the auditor to inform the appropriate level of management and the audit committee of the illegal act.

   3. When intentional misstatements are detected, AU Section 316.34 and 316.35 require auditors to:

      a) Re-evaluate the degree of audit risk involved in the audit engagement,
      b) Determine whether to revise the nature, timing, and extent of audit procedures accordingly, and
      c) Consider whether to resign.

   4. AU Section 316.39 states that intentional misstatements may also signal the existence of reportable conditions or material weaknesses in the registrant's system of internal accounting control designed to detect and deter improper accounting and financial reporting.

FASB Statement No. 133: Accounting For Derivative Instruments And Hedging Activities

I. Introduction

   A. FASB Statement 133 prescribes

      1. Accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and
      2. Accounting for hedging activities.

   B. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value.
1. The accounting for changes in the fair value of a derivative (i.e.,
unrealized gains and losses) depends on the intended use of the
derivative and the resulting designation.

C. Prior to the issuance of SFAS 133,
   1. Hedging activities relating to changes in foreign exchange rates
      were addressed in FASB Statement No. 52, Foreign Currency
      Translation.
   2. FASB Statement No. 80, Accounting for Futures Contracts,
      addressed the use of futures contracts in other hedging activities.
      a) These Statements addressed only certain derivative
         instruments and differed in the criteria required for hedge
         accounting.
   3. The Emerging Issues Task Force [EITF] had also addressed several
      issues pertaining to the accounting for various hedging activities.

D. SFAS 133 amends FASB Statements No. 52 and No. 107, Disclosure about
   Fair Value of Financial Instruments, and it supersedes FASB Statements No.
   80 and No. 119, Disclosure about Derivative Financial Instruments and Fair
   Value of Financial Instruments. SFAS 133 also nullifies or modifies several of
   the consensuses issued by the EITF.

E. SFAS 133 applies to all entities, including not-for-profit entities.

F. This Statement was initially to apply to fiscal years beginning after June
   15, 1999. However, the FASB postponed the effective date for companies
   that have not already implemented SFAS 133 to fiscal years beginning after
   1. SFAS 133 should not be applied retroactively to financial
      statements of prior periods.

II. To Learn More About Implementing SFAS 133
   A. Recognizing the technical complexity of the derivative instruments
      covered by FASB Statement No. 133 and the range of sophisticated hedging
      strategies used in practice, the FASB staff has developed a self-study CPE
      training course and research tool on CD-ROM that will help constituents
      understand the provisions of the standard.
      1. The course, A Review of Statement 133, Accounting for Derivative
         Instruments and Hedging Activities, will enhance knowledge of
         derivative instruments and hedging activities.
      2. Prepared for auditors, practicing accountants, executives with
         accounting and/or financial responsibilities, and financial analysts,
         the course will familiarize users with the major provisions of the
         standard and help in the implementation of Statement 133. See
         http://www.rutgers.edu/Accounting/raw/fasb/
   B. The FASB's Derivatives Implementation Group website is
      http://www.rutgers.edu/Accounting/raw/fasb/public/index.html
C. The Chicago Board of Options Exchange has some excellent free tutorials on derivatives investment and hedging strategies. These do not help much, however, in learning about accounting for derivatives under \textit{SFAS 133} and \textit{IAS 39}. You must download the Authorware player per instructions at 
\url{http://www.cboe.com/education/}

D. For a free tutorial on the implementation of \textit{SFAS 133}, log onto 
\url{http://www.cs.trinity.edu/~rjensen/13300tut.htm}

\textbf{III. Very General Overview of Provisions}

\textbf{A. In general}

1. In developing the standards set forth in this Statement, the Board concluded that the following four fundamental decisions should serve as cornerstones:

   a) Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported on the financial statements.

   b) \textit{Fair value} is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value, and adjustments to the carrying amount of hedged items should reflect changes in their fair value (i.e., gains and losses) that are attributable to the risk of being hedged and that arise while the hedge is in effect.

   c) Only items that are assets and liabilities should be reported as such in financial statements.

   d) Special accounting for items designated as being hedged should be provided for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged.

2. This Statement generally provides for matching

   a) The timing of gain or loss recognition on the hedging instrument with

   b) The recognition of the changes in the fair value of the hedged assets or liability that are attributable to the hedged risk.

