TOP ACCOUNTING ISSUES FOR 2008

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CCH Editorial Staff Publication

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TOP ACCOUNTING ISSUES FOR 2008 CPE COURSE

Introduction

CCH's *Top Accounting Issues for 2008 CPE Course* helps CPAs stay abreast of the most significant new standards and important projects in the accounting field. It does so by identifying the events of the past year that have developed into hot issues and reviewing the opportunities and pitfalls presented by the changes. The topics reviewed were selected because of their impact on financial reporting and because of the role they play in understanding the accounting landscape in the year ahead. The topics examined in this Course include:

- Derivatives and Hedging: FASB No.133
- Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: FASB No. 140
- Accounting for Certain Hybrid Financial Instruments and for Servicing of Financial Assets: FASB No. 155 and 156
- Fair Value Measurements: FASB No. 157
- Pension Plans—Employers: FASB No. 87 and 158
- Accounting for Uncertainty in Income Tax: FIN 48
- Financial Performance Reporting by Business Enterprises
- Cash Flow, Working Capital, and Other Financial Measurements

Throughout this Course you will find Examples and Observations to illustrate the topics covered and assist you with comprehension of the Course material, as well as Study Questions to help you test your knowledge. Answers to the Study Questions, with feedback on both correct and incorrect responses, are provided in a special section beginning on page 219.

To assist you in your later reference and research, a detailed topical index has been included for this Course beginning on page 247.

This Course is divided into three Modules. Take your time and review each Course Module. When you feel confident that you thoroughly understand the material, turn to the CPE Quizzer. Complete one or all Module Quizzers for Continuing Professional Education credit. You can complete and return the Quizzers to CCH for grading at an additional charge. If you receive a grade of 70 percent or higher on the Quizzers, you will receive CPE credit for the Modules graded. Further information is provided in the CPE Quizzer instructions on page 257.

September 2007

COURSE OBJECTIVES

This Course provides an overview of important accounting developments. At the completion of the Course, the user will:

- Know the definition of a derivative instrument, the general requirements for hedge accounting and understand fair value hedges, cash flow hedges, and net investment hedges
- Know how to assess control over financial assets, as well as how to account for the sale of and borrowing secured with financial assets
- Understand the accounting implications of an SPE and a VIE
- Comprehend the fair value measurement rules under Statement No. 157 and know about the tentative decisions regarding the future plans of FASB pertaining to fair value measurement
- Record entries for pension events, perform calculations to determine the net periodic pension cost, and value pension plan assets
- Prepare disclosures regarding pension plans for financial statements
- Understand the key ratios and calculations that track cash flow and other financial measurements in relation to GAAP income
- Comprehend the revenue recognition issues and primary concern in recent cases of fraud and accounting violations noted by the SEC as well as the status of the current FASB revenue recognition project
- Know about reporting problems announced by the SEC and the financial press such as restatements and underfunding of pension plans

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Derivatives and Hedging: FASB No. 133

LEARNING OBJECTIVES

At the completion of this chapter, the user will be able to:

- Comprehend the definition of a derivative instrument
- Review the general requirements for hedge accounting
- Understand fair value hedges
- Be aware of the "shortcut" method for interest-rate swaps
- Identify with cash flow hedges
- Comprehend net investment hedges
- Understand the disclosure requirements

UNDERSTANDING FASB STATEMENT NO. 133

Introduction

Advancing its long-term objective of measuring all financial assets and financial liabilities at fair value, the FASB issued Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, in June 1998.

This chapter discusses Statement 133 as amended, which addresses the accounting for derivative instruments including certain derivative instruments embedded in other contracts, and hedging activities.

FASB-issued Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, establishes the accounting framework for derivative instruments and hedging activities.

The FASB has developed a training course covering Statement 133's fundamentals. Also, the FASB has established a derivatives implementation group (DIG) that has assisted in developing implementation guidance. Once finalized and cleared by the FASB, the DIG issues become official FASB staff questions and answers (which are "level D" generally accepted accounting principles or GAAP). Fifteen public meetings of the DIG were held between September 1998 and March 2001. As a result of issues discussed during those meetings and subsequent implementation issues that continue to be developed by the FASB staff, a significant body of interpretative literature related to Statement 133 exists. In addition to DIG issues, there are several EITF issues and one D-Topic related to Statement 133, which are contained in *EITF Abstracts*.

Statement 133 sweeps in a broad population of entities and transactions. Under Statement 133, every derivative instrument is recorded in the balance sheet as either an asset or liability measured at its fair value. Statement 133 requires that changes in the derivative instrument's fair value be recognized currently in earnings unless specific hedge accounting criteria are met.

An entity that does not report earnings—for example, a not-for-profit—is required to report such changes as part of the change in its net assets.

Excerpt from Official Text:

Derivative Instruments

6. A *derivative instrument* is a financial instrument or other contract with all three of the following characteristics:

a. It has (1) one or more **underlyings** and (2) one or more **notional amounts**[3] or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.[4]

[3] Sometimes other names for "notional amount" are used. For example, the notional amount is called a face amount in some contracts.

[4] The terms *underlying, notional amount, payment provision,* and *settlement* are intended to include the plural forms in the remainder of this Statement. Including both the singular and plural forms used in this paragraph is more accurate but much more awkward and impairs the readability.

b. It requires no initial net investment or an initial net 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.

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

Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers) [as amended by paragraph 3 of Statement 149].

Statement 133 applies to all entities. The application of this Statement to entities such as not-for-profit organizations and defined benefit pension plans which do not report earnings as a separate caption in a statement of financial performance, is set forth in paragraph 43. Statement 133 does not apply to state and local governments; they are subject to generally accepted accounting principles established by the Governmental Accounting Standards Board (GASB).

STUDY QUESTIONS

1. Statement 133 changes the previous accounting definition of a derivative instrument in order to exclude embedded derivative instruments. ***True or False?***
2. Under Statement 133, every derivative instrument is recorded in the balance sheet at its cost. ***True or False?***
3. A derivative instrument is a financial instrument or other contract which must, in part, have (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. ***True or False?***
4. Statement 133 states that a derivative instrument does not require initial net investment or an initial net 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. ***True or False?***
5. Statement 133 does ***not*** apply to non-profit entities. ***True or False?***

Derivative Designations

Statement 133 does not provide hedge accounting to all transactions that are economic hedges. However, it does give accounting recognition to three types of hedging transactions:

- Exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment
- Exposure to variable cash flows of a forecasted transaction
- Foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction

Statement 133 requires entities to formally *document, designate, and assess the effectiveness of transactions that receive hedge accounting.* Special accounting for qualifying hedges allows a derivative instrument's gains and losses to offset related results on the hedged item as follows:

- Entities may designate a hedge against changes in the fair value of an asset, liability, or firm commitment due to a targeted, identified risk inherent in the hedged item (unless otherwise prohibited), referred to as a fair value hedge. In a fair value hedge, a derivative instrument is marked to its fair value currently through earnings with an offsetting, partial mark-to-fair-value of the hedged item (for the risk being hedged) currently through earnings.
- For forecasted transactions, an entity may designate a hedge against the variability in the transaction's cash flows due to an identified risk, referred to as a cash flow hedge. In a cash flow hedge, a derivative instrument is marked to its fair value through other comprehensive income (equity) and the gain or loss on the derivative instrument is removed from equity and recognized in earnings in the same period as the loss or gain on the hedged cash flow.

An entity may also decide to designate a hedge of the foreign currency exposure of a net investment. In a foreign operation, the changes in fair value of the derivative instrument (or the transaction gain or loss on a qualifying nonderivative instrument) are reported the same as the cumulative translation adjustment.

Statement 133 recognizes other hedges involving foreign currency exposures, including hedges involving:

- An unrecognized firm commitment (a foreign currency fair value hedge): offsetting loss or gain is recognized currently in earnings in the same accounting period
- An available-for-sale security (a foreign currency fair value hedge): offsetting loss or gain is recognized currently in earnings in the same accounting period
- A forecasted transaction (a foreign currency cash flow hedge): the effective portion of the gain or loss is reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings. The remaining gain or loss on the hedging instrument shall be recognized currently in earnings.

The remainder of this chapter explores several of Statement 133's key provisions, highlights specific implementation issues and illustrates the application of certain requirements.

STUDY QUESTIONS

6. If all hedge criteria are met, Statement 133 gives accounting recognition to the following types of economic hedges: a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; a hedge of the exposure to variable cash flows of a forecasted transaction; and a hedge of the foreign currency exposure of a net investment in a foreign operation. ***True or False?***

7. In a fair value hedge, a derivative instrument is marked to its fair value currently through earnings with an offsetting, partial mark-to-fair-value of the hedged item (for the risk being hedged) currently through earnings. ***True or False?***

8. In a cash flow hedge, a derivative instrument is marked to its fair value through other comprehensive income (equity) and the gain or loss on the derivative instrument is removed from equity and recognized in earnings in the same period as the loss or gain on the hedged cash flow. ***True or False?***

DEFINING A DERIVATIVE INSTRUMENT

Recognizing a derivative instrument as an asset or liability in the balance sheet seems straightforward in concept. But how is *derivative instrument* defined?

Statement 133 defines a derivative instrument as a financial instrument or other contract with all three of the following distinguishing characteristics:

- The settlement amount is determined using an underlying (for example, a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates) and a notional amount (such as a number of currency units, shares, bushels, pounds) or a payment provision.
- The initial investment is zero or is an amount that is smaller than, for example, the notional amount or the amount determined by applying the notional amount to the underlying.
- Net settlement is permitted or required, a market mechanism exists for net settlement, or the asset to be delivered is readily convertible to cash (as defined).

Excerpt from Official Text:

Derivative Instruments

9. *Net settlement.* A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:

a. Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.

b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

c. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash5 or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative.

[5] FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* states that assets that are readily convertible to cash "have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price" (paragraph 83(a)). For contracts that involve multiple deliveries of the asset, the phrase *in an active market that can rapidly absorb the quantity held by the entity* should be applied separately to the expected quantity in each delivery.

Note that this definition sweeps in commodity contracts (natural gas, corn, electric power and so on) if the contract has the characteristic of net settlement. Such contracts may be subject to an exception under paragraph 10(b) of Statement 133, as amended, if it is probable that the contract will not settle net and will result in physical delivery. Also, exceptions are made for the following items (as defined):

- "Regular-way" securities trades;
- Certain insurance contracts;
- Certain financial guarantees;
- Certain non-exchange-traded contracts (for example, weather derivatives);
- Contingent consideration issued in a business combination;
- Most contracts in an entity's own stock; and
- Contracts for stock-based compensation purposes.

Though *derivative* suggests stand-alone, option- or forward-based contracts—purchased commodity options, foreign exchange contracts, and interest-rate swaps, to name a few—Statement 133 also sweeps in derivative instruments embedded in broader nonderivative contracts, referred to as *embedded derivative instruments.*

Specifically, if the economic characteristics of an embedded derivative instrument and its host contract are not closely related, Statement 133 requires that the embedded derivative instrument be broken out (referred to as *bifurcation*) and accounted for like a stand-alone derivative instrument. For example, Statement 133 requires that, for financial accounting purposes, the call option embedded in an investment in convertible debt (the investor's option to call the issuer's stock) must be broken out from the host contract (plain-vanilla, interest-bearing debt).

For certain hybrid financial instruments that otherwise would require bifurcation, an entity may irrevocably elect to carry the entire instrument at fair value with changes in fair value reported in earnings. In that circumstance, neither the hybrid instrument nor the embedded derivative feature can qualify as a hedging instrument or hedged item.

In contrast, Statement 133 prohibits entities from separating a compound derivative instrument into components representing different risks and, thus, designating any such component as a hedging instrument.

Statement 133 requires entities to identify contracts that traditionally have not been considered derivative instruments. The bottom line is that entities must assess carefully the transactions and contracts that may be subject to Statement 133.

STUDY QUESTIONS

9. Contracts for stock-based compensation purposes are considered derivatives. ***True or False?***

10. If the economic characteristics of an embedded derivative instrument and its host contract are not closely related and the fair value election is not available or made, Statement 133 requires that the embedded derivative instrument be broken out and accounted for like a stand-alone derivative instrument. ***True or False?***

CLEARLY AND CLOSELY RELATED—IDENTIFYING EMBEDDED DERIVATIVE INSTRUMENTS

An embedded feature that meets the definition of a derivative instrument must be accounted for separately from its host contract if the economic characteristics and risks of the derivative instrument and host contract are not *"clearly and closely related"* (paragraph 12(a) of Statement 133). Separate accounting is not required if the entire contract is marked to fair value through earnings.

Examples of features that, if embedded in interest-bearing assets and liabilities, are not considered to have clearly-and-closely-related economic characteristics and risks include those which:

- Could cause the overall yield on the holder's investment to become negative (that is, could potentially cause the investor not to recover its investment under the contractual terms)

EXAMPLE

The contractual interest payments on a bond vary inversely with changes in the London Interbank Offered Rate (LIBOR). For example, the coupon interest rate is 12% minus three-month LIBOR. Since changes in three-month LIBOR could cause the investor's yield to become negative (for example, when three-month LIBOR exceeds 12%), this instrument would be split into a fixed-rate bond component and a receive-fixed, pay-floating interest-rate swap component. For accounting purposes, the embedded interest-rate swap must be accounted for separately from the host interest-bearing bond.

- Could at least double the investor's initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract with similar terms and credit quality.

- Automatically extends, or allows the counterparty unilaterally to extend, the remaining term of the contract, unless the interest rate is reset to current market interest rates and other criteria are met.

EXAMPLE

A five-year bond includes a provision that, if LIBOR falls by five basis points on any day, the maturity of the bond automatically is extended to seven years. The option to extend the maturity by two years must be accounted for separately from the host interest-bearing, five-year bond.

- Are tied to equity or commodity prices or indexes—for example, the price of IBM stock or gold, or the S&P 500.

EXAMPLE

The principal payments on a bond are tied to the S&P 500. The economic characteristics and risks of changes in the S&P 500 are not considered clearly and closely related to interest rates. So, the contract on the S&P 500 would need to be accounted for separately from the host contract, a plain interest-bearing bond.

In contrast, interest rates tied to inflation, such as inflation-indexed bonds, are considered to be clearly and closely related economically to an interest-bearing asset or liability, as are changes in interest rates tied to a change in creditworthiness.

EXAMPLE

Splitting is not required for a credit-sensitive bond having an interest rate that changes if *(a)* the issuer defaults, *(b)* the issuer's credit spread over U.S. Treasuries changes, or *(c)* the issuer's published credit ratings change. Also, entities are generally not required to split out any of the following:

- Interest-only and principal-only securities and prepayment features of servicing rights;
- Interest-rate caps and floors embedded in interest-bearing contracts;
- Puts or calls that accelerate principal repayment;
- Rentals indexed to inflation or contingent on changes in interest rates or the lessee's sales; or
- Instruments that have either principal, interest, or both, denominated in a foreign currency (for example, dual currency bonds).

Conclusions about whether to bifurcate generally, but not always, apply to both the investor and issuer.