

pricing inventory, from specific identification to a first-in-first-out method,<sup>2</sup> or a change in the method of revenue recognition. A change from an accounting principle that is *not* generally accepted to one that *is* generally accepted is treated as an error correction rather than as a change in accounting principle. In addition, the following are not treated as changes in accounting principles: adoption of an accounting principle for transactions that occur for the first time, such as adopting the leasing standard for a lease when the company has no other lease activities, and modification or adoption of an accounting principle for transactions or events that are clearly different from those that have occurred in the past. An accounting principle may be changed when one of the following two conditions are met: a new generally accepted accounting standard that requires the change is issued or the reporting entity can justify that a change to an alternative accounting principle is preferable (Paragraph 5).

When a newly issued accounting principle requiring a change in accounting principle does not specify the method of transition to the new statement, the provisions of SFAS No. 154 should be used when making the transition to the new statement (Paragraph 6).

If it is practicable to apply the retrospective method, a change in accounting principle is accounted for by using a retrospective application (Block 16) to all prior periods. The retrospective method is applied in the following manner:

1. Compute the cumulative effect of changing to the new accounting method for accounting periods prior to the earliest accounting period presented and report the impact of the change in the beginning balances of assets and/or liabilities affected by the change at the beginning of the first accounting period presented (Block 19),
2. Adjust the beginning balance of retained earnings<sup>3</sup> in the same accounting period in which the assets and/or liabilities are adjusted (Block 20), and
3. Restate all prior accounting periods presented using period-specific application to reflect the impact of the change in individual accounting periods presented (Block 21) (Paragraph 7).

The cumulative effect adjustment reported in the earliest period presented is computed as the difference between what the balances are in assets, liabilities, and retained earnings using the old method versus what the balances would have been if the new method had been used prior to the earliest period presented. The period-specific application is the adjustments to assets, liabilities, equity, and/or income as a result of applying the new accounting method to a specific accounting period presented. Only the direct effects (Block 18) of applying the

<sup>2</sup> In addition to these examples, FASB Interpretation No. 1 requires that changes in the computation of the cost elements included in inventory be treated as a change in accounting principle.

<sup>3</sup> Different types of organizations, such as not-for-profit organizations, may use different

terminology or concepts for retained earnings, such as other components of equity or net assets. Any reference to retained earnings in discussion of this material relative to the retrospective application also applies to these other components or concepts.

new accounting standards, including any effects on tax, should be used when applying the retrospective application. Indirect effects (Block 17), such as the impact of a change in a bonus in a prior accounting period as a result of a change in income from a retrospective application of a changed accounting principle, are not included in the retrospective application. If the indirect effects are actually reported—for example, the bonus in prior years is recomputed and recognized as a result of the change in accounting principle—they are reported in the accounting period that the change is made (Block 24) (Paragraph 10).

If it is impracticable to determine the period-specific impact on prior periods presented, but the cumulative effect on prior periods can be computed, the cumulative effect adjustment to the assets and liabilities and beginning retained earnings should be reported as described in 1 and 2 above. However, the restatement of prior accounting periods using a period-specific application as noted in 3 above would not be used, as it is impracticable to make that determination. When it is impracticable to determine the cumulative impact (Block 15) of a change in accounting principle on prior accounting periods, the change in principle should be applied in a prospective manner using the earliest date that is practicable (Block 23). A typical example of the prospective reporting of a change in accounting principle is a change to the last-in, first-out (LIFO) method of reporting inventory from another acceptable inventory method. SFAS No. 154 provides guidelines as to when an entity may apply the impracticability option when accounting for a change in accounting principle using the retrospective method. An entity may apply the impracticability option when one of the following criteria is met:

1. The entity is unable to apply the method after making all reasonable effort,
2. The entity cannot independently substantiate assumptions about intent of management in prior accounting periods, or
3. The entity cannot distinguish information about:
  - a. Estimates as they relate to availability at the date of the prior period, and
  - b. Evidence of circumstances in existence on the dates that amounts would be measured, reported, or disclosed because the method requires significant estimates (Paragraph 11).

A change in accounting principle must be justified by the entity making the change on the basis that an alternative acceptable accounting principle selected is preferable to the acceptable accounting principle previously used. The preferability requirement is satisfied when a new accounting principle is created, a preference is expressed for an existing accounting principle, or an accounting principle is rejected by the issuance of a new accounting principle by the Board. All other types of changes in accounting principles must be justified by the entity making the change. However, it is not acceptable to change an accounting principle for a single nonrecurring event or for situations that will be terminated or discontinued (Paragraphs 13 and 14).

- 505-10 Equity > Overall
- 605-10 Revenue Recognition > Overall
- 740-10 Income Taxes > Overall
- 830-10 Foreign Currency Matters > Overall
- 840-20 Leases > Operating Leases
- 840-30 Leases > Capital Leases
- 855-10 Subsequent Events > Overall

### Flowchart and General Discussion

This section of material covers issues related to revenue recognition and income statement presentation issues. APB No. 10 and several related accounting standards cover issues related to revenue recognition and APB Opinion Nos. 9<sup>1</sup> and 30, SFAS No. 144, and related standards cover income statement presentation issues.

APB No. 10 states that revenue is realized at the end of a completed transaction with adequate allowance for bad debts and, unless circumstances indicate that collectibility of the receivable is in doubt, the installment method of revenue recognition is unacceptable. In addition, FASB Concepts Statement No. 5 may be consulted for additional information about revenue recognition. Concepts Statement No. 5 states that revenue generally is recognized when it has been earned and realized. Normally, it is assumed that revenue has been realized when items such as merchandise have been exchanged for cash or claims to cash, and revenue has been earned when substantially all activities to earn the revenue have been accomplished (Paragraph 83). Additional revenue recognition issues are discussed in SEC SAB No. 101.<sup>2</sup> SAB No. 101 covers revenue recognition and income statement presentation issues and SAB No. 101B specifies the implementation date for SAB No. 101 to be the fourth quarter of the accounting period after December 15, 1999. SAB No. 101A specifies how registrants should comply with the revenue recognition accounting and disclosure requirements. FASB EITF No. D-85 covers transitional issues related to SAB No. 101. EITF No. D-85 states that all SEC registered companies must comply with the provisions of SAB No. 101. Depending upon the situation, transition will have to be made in one of the following ways: retroactive restatement of prior year's financial statements, change in accounting principle in accordance with SFAS No. 154 or error correction in accordance with SFAS No. 154. FASB EITF No. 99-19 also addresses a revenue recognition issue. The question addressed in EITF No 99-19 is whether

<sup>1</sup> The results of operations of an enterprise would not include transactions in company stock, changes in appropriated retained earnings, and adjustments associated with a quasi-reorganization. EITF No. 86-22 states that the Task Force did not recommend an income statement presentation for business restructuring costs.

<sup>2</sup> SEC SAB No. 104 revises and rescinds certain aspects in staff accounting bulletins related to Chapter 13 to make such guidance more consistent with current generally accepted accounting principles. See SAB No. 104 for more details about the revisions and modifications.

an entity should record revenue using a gross or net approach. Under the gross approach, an entity reports revenue equal to an amount that was billed to the customer. An entity, under the net method, reports revenue for the net amount retained from the sale, which is the difference between the amounts billed the customer less the amount paid to a supplier. EITF No. 99-19 states that whether the gross or net method is used depends on the circumstances. Several indicators of when each method should be used are provided by EITF No. 99-19.<sup>3</sup> EITF No. 07-1 states that a collaborative arrangement is an arrangement where two or more parties agree to jointly participate in an operating activity, such as the development of a drug or computer hardware. EITF No. 07-1 discusses how participants in a collaborative arrangement should report revenue earned and costs incurred from sales to third parties. The Task Force concluded that EITF No. 99-19 should be used to determine how costs and revenues should be reported. However, EITF No. 07-1 states that the equity method should not be applied to collaborative arrangements. In addition, the party to the collaborative arrangement that is classified as the principal participant should report the transaction on a gross basis. When other authoritative accounting requirements apply to payments related to collaborative arrangements, those requirements should be used. Other issues, including the definition of a collaborative arrangement and disclosure requirements, are discussed in Chapter 5. Additional revenue recognition issues are addressed in FASB EITF No. 00-21. EITF No. 00-21 discusses revenue recognition issues when there are multiple deliverables by the company to its customers, such as multiple products, performances, or services that may be delivered at different times. (See EITF No. 00-21 for more details). FASB EITF No. 00-24 covers revenue recognition issues related to situations where a company sells equipment with a trade-in right at a specified price. The issue is whether all the revenue from the sale should be recognized in the accounting period that the sale is made or whether part of the revenue should be allocated to the trade-in right. EITF No. 00-24 did not reach a consensus and FASB Interpretation No. 45 nullifies the majority view that revenue should not be allocated to the trade-in right. However, the Task Force discontinued discussion of issues related to EITF No. 00-24, because a major project on revenue recognition is planned by the FASB.

FASB EITF No. 00-10 covers income presentation requirements for shipping and handling costs. EITF No. 00-10 addresses the following two issues: what is the classification of shipping and handling costs billed to customers by the seller of merchandise, and what is the classification of shipping and handling costs when incurred by the seller? The Task Force EITF concluded that shipping and handling costs billed to customers should be classified as revenue in the income

<sup>3</sup> EITF No. 06-3 also addresses a net versus gross presentation in the financial statements covering taxes collected for revenue-producing activities of an entity. A consensus was reached in EITF No. 06-3 that the scope of EITF No. 06-3 applies to all taxes, such as sales, value added, and use tax related to revenue-producing transactions between a customer and a seller that is imposed by

governmental authorities and collected by the entity. In addition, the Task Force reached a consensus that using a gross or net presentation in the financial statements of such taxes collected is a policy decision to be made by the entity. The method elected by the entity should be disclosed in the financial statement footnotes in accordance with APB Opinion No. 22.

is appropriate in the circumstances, that operating segment is a reportable segment.<sup>2</sup>

If an operating segment fails both the revenue and profitability tests, it still may qualify for separate reporting, depending upon the dollar value of its assets. Operating segment assets used in the asset test are the assets used in allocation of resources to the segment and segment performance assessment.

If the assets of an operating segment are 10% or more of the combined total assets of all operating segments (Block 11), separate reporting for the segment is appropriate.

If an individual operating segment fails to meet any of the three major tests, it still may be reported separately if, in the accounting period prior to the current reporting period, the operating segment was a reportable segment and the enterprise believes that continued separate reporting of the segment is important (Block 12). When individual operating segments fail to meet any of the requirements for separate reporting, an entity may elect to combine information for two or more operating segments for purposes of retesting using the revenue, profitability, or asset test when most of the criteria for aggregation,<sup>3</sup> discussed above, are met (Blocks 13 and 14). Each individual operating segment must be tested separately or in some combination if aggregation is allowed or elected, to determine whether it should be classified as reportable or non-reportable (Block 15). Once the testing for all operating segments has been completed and all reportable segments have been isolated, two tests are imposed by SFAS No. 131 to insure that the information to be disclosed in the financial statements is meaningful.

First, the revenue from sales to external customers of all reportable operating segments should be combined. The combined total from reportable operating segments must be 75% or more of consolidated revenue (Block 16). If the combined revenues do not meet this test, additional operating segments must be added as reportable segments until the test is met. The additional operating segments to be added should come from the group of segments that failed to meet any of the tests described above. Although SFAS No. 131 does not provide guidance on how to select the additional segments for inclusion, it is logical to select those segments that came nearest to meeting the three major tests. For example, assume that one segment was excluded because its revenue, profitability, and assets were about 8% of the respective totals and that another excluded segment had revenues, profitability, and assets of about 5% of the same totals.

<sup>2</sup> EITF No. D-70 states that for the 10% profit or loss test used to determine reportable segments, an entity should use consistent profit and loss amounts for the test even if the chief decision maker uses different measures of profit and loss for different segments for decision making purposes.

<sup>3</sup> EITF No. 04-10 states that operating segments that do not meet the quantitative tests for reportable segments may be aggregated with other segments when such aggregation

is consistent with the objective of SFAS No. 131, meets the majority of the aggregation criteria discussed in this Chapter, and have similar economic characteristics. The effective date for EITF 04-10 is for years ending after September 15, 2005, with early application permitted. All prior years and interim period statements presented should be restated, unless the entity is unable to restate the statements.

Logic would dictate inclusion of the 8% segment before the 5% segment for purposes of meeting the 75% revenue test.

The final test identified in SFAS No. 131 involves the number of separately reportable segments. The purpose of this test is to keep the reporting and disclosure of operating segment information from becoming too detailed. If the number of reportable segments is greater than 10, the enterprise should consider whether a limit on the number of reportable operating segments has been reached, and the enterprise may wish to make an effort to combine segments in order to reduce the total reportable segments to 10 or less (Block 17). When combining reportable operating segments, logic suggests that those segments meeting more of the aggregation criteria should be combined first.

After all tests and other considerations, all operating segments that are classified as reportable segments should provide, by segment, the disclosure information required by SFAS No. 131 for reportable segments. Any operating segment not meeting the requirements to be reported separately may be separately disclosed if the company feels that separate reporting would be helpful to the users of the financial statements (SFAS No. 135, Paragraph 4 (x)). Otherwise, all operating segments classified as non-reportable segments should be combined into one category, and information reported separately for this category.

Reportable operating segments may not be structured in such a way as to report information about individual enterprise products or services or groups of related products and services, or the operating segments of an enterprise may not be structured such that operations of the segment are in one geographic area. For example, an individual operating segment may have several different products or services, and when disclosure information is provided by the operating segment, it is not possible for the users of such information to determine information about individual products or services and to assess risk related to such products and services. In addition, an operating segment may have operations in several different foreign countries and, because information is not provided by specific foreign countries, a user of the disclosure information provided by that reportable operating segment might not be able to assess the risk related to operations in one specific foreign country or geographic area. Therefore, SFAS No. 131 requires disclosures on an enterprise basis of information about products and services, geographic areas, and major customers on a total company basis if such information is not reported by the operating segment (Paragraph 36).

Flowchart 2-2 depicts the decision making process and general reporting requirements for products and services, geographic areas, and major customer information. If the operating segments of an entity are structured using individual products or services or related products or services (Block 1), product and service information is already included in the disclosures for reportable segments and no additional disclosures are required for products or services. However, if operating segments are not structured by products or services, the entity must disclose the amount of revenue for each product or service or related products or services generated from external customers, unless it is not possible for the enterprise to report such information. If reportable operating segments are

### Example 4-3 Exchange Assumptions

	Equipment A (Book-It, Inc.)	Equipment B (Jar, Inc.)
Cost	\$100,000	\$90,000
Accumulated Depreciation	20,000	15,000
Book Value	\$80,000	\$75,000
Fair Market Value	\$95,000	\$100,000

Again, the first step is to determine whether a loss is indicated. Turning first to Book-It, Inc., the fair value of \$95,000 is greater than the book value of \$80,000; therefore, no loss is indicated. Because Book-It, Inc. is the payer of the boot, no gain can be recognized on the exchange (Block 10). The asset received, Equipment B, is recorded at an amount equal to the book value of the asset surrendered, Equipment A, plus the boot paid. In this particular case, the amount assigned to Equipment B would be calculated as follows:

Book Value of Asset Surrendered	\$80,000
Cash Paid	5,000
Amount Assigned to Equipment B	\$85,000

The following journal entry is required on the books of Book-It, Inc. to record the nonmonetary exchange.

Equipment B	85,000	
Accumulated Depreciation—Equipment A	20,000	
Equipment A		100,000
Cash		5,000

For Jar, Inc., the fair market value of \$100,000 is greater than the \$75,000 book value of the asset. Therefore, no loss is indicated. On the contrary, a gain is indicated and Jar, Inc., as recipient of the boot, must recognize a portion of the gain. The amount of gain to be recognized is determined by the following formula:

$$G = MC - \left[ \left( \frac{MC}{MC + FAR} \right) (BV) \right]$$

Where:	G	=	Gain to be recognized.
	MC	=	Monetary consideration received.
	FAR	=	Fair value of asset received (or, if more clearly determinable, the fair value of the asset surrendered).
	BV	=	Book value of the asset surrendered.

Using this formula and the information given above, the gain to be recognized is calculated as follows:

$$G = \$5,000 - \left[ \left( \frac{\$5,000}{\$5,000 + 95,000} \right) (\$75,000) \right]$$

$$G = \$1,250$$

The expression is used to determine the percentage of the book value of the asset considered to be sold is:

$$MC = MC + FAR$$

Next, the amount to be recorded as the value of the asset received must be calculated, using a similar formula. The formula used for this purpose is presented below.

$$A = BV - \left[ \left( \frac{MC}{MC + FAR} \right) (BV) \right]$$

Where:	A	=	Amount recorded for the asset received.
	BV	=	Book value of asset surrendered.
	MC	=	Monetary consideration received.
	FAR	=	Fair value of asset received (or, if more clearly determinable, the fair value of the asset surrendered).

Using this formula and the related information, the amount to be used for the asset received can be calculated as follows:

$$A = \$75,000 - \left[ \left( \frac{\$5,000}{\$5,000 + \$95,000} \right) (\$75,000) \right]$$

$$A = \$71,250$$

Based upon the information generated from the two formulas, the following journal entry is required by Jar, Inc. to record the exchange:

Equipment A	71,250	
Accumulated Depreciation—Equipment B	15,000	
Cash	5,000	
Equipment B		90,000
Gain on Nonmonetary Exchange		1,250

With this entry, the discussion and illustrations of accounting for nonmonetary transactions is complete. Additional consideration will be given to the income tax implications of APB Opinion No. 29 as well as to the required disclosures.

### Income Tax Considerations

A difference may exist between the financial reporting and tax reporting of gains and losses on nonmonetary transactions. Any difference is considered to be a temporary difference and is accounted for in accordance with the provisions of SFAS No. 109. (See SFAS No. 109 in Chapter 6 for a detailed analysis of accounting for temporary differences.)

### Disclosure Requirements

The disclosure requirements of APB Opinion No. 29 are minor in nature and include the following items:

1. A description of the nature of the nonmonetary transactions, as well as of the accounting basis used for the transferred assets, must be disclosed; and
2. Gains and losses on nonmonetary exchanges must be disclosed.

property under operating leases of the lessor, capital leases recorded by a lessee, prepaid assets classified as long-term, and proved oil and gas properties when the successful efforts accounting is used (Paragraph 3). However, selected long-lived assets are not covered by SFAS No. 144. The following are excluded from the provisions of SFAS No. 144 (Paragraph 5):

1. Goodwill.
2. Intangible assets not subject to amortization.
3. Financial instruments.
4. Equity investments accounted for using either the cost or equity method.
5. Deferred tax assets.
6. Servicing assets.
7. Costs of policy acquisitions that are deferred.
8. Unproven oil and gas properties when successful efforts accounting is used.
9. Long-lived assets covered by SFAS Nos. 50, 63, 86, and 90.

When a long-lived asset covered by SFAS No. 144 is part of a group of assets, some of which are not covered by SFAS No. 144, SFAS No. 144 applies to the entire group, commonly referred to as the asset group. When the asset group is held for use, the group should be the lowest level of assets that generate independent cash flows. If the asset group is held for disposition, the disposal group represents an asset disposition that will occur in a single transaction and includes liabilities that will be transferred in the disposition.

SFAS No. 144 must be applied if an enterprise has recognized long-lived assets. The following discussion on long-lived assets is divided into two parts: long-lived assets held for disposition and long-lived assets held for use.

### Long-Lived Assets Held for Disposition<sup>2</sup>

When a long-lived asset is held for disposition, an enterprise must determine if the expected disposition is classified as a discontinued segment of a business, disposition of assets by abandonment, disposition by exchange or in a spin-off, or disposition by sale. If the proposed asset disposition meets the requirements for discontinued operations using Paragraphs 41–44 of SFAS No. 144, review the detailed discussion of discontinued operations in Chapter 1.

<sup>2</sup> SEC SAB No. 48 addresses the issue of whether to use cost or fair value to record assets transferred to a corporation from an individual when the individual retains control of the corporation. The individual may have received stock or cash in the transfer. SEC SAB No. 48 states that the cost basis of the party transferring the assets should be used

when recording the asset when the transfer is made by promoters or shareholders. SFAS No. 123(R), states that when goods and services are exchanged for stock with nonemployees, fair value should be used when recording the asset. See a detailed discussion of SFAS No. 123 in Chapter 8.

If the proposed asset disposition is not classified as discontinued operations, and the disposition is to be accomplished by abandonment, the long-lived asset should continue to be accounted for as an asset that is held for use. See a detailed discussion of assets held for use in the next section of this chapter. Disposition by abandonment of a long-lived asset is assumed to occur when the asset is no longer used. When a company has a specified plan for disposition that indicates a time period for abandonment that is less than the useful life used to compute current depreciation amounts, the depreciation amounts should be adjusted to reflect the shorter useful life of the asset. An asset should not be accounted for as abandoned when it is temporarily not in use (Paragraph 28).

Long-lived assets expected to be disposed of by exchanging them for similar productive assets or assets that will be disposed of in a spin-off to owners should be accounted for as held for use until the actual exchange or spin-off occurs. When future expected cash flows are used in the computation of any impairment loss while accounted for as held for sale, an entity must assume that the assets will not be exchanged or distributed. If the fair value of the asset is less than its carrying amount on the date of exchange or distribution, an impairment loss is reported for the difference. This impairment loss is in addition to any impairment loss reported while accounted for as held for use. See a detailed discussion of APB Opinion No. 29 in this chapter as it relates to the type of transaction that is considered an exchange or spin off.

Long-lived assets expected to be disposed of by sale must meet certain conditions before the assets can be classified as held for sale. When all of the following conditions are met, the asset or asset group should be classified as held for sale:

1. A plan to sell the asset has been committed to by management.
2. The asset can be sold in its current condition.
3. An active plan has been initiated to find a buyer.
4. It is probable that the asset will be sold and the sale will be completed within one year and will qualify as a completed sale, except as noted in Paragraph 31.<sup>3</sup>
5. The sales price is reasonable relative to the asset's current fair value and the entity is actively marketing the asset.
6. It is unlikely that the plan to sell the asset will be withdrawn or changed significantly.

If all the conditions are not met, the asset shall be classified as held for use (Paragraph 30).

Once an asset or asset group meets the preceding requirements, the asset is classified as held for sale. However, when assets no longer meet all held-for-sale

<sup>3</sup> EITF No. D-104 discusses issues related to transition under Paragraph 51 of SFAS No. 144. The Task Force does not think that the one-year rule applies to abandonment

through liquidation or run-off of operations because of specific situations. See more details in EITF No. D-104.

### Disclosures

The disclosure requirements for SFAS No. 86 are specified in Paragraphs 11 and 12 of SFAS No. 86 and include the following:

1. For each date that a balance sheet is presented, the balance in the unamortized computer software costs account is disclosed.
2. For each period that an income statement is presented, the following information is disclosed:
  - a. The amount of amortization of capitalized computer software costs charged to expense.
  - b. The amount of any losses incurred from the writedown of computer software costs to net realizable value.
  - c. The total research and development costs charged to expense.

This completes the discussion of SFAS No. 86.

### Historical Pronouncements

#### SFAS No. 142 (June 2001) Goodwill and Other Intangible Assets

and

#### SFAS No. 145 (April 2002) Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections

#### ASC References

- 205-20 Presentation of Financial Statements > Discontinued Operations
- 280-10 Segment Reporting > Overall
- 323-10 Investments—Equity Method and Joint Ventures > Overall
- 350-10 Intangibles—Goodwill and Other > Overall
- 350-20 Intangibles—Goodwill and Other > Goodwill
- 350-30 Intangibles—Goodwill and Other > General Intangibles Other than Goodwill
- 730-10 Research and Development > Overall

### Introduction<sup>1</sup>

SFAS No. 142, as amended by SFAS No. 141(R), supersedes APB Opinion No. 17, AICPA Interpretations related to Opinion No. 17 and ARB No. 43, Chapter 5, and amends several other accounting principles. SFAS No. 142 specifies the accounting and reporting requirements at the date of acquisition for intangible assets acquired individually or as a group purchase, except for intangible assets acquired in a business combination. SFAS No. 141(R) specifies the accounting and reporting requirements on the date of acquisition for intangibles and goodwill acquired in a business combination. However, SFAS No. 142 specifies the accounting and reporting requirements for goodwill and other intangibles subsequent to the date of acquisition. SFAS No. 142 does not apply to intangible assets reported as part of insurance contracts acquired using the provisions of SFAS No. 60. In addition, SFAS No. 142 does not change the accounting for specific accounting standards listed in Paragraph 8 (Paragraphs 1, 6, and 8 as amended by SFAS No. 141(R)). Intangible assets may be purchased individually, as part of a group, acquired as part of a business combination, or developed internally. Acquired intangible assets are recorded at fair value and amortized over their useful lives if the assets are deemed to have a finite life. In addition, intangible assets with finite lives are tested for impairment using SFAS No. 144. Intangible assets with indefinite lives are not amortized, but are tested for impairment using the provisions of SFAS No. 144. Goodwill acquired in a business combination is not amortized but is allocated to reporting units and tested for impairment using the provisions of SFAS No. 142.

#### Intangible Assets Acquired Individually or in a Group

An intangible asset acquired individually, such as the purchase of a patent, Internet domain name or customer lists, or with a group of assets should be reported as an asset at fair value (Paragraph 9). The fair value of an intangible asset is the amount that would be determined if the entity used the assumptions that market participants would use if they were pricing the intangible asset. The intangible asset should be measured at fair value even if the entity does not expect to use it or expects to use it in a manner that is not considered its highest and best use. SFAS No. 141(R), Paragraphs D2–D7, provide general concepts for initial measurement of intangible assets. When an intangible asset is purchased as part of a group of assets (acquisition of an intangible asset in a business combination is excluded), the fair value of the intangible asset is determined by allocating the acquisition price to all the assets acquired based on the relative fair values of all the assets purchased. No goodwill is to be recognized in such a group acquisition. (See Statement No. 141(R) in Chapter 13 for a detailed discussion of acquisition of intangible assets in business combinations and goodwill computations.) An intangible asset acquired individually or in a group purchase may have a finite or

<sup>1</sup> SFAS No. 145 rescinds the provisions of SFAS No. 44 related to the accounting for intangible assets related to motor carriers. SFAS No. 44 is no longer needed because transition to the deregulation laws related to

motor carrier interstate operating rights has been completed. Fair value used in SFAS 142 is computed using the fair value measurement requirements of SFAS No. 157. SFAS No. 157 is discussed in detail in Chapter 12.

### General Discussion

SFAS No. 5<sup>1</sup> identifies accounting principles and reporting requirements for contingencies.<sup>2</sup> A contingency is defined in SFAS No. 5 (Paragraph 1) as the

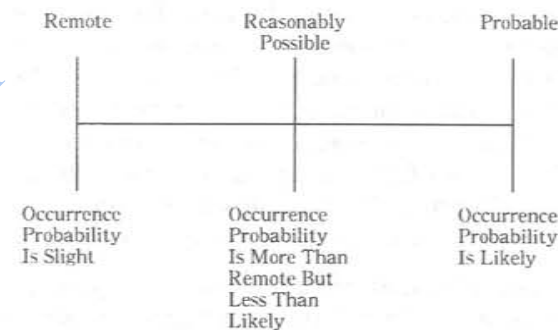
<sup>1</sup> SFAS No. 5, as amended by SFAS No. 112, does not apply to postemployment benefits offered through a pension or postretirement plan. However, SFAS No. 112 requires accrual of postemployment benefits when the benefits meet the requirements of SFAS No. 43 or SFAS No. 5. See an analysis of Statement No. 112 in Chapter 11. EITF No. 01-9 covers several issues related to the appropriate accounting for consideration given to a customer by a vendor. EITF No. 01-9 codifies the accounting information that previously was included in EITF Nos. 00-14 and 00-25. Some of the issues covered in EITF No. 01-9 include the following: when is a sales incentive given to a customer considered a reduction of revenue of the vendor and when is it considered to be a cost; when item 1 is reported as a reduction in revenue and this reduction creates negative revenue, should the negative revenue be reclassified as an expense; when should nonrefundable consideration given to a customer be reported as an asset and when should it be reported as an expense; and how should a sales incentive be reported if it results in a loss or does not result in a loss to the vendor? See EITF No. 01-9 for more details on issues discussed in EITF No. 01-9 and the conclusions reached by the Task Force. EITF No. 06-1 states that the provisions of EITF No. 01-9 should be used by a service provider to determine whether consideration is cash or other than cash consideration when the consideration is provided to a manufacturer or reseller (not a customer of the service provider) by the service provider and the consideration can contractually be linked to the benefit received by a customer of the service provider. In addition, EITF No. 06-1 states that the following disclosures are required: (1) amounts and related classification reported in the operations statement and for each accounting-period presented, and (2) nature of the programs provided. In addition, EITF No. 00-22 covers issues related to sales incentives. EITF No. 00-22 covers accounting issues by vendors related to points and time-based or volume-based sale incentive offers. The Task Force has discontinued discussion of issues in EITF No. 00-22 because they relate to revenue recognition and the FASB is working on a major project on revenue recognition. EITF No. 02-16 covers accounting issues by a

customer or reseller for consideration received from a vendor. EITF No. 02-16 states that cash received from the vendor generally should be a reduction of the cost of sales of the customer when reported in the customer's income statement. However, there are some other possible ways to handle the consideration depending on the circumstances. The customer should treat the cash consideration as revenue if it is considered a payment for assets or services delivered to the vendor. The consideration would be considered a payment for goods and services when the vendor receives an identifiable benefit (services or goods) for the cash consideration. The customer may be required to account for the cash consideration as a reduction of cost incurred by the customer to sell vendor products if the cash is a reimbursement of specific costs incurred in selling the product. The Task Force reached other conclusions relative to other accounting issues. See more details in EITF No. 02-16. EITF No. 03-10 changes some of the accounting as specified in EITF No. 02-16. When a reseller receives an incentive reimbursement from the vendor, the reseller should include the incentive reimbursement in sales if the following conditions are met: an incentive that can be tendered to the reseller by the consumer in part or full payment for a vendor product, the reseller receives a reimbursement based on the face amount of the incentive, the incentive is not negotiated as part of other offers, and the reseller has an agency relationship with the vendor. FASB Interpretation No. 48 states the provisions of SFAS No. 5 no longer cover uncertainty in income taxes. Uncertain tax positions now are accounted for using the provisions of FASB Interpretation No. 48. See a detailed discussion of FASB Interpretation No. 48 in Chapter 6.

<sup>2</sup> EITF No. 03-8 covers several issues related to insurance policies based on claims that are made. See Chapter 15 in the insurance area for more information about insurance policies. EITF No. D-77 discusses issues involving legal costs incurred or anticipated to be incurred when accounting for loss contingencies under SFAS No. 5. FSP EITF No. 00-19-2 states that a registration payment agreement where an entity has a contingent obligation to provide payments in the future

possibility of a gain or loss resulting from a situation, set of circumstances, or condition that currently exists where the outcome of the gain or loss will be determined at some future date by the occurrence or lack of occurrence of an event. Where a contingency may involve a gain, it is referred to as a gain contingency; and, where the possibility of a loss exists, the amount is referred to as a loss contingency. SFAS No. 5 provides new principles and procedures for the treatment of loss contingencies, but does not change existing practice relating to gain contingencies. SFAS No. 11 is an amendment to SFAS No. 5, and deals with the proper accounting for contingencies during the transition period.

SFAS No. 5 identifies different probabilities for the occurrence of a loss contingency. The probabilities range from probable to reasonably possible to remote. It is helpful to think of the range of probabilities as a continuum:



As indicated by the continuum, when a loss contingency exists, and it is determined that the probability of the future event occurring or failing to occur is slight, the loss contingency is referred to as remote. When the probability of the future event occurring is more than remote, but less than likely, the loss contingency is

(footnote continued)

should be accounted for using the provisions of SFAS No. 5 and FASB Interpretation No. 14. In addition, financial instruments subject to registration payment agreements should be accounted for using appropriate accounting principles such as SFAS No. 133 or APB Opinion No. 21. The following disclosures should be provided by the entity issuing the registration payment agreement: (1) nature of the agreement (agreement term, instruments covered by the agreement, and circumstances that would require transfer of consideration), (2) settlement alternatives and party controlling alternatives, (3) undiscounted maximum consideration or indication that no maximum is provided, and (4) carrying amount of issuer's liability and where gains and losses from change in the

liability are reported in the statement of income. SFAS No. 141(R), as amended by FSP FAS 141(R)-1, amends SFAS No. 5 and states that the initial recognition of assets or liabilities arising from contingencies that are recognized at fair value (or assets arising from contingencies recognized at an amount other than fair value) on the acquisition date in a business combination are not covered by SFAS No. 5. Initial recognition and measurement requirements for the assets and liabilities arising from contingencies recognized at fair value (and for assets arising from contingencies recognized at an amount other than fair value) as part of a business combination are covered by the provisions of SFAS No. 141(R) as amended by FSP FAS 141(R)-1.

## Historical Pronouncements

### SFAS No. 15 (June 1977) Accounting by Debtors and Creditors for Troubled Debt Restructurings

### SFAS No. 114 (May 1993) Accounting by Creditors for Impairment of a Loan and

### SFAS No. 118 (October 1994) Accounting by Creditors for Impairment of a Loan— Income Recognition and Disclosures

## ASC References

310 Receivables

450-20 Contingencies > Loss Contingencies

470-60 Debt > Troubled Debt Restructurings by Debtors

### Flowchart and General Discussion

SFAS No. 15, as amended by SFAS No. 114, establishes accounting and reporting standards for a restructuring of troubled debt.<sup>1</sup> Not all debt restructurings qualify for treatment as a troubled debt restructuring. Debt restructuring, troubled or otherwise, involves the modification or elimination of a debt instrument before, at, or after maturity date by means other than those required in the debt instrument. A troubled debt restructuring exists when the debtor is unable to meet current debt requirements and the creditor grants to the debtor a concession that normally would not be provided (Paragraph 2). In effect, the creditor is making the concession in hopes that he will receive more from the debtor than he would if the concession were not made.

Although there are many types of troubled debt restructurings, SFAS No. 15 identifies and treats in detail the following:

<sup>1</sup> FASB Technical Bulletin 80-2 states that it is possible for a debtor to have a troubled debt restructuring even though the related creditor's restructuring is not classified as troubled. To determine a troubled debt restructuring, the debtor and the creditor must individually apply the provisions of SFAS No. 15. In addition, FASB Technical Bulletin 80-1 states that the provisions of either APB Opinion No. 26 or SFAS No. 15 will be used to account for all early extinguishment of debt. In addition, FASB Technical Bulletin 81-6

suggests that the provisions of this pronouncement do not apply to debtors who, in connection with bankruptcy proceedings, enter into troubled debt restructuring that results in a *general* restatement of the debtor's liabilities. FASB Staff Position No. FAS 144-1 states that the valuation allowance related to foreclosed assets under SFAS No. 15 should not be carried over as a separate part of the cost basis for purposes of accounting under SFAS No. 144 after foreclosure.

1. Transfer of assets from the debtor to the creditor in full settlement of the debt;
2. Transfer of an equity interest in the debtor to the creditor in full settlement of the debt;
3. Modification of the terms<sup>2</sup> of the debt through a change in the interest rate, maturity date, face or maturity value of the debt, and accrued interest, or some combination of these items;<sup>3</sup>
4. Transfer of assets or an equity interest in partial settlement of the debt, and modification of the terms as described in 3 above.

This list is not meant to be all-inclusive