\textbf{IV. Definitions}

\textbf{A. A derivative instrument is a financial instrument or other contract which possesses all three of the following characteristics:}

1. It has one or more “underlyings” and one or more “notional amounts” or payment provisions or both.

   a) An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable.
b) A “notional amount” is a specified unit of measure as specified in the contract.

c) A payment provision specifies an outcome that will occur if the underlying behaves in a specified manner.

2. It requires no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

3. Its terms require or permit net settlement, it can be readily settled net by a means of an outside contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

B. For purposes of this Statement, the following contracts are not considered to be derivative instruments to the reporting entity:

1. Contracts issued or held by the entity that are both indexed to its own stock and classified in the stockholders' equity section in its statement of financial position.

2. Contracts the entity has issued in connection with stock options. Such compensation arrangements are addressed in FASB Statement No. 123.

3. Contracts the entity has issued as contingent consideration from a business combination. Such arrangements are discussed in FASB Statement No. 16.

C. D. In some cases, such as with bonds, insurance policies and leases, contracts may not meet the definition of a derivative. Such contracts may have embedded derivatives, which in some way have an effect on the cash flows or the value of other exchanges required by the contract, similar to derivative exchanges.

V. Recognition of Derivatives and Measurement of Derivatives and Hedged Items

A. Derivatives should be recognized as either assets or liabilities in an entity's statement of financial position.

B. Derivatives should be measured at fair value.

1. If expected future cash flows are used to estimate fair value, those expected cash flows are the best estimate based on reasonable and supportable assumptions and projections.

2. An asset or liability's change in fair value for a period refers to the difference between its fair value at the beginning of the period and the end of the period, adjusted to exclude:

   a) Changes in fair value due to the passage of time.

   b) Changes in fair value related to any payments received or made.
VI. Fair Value Hedges

A. In General

1. An entity may designate a derivative as one that hedges the exposure of changes in the fair value of an asset or liability that is attributable to a particular risk.
   a) A fair value hedge is an instrument designed to hedge the risk of exposure to change.
   b) Fair value hedges qualify as such if the reporting entity designates the hedge as an asset or liability and if the hedge is a firm commitment that has yet to be recognized.

2. All of the following criteria must be met in order to qualify for fair value hedge accounting.
   a) 1. Upon creation of a hedge, there must be formal documentation of the hedging relationship and management's strategy and objectives for undertaking the hedge.
      b) 2. From the creation of the hedge and throughout its life, the hedging relationship must be effective at offsetting changes in fair value attributable to the hedged risk. An evaluation of this effectiveness must occur at least every three months.
      c) 3. If a written option is designated as hedging a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favorable exchange in the fair value of the combined instruments as exposure to losses from an unfavorable change in their combined fair value.
      d) 4. The hedged item must be specifically identified as either all of a specific portion of a recognized asset or liability or of an unrecognized commitment.
      e) 5. The hedged item must be one of the following:
          (1) A percentage of the entire asset or liability.
          (2) One or more selected contractual cash flows.
          (3) A put option, a call option, an interest rate cap or floor.
          (4) The residual value in a lessor's investment in a direct financing or sales-type lease.
      f) The hedged item must be exposed to changes in fair value due to the hedged risk that could affect reported earnings.
      g) The hedged item is not:
          (1) An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk.
reported currently in earnings (e.g., the hedge of foreign exchange risk).

(2) An investment accounted for by the equity method.

(3) A minority interest in one or more consolidated subsidiaries.

(4) An equity investment in a consolidated subsidiary.

(5) A commitment to either enter into or dispose of a business combination.

(6) An equity instrument issued by the entity and classified as stockholders' equity in the statement of financial position.

h) If the hedged item is a held-to-maturity debt security, the hedged risk is due to changes in the obligor's creditworthiness. If the hedged item is an option component of a held-to-maturity debt security, the hedged risk is the risk of changes in the entire fair market value of that option component.

i) If the hedged item is not a financial asset or liability, the hedged risk is that of changes in the fair value of the entire hedged asset or liability.

j) If the hedged item is a financial asset or liability, the hedged risk is one of the following:

(1) The risk of changes in the fair value of the entire hedged item.

(2) The risk of changes in the fair value due to changes in the market interest rate.

(3) The risk of changes in the fair value due to changes in foreign currency exchange rates.

(4) The risk of changes in the fair value due to changes in the obligor's creditworthiness.

B. Accounting for Gains and Losses

1. The gain or loss on the hedging instrument must be recognized in current earnings.

2. The gain or loss on the hedged item caused by the hedge risk will adjust the carrying amount of the hedged item and must be recognized in current earnings.

3. Once the asset or liability no longer meets the necessary conditions, expires, or is sold, terminated, or exercised, or is no longer classified as a fair value hedge, gains and losses are no longer accounted for under SFAS 133.
VII. Cash Flow Hedges

A. In General

1. A hedge instrument can hedge the exposure to variability in the expected cash flows that is attributable to a particular risk.
   a) This risk can be associated with an existing recognized asset or liability (e.g., future interest payments on variable-rate debt) or a forecasted transaction (e.g., a forecasted purchase or sale).

2. Cash flow hedges are designed to hedge "the exposure to variability" due to risk of a particular cash flow of either an entity-recognized asset or liability or a transaction that is forecasted to occur.

3. In order to qualify as a cash flow hedge, all of the following criteria must be met.
   a) Upon creation of a hedge, there must be formal documentation of the hedging relationship and management's strategy and objectives for undertaking the hedge.
   b) From the creation of the hedge and throughout its life, the hedging relationship must be effective at offsetting changes in fair value attributable to the hedged risk. An evaluation of this effectiveness must occur at least every three months.
   c) If a written option is designated as hedging the variability in cash flows for a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows.
   d) If a hedging instrument is used to offset risk associated with variable rates, it must be a link between an existing designated asset with variable cash flows and an existing designated liability with variable cash flows. The instrument must be effective at offsetting these cash flows.
   e) The forecasted transaction must be specifically identified as a single transaction or group of transactions sharing identical risk.
   f) The occurrence of the forecasted transaction must be probable.
   g) The transaction must be with an external party and must present an exposure to variations in cash flows for the hedged risk that could affect reported current earnings.
   h) If the forecasted transaction relates to a recognized asset or liability, the asset or liability will not be remeasured with
changes in fair value attributable to the hedged risk reported currently in earnings.

i) For variable cash flows related to held-to-maturity securities, the risk being hedged cannot be the risk of changes in its cash flows attributable to changes in market interest rates.

j) The forecasted transaction cannot involve a business combination subject to the provisions of APB Opinion 16 and is not a transaction (such as a forecasted purchase, sale, or dividend) involving:

   (1) A parent companies interests in consolidated subsidiaries.

   (2) A minority interest in a consolidated subsidiary.

   (3) An equity method investment.

   (4) An entity’s own equity instruments.

k) If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the risk being hedged is not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient. (ex: in hedging the exposure to changes in the cash flows relating to the purchase of bronze inventory, an entity cannot designate the risk of changes in the cash flows relating to the purchasing of the copper component in bronze as the risk being hedged.)

B. Accounting for Gains and Losses

1. The effective portion of the gain or loss on cash flow hedges will be reported in other comprehensive income, and the ineffective portion will be reported in earnings.

2. Amounts in accumulated other comprehensive income are reclassified into earnings in the same period during which the hedged forecasted transaction affects earnings.

3. If an entity expects at any time that continued reporting of a loss in accumulated other comprehensive income would lead to recognizing a net loss on the combination of the hedging instrument and the hedged transaction, a loss is reclassified immediately into earnings for the amount that is not expected to be recovered.

4. Once the asset or liability no longer meets the necessary conditions, is expired, sold, terminated, or exercised, or is no longer classified as a cash flow hedge, accounting for gains and losses as described will cease.

   a) The net gain or loss will remain in accumulated other comprehensive income and will be reclassified into earnings
in the same period during which the hedged forecasted transaction affects earnings.

b) If a cash flow hedge is discontinued because it is probable that the original forecasted transaction will not occur, the net gain or loss in accumulated other comprehensive income is immediately reclassified into earnings.

VIII. **Foreign Currency Hedges**

A. Foreign Currency Fair Value Hedges

1. Foreign currency hedges are designed to hedge the risk of foreign currency changes for "an unrecognized firm commitment, an available-for-sale security, a forecasted transaction, or a net investment is a foreign operation."

   a) The same criteria applicable to fair value hedges apply to foreign currency fair value hedges.

   b) An instrument that may result in a foreign currency transaction gain or loss can be designated as hedging changes in the fair value of an unrecognized firm commitment attributable to foreign currency exchange rates.

   c) A nonderivative financial security cannot be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale security.

   d) A derivative instrument can be designated as hedging the changes in the fair value of an available-for-sale debt security attributable to changes in foreign currency exchange rates.

   e) An available-for-sale equity security can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates if the following conditions are met:

      (1) The fair value hedge criteria must be met.

      (2) The security cannot be traded on an exchange or other established marketplace on which trades are denominated in the investor's functional currency.

      (3) Dividends or other cash flows to holders of the security are all denominated in the same foreign currency as the currency expected to be received upon the sale of the security.

   f) Gains and losses on a qualifying foreign currency fair value hedge must be accounted for as specified for the fair value hedge.

      (1) The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under Statement 52.
(2) The foreign currency transaction gain or loss must be recognized currently in earnings along with the change in the carrying amount of the hedged firm commitment.

B. Foreign Currency Cash Flow Hedges

1. A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with either a forecasted foreign-currency-denominated transaction or a forecasted intercompany foreign-currency-denominated transaction qualifies for hedge accounting if the following criteria are met:
   a) The entity that has the exposure to foreign currency risk must be a party to the hedging instrument.
   b) The hedged transaction must be denominated in a currency other than the entity's functional currency.
   c) All of the criteria specified for cash flow hedges is met except the criteria that requires that the forecasted transaction be with a party external to the reporting entity.
   d) If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

2. A derivative instrument or a nonderivative financial instrument can be designated as hedging the foreign currency exposure of a net investment in foreign operations if the instrument may result in a foreign currency gain or loss under Statement 52.
   a) The gain or loss will be reported in the same manner as a translation adjustment to the extent it is effective for the hedge.
   b) Accounting for such a hedged investment will be consistent with Statement 52.
   c) The provisions set forth in this statement for recognizing the gain or loss on instruments in a fair value hedge do not apply to hedges on the net investment in a foreign operation.

IX. Disclosures

A. Information regarding hedging instruments must be disclosed.

1. Objectives for holding and issuing derivative instruments and the strategies for achieving those objectives must be disclosed.

2. The description must distinguish between derivative instruments designated as fair value hedging instruments, cash flow hedging instruments, hedges of the foreign currency exposure of a net investment, and all other derivatives.
3. Management's risk policy should also be disclosed.

B. Information regarding instruments not designated as hedging instruments must also be disclosed.
   1. The purpose of the hedge should be detailed.
   2. Management's objectives and strategies should be described in the context of the entity's overall risk profile.
   3. Additional qualitative disclosures are encouraged, but not required.

C. Disclosures for fair value hedges must include the following:
   1. The net gain or loss recognized in earnings for the period indicating the amount of the hedges' ineffectiveness and a description of where the net gain or loss is reported in the financial statements.
   2. The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.

D. Disclosures for cash flow hedges will include the following:
   1. The net gain or loss recognized in earnings for the period indicating the amount of the hedges' ineffectiveness and a description of where the net gain or loss is reported in the financial statements.
   2. A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in other comprehensive income and the estimate of gains or losses that will be reclassified in the next 12 months.
   3. The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions.

X. Reporting Changes in the Components of Comprehensive Income

A. An entity must display as a separate classification within other comprehensive income the net gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments that are reported in comprehensive income.

B. An entity must separately disclose the beginning and ending accumulated derivative gain or loss, the related net change associated with current period hedging transactions, and the net amount of any reclassification into earnings.

C. Effective date and transition
   1. This Statement will be effective for all fiscal quarters of all fiscal years beginning after June 15, 2000.
      a) On this date, all hedging relationships will be redesignated and documented according to this Statement.
b) This Statement will not be applied retroactively.

2. At the date of application, an entity must recognize:

   a) All freestanding derivatives in the statement of financial position as either assets or liabilities.

   b) A transition adjustment reporting the difference between a derivative's previous carrying amount and its fair value.

   c) Offsetting gains and losses on hedged assets, liabilities, and firm commitments by adjusting their carrying amounts.

   d) Any gains or losses that are reported independently as deferred gains or losses as of the date of initial application will be derecognized at that time.

   e) Any gains or losses on derivative instruments reported in other comprehensive income at the date of initial application.

D. Benefits of SFAS 133

1. Problems with previous accounting and reporting practices

   a) The effects of derivatives were not easily identified in the basic financial statements.

      (1) Under prior accounting practices, some derivatives were recognized in the financial statements and some were not.

      (2) Users of financial statements found it difficult to determine what an entity had or had not done with derivatives and the related effects because the basic financial statements often did not report the rights and obligations associated with derivative instruments.

   b) The accounting guidance for derivative instruments and hedging activities was incomplete.

      (1) Before SFAS 133, accounting standards had specifically addressed only a few types of derivatives.

      (2) Many derivative instruments were carried "off-balance-sheet" regardless of whether they were formally part of a hedging strategy.

      (3) Practices among entities were inconsistent in terms of accounting for derivatives.

      (4) Users of financial reports had inadequate information.

   c) The accounting guidance for derivative instruments and hedging activities was inconsistent.

      (1) Under previous guidance, the required accounting treatment differed depending on the type of
instrument used in a hedge and the type of risk being hedged.

(2) Derivatives were measured differently, and often, derivatives were unrecognized or were reported at nominal amounts not closely related to the fair value of the derivatives.

(3) Accounting standards were inconsistent on whether qualification for hedge accounting was based on risk assessment at an entity-wide or an individual-transaction level.

d) The accounting guidance for derivatives and hedging was difficult to apply.

(1) The lack of a single, comprehensive approach to accounting for derivatives made the available guidance difficult to apply.

(2) The incompleteness of FASB Statements on derivatives and hedging forced entities to look to a variety of different sources for guidance on proper accounting.

2. **SFAS 133** mitigates these problems

a) This Statement increases the visibility, comparability, and understandability of the risks associated with derivatives.

(1) It requires that all derivatives be reported as assets or liabilities and measured at fair value.

(2) It provides comprehensive guidance for all derivatives and hedging activities.

b) This Statement accommodates a range of hedge accounting practices.

c) This Statement clarifies and accommodates hedge accounting for more types of derivatives and different views of risk, and provides more consistent accounting for hedges of forecasted transactions than did the limited guidance that existed previously.

d) This Statement reduces the disclosure requirements that previously were required for derivatives.

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**FASB Exposure Draft:**

**Accounting For Certain Transaction Involving Stock Compensation An Interpretation Of APB Opinion No. 25**

I. **Introduction**
A. *APB Opinion No. 25, Accounting for Stock Issued to Employees,* was issued in October 1972.

1. Since that time, several issues regarding its application arose.
2. Many of these were addressed in *FASB Statement No. 123,* Accounting for Stock-Based Compensation.
3. However, *SFAS 123* did not supersede *APB Opinion 25.*
   a) It permitted entities to continue applying *APB Opinion 25* to stock-based compensation paid to employees but left many questions about the application of *APB Opinion 25* unanswered.
4. The issues addressed by this Interpretation have been resolved strictly within the framework of the intrinsic value method explained by *APB Opinion 25.*
5. Issues related to the accounting for stock-based compensation under *SFAS 123* are generally not addressed.

II. Scope

A. *APB Opinion 25* only applies to compensation that involves stock of the employer corporation issued to officers and other employees of the corporation.

1. This includes transactions that involve parent-company stock issued to an employee of a consolidated subsidiary reported in the separate financial statements of that subsidiary.

B. The common law definition of “employee” should be used to determine the applicability of *APB Opinion 25.*

1. Under the current common law definition, an individual is considered to be an employee if an entity has the right to direct and control the final results and details of when, where, and how the individual works.
2. In other words, the individual is subject to the will and control of the entity as to what is done and how it is done.

C. Currently, for payroll tax purposes the Internal Revenue Code defines an employee as an individual who qualifies as an employee under the common law definition.

1. Therefore, an individual that qualifies as an employee for payroll tax purposes will generally be regarded an employee for the purposes of applying *APB Opinion 25.*

D. *APB Opinion 25* does not apply to:

1. Grantees who are independent contractors or other service providers who are not reported as employees of the grantor for payroll tax purposes.
2. Compensation that involves stock options or awards granted to independent members of an entity's board of directors because such members are not employees under common law.

3. Transactions in which grants are made for stock or stock options of an entity that is not the employer corporation or its parent.

E. If a lease or co-employment agreement causes an individual to meet the definition of employee for the same set of services provided to more than one unaffiliated entity, only one entity can be designated as the employer corporation for purposes of applying APB Opinion 25.

1. The designated employer corporation is the entity that is primarily responsible for compensating the employee for those services.

2. The entity responsible for the payment and reporting of wages and collection and payment of related payroll taxes is usually presumed to be the employer primarily responsible for compensation.

F. If an individual changes status to or from an employee, but continues to provide services and no significant modifications are made to the terms of the nonvested stock option or award, compensation cost is measured under the appropriate method of accounting [the intrinsic value method under APB Opinion 25 or the fair value method under SFAS 123] as if the outstanding option or award was newly granted at the date of the change in status.

1. However, no adjustment is made to any compensation cost recognized during the vesting period prior to the change in status.

2. Moreover, if a significant modification is made to the terms of a nonvested stock option or award in conjunction with a change in employee status, the modified option or award is accounted for [prospectively] as an entirely new grant under the method of accounting appropriate for the new status of the grantee.

   a) In that case, any compensation cost measured is fully recognized over the remaining vesting [service] period.

3. Example: An independent contractor [nonemployee] is granted an option that vests in full five years from the date of grant. At the end of the second year of the vesting period, the independent contractor becomes an employee and continues to provide the same services.

   a) If the option qualifies as a fixed award under APB Opinion 25, a new measurement date is required under the intrinsic value method at the date of the change in status.

   b) However, only that portion of the newly measured compensation cost attributable to the remaining service period of 3 years (that is, 60 percent of the total vesting period of 5 years) is recognized. In other words, if the compensation cost measured at the intrinsic value at the date
of the change in status is $100, only $60 of that cost is recognized over the remaining 3-year vesting period. The remaining compensation cost measured as of the date of the change in status is not recognized. The compensation cost that was recognized during the first two years of the vesting period [under the fair value method of SFAS 123] is not adjusted.

III. Noncompensatory Plans

A. APB Opinion 25 refers to a plan that qualifies as a noncompensatory plan under Section 423 of the U.S. Internal Revenue Code.

1. Section 423 provides that one criteria for determining whether a plan is noncompensatory is that “the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others.” and a discount of up to 15 percent is reasonable for a qualified employee stock purchase plan.

B. A noncompensatory plan can be in the form of:

1. A stock option with an exercise price that is fixed at the date of grant.
   a) Provided that the exercise price of the option is not less than 85 percent of the stock price at the date of grant.

2. A plan with a look-back option.
   a) An example of a look-back option is a provision in an employee stock purchase plan that identifies the purchase price as the lesser of the stock's market price at the grant date or its market price at the exercise [purchase] date.

IV. New Measurement Date

A. According to the interpretation a new measurement date is required if the increase in the fair value of the stock option or award resulting from the plan modification is more than de minimis.

1. In applying that test, a comparison is made of the fair value of the option or award immediately before and after the modification.

2. The fair value of an option is determined using its remaining contractual term rather than its remaining expected life.

B. If the vesting date is accelerated because of a specific event or condition in accordance with the original terms of a stock option or award, no new measurement date is required. I.e.g. the vesting date is accelerated upon retirement, death, disability, or a change in control.

C. If, however an acceleration of the vesting date is not in accordance with the original terms of the option or award, it represents a modification. Therefore, a new measurement date is required if the increase in the fair value of the option or award is considered more than de minimis.

D. If a new measurement date is required for a nonvested option or award, the unrecognized portion of the original intrinsic value (if any) plus any
additional compensation cost measured is recognized over the remaining vesting period.

E. If a new measurement date is required for a fully vested option or award, any additional compensation cost is to be immediately recognized in full.

F. If a new measurement date is required, compensation cost is recognized and measured as follows:
   1. The compensation cost previously measured for the original intrinsic value of the stock option or award (if any) is recognized.
   2. For transactions that involve the cancellation of an option or award in connection with the issuance of a different type of award (for example, the cancellation of an option in connection with the issuance of restricted stock), additional compensation cost is recognized to the extent that the intrinsic value of the new award exceeds the intrinsic value of the original award at the new measurement date.
   3. For transactions that do not involve a change to the exercise price or the number of shares of an option (for example, an extension or renewal of the option term or an acceleration of the vesting date that reinstates an option that otherwise would be forfeited), additional compensation cost is recognized to the extent that the intrinsic value of the new award exceeds the original intrinsic value (if any) of the original award.

G. If cash is paid to an employee to settle an outstanding stock option, the total compensation cost recognized is the sum of:
   1. The original intrinsic value of the option (if any)
   2. Any cash paid in excess of that value.

H. If cash is paid to settle an earlier award of stock or to repurchase shares shortly after exercise of an option (for example, within six months), the total compensation cost recognized is the sum of:
   1. The original intrinsic value of the option or award (if any)
   2. The cash paid to repurchase the shares (reduced by any amount paid by the employee to acquire those shares) in excess of the original intrinsic value of the option or award.

I. The original intrinsic value of the option or award refers to the intrinsic value previously used to measure compensation cost.

**V. Variable Awards**

A. Variable reward accounting in required if:
   1. The exercise price or the number of shares to be issued are changed during the term of a fixed stock option, whether that option is vested or nonvested on the date it is modified.
      a) Consequently, the final measurement of compensation cost occurs at the date of exercise.
2. Shares of a stock option with a repurchase feature are expected to be repurchased shortly after option exercise or issuance (within six months), unless the repurchase is for tax withholding (public entities only).

3. The terms of the plan specify that shares can be withheld in excess of the minimum number required for tax withholding, any option or award granted is accounted for as a variable award.
   
   a) If the terms of the plan do not specify whether shares can be withheld in excess of the minimum number required for tax withholding and additional shares are withheld, compensation cost is measured at the date of the withholding and recognized as if the entire option or award is a variable award.

B. Variable award accounting is not required if:

1. The exercise price or the number of shares changes as a result of stock splits, stock dividends, and other similar equity restructurings and the increase in the option fair value is de minimis.

2. The stated share repurchase price is equal to the fair value of the shares at the date of repurchase, and the shares are not expected to be repurchased shortly after option exercise or issuance (nonpublic entities only).

3. The stated share repurchase price is not equal to the fair value of the shares at the date of repurchase, but the employee has a substantial investment and bears risks and rewards normally associated with share ownership for a reasonable period (nonpublic entities only).

4. Shares are repurchased for tax withholding purposes (nonpublic entities only).

5. Shares expected to be repurchased at fair value upon option exercise or issuance only to meet required tax withholding (based on the minimum statutory withholding rates for federal and state tax purposes, including applicable payroll taxes). If the terms of the plan specify that shares cannot be withheld (meaning that the employer retains the shares and applies the proceeds to the employees' tax withholding) in excess of the minimum number required for tax withholding, a stock option or award granted under the plan can be accounted for as a fixed award.

VI. Business Combinations

A. If options are exchanged in a pooling of interest business combination, a new measurement date is not required for changes to the exercise price or the number of shares of an outstanding option if at the date of the exchange:

1. The aggregate intrinsic value of the options immediately after the exchange is no greater than the aggregate intrinsic value of the options immediately before the exchange.
2. The ratio of the exercise price per option to the market value per share is not reduced.

B. In a purchase business combination, stock options granted by the acquirer in exchange for outstanding vested options for options that vest upon the change in control of the acquiree are considered part of the purchase transaction and accounted for under APB Opinion 16.

   1. Accordingly, the fair value of the acquirer options is included as part of the consideration paid for the acquiree.

VII. Other Related Issues

A. Grant Date

   1. Generally, awards granted under a plan that is subject to shareholder approval are not deemed granted until that approval is obtained. However, if such approval is essentially a formality (e.g., management and the members of the board of directors control enough votes to approve the plan), the grant date can be deemed to occur prior to shareholder approval.

B. Deferred Tax Assets

   1. Deferred tax assets are determined by the compensation expense recognized for financial reporting rather than by reference to the expected future tax deduction (which would be estimated using the current intrinsic value of the award).

      a) A valuation allowance to reduce the carrying amount of those deferred tax assets should only be established if the entity expects future taxable income to be insufficient to recover the deferred tax assets in the periods in which the deduction would otherwise be recognized for tax purposes.

C. Cash Bonus Plan Linked to a Stock-Based Plan

   1. A cash bonus associated with the grant of a stock option or award is accounted for as a combined variable award if payment by the entity or refund by the employee of the bonus is contingent upon vesting or exercise of the option.

VIII. Effective Dates

A. The provisions of the Interpretation would be effective upon issue and would apply to grants of stock options or awards, modifications to outstanding grants of stock options or awards, and changes in employee status after December 15, 1998.

B. The variable award provisions would apply to grants of stock options or awards made after December 31, 1999.

C. No compensation would be recognized for any additional cost measured upon initial application of this Interpretation that is attributable to periods prior to its issuance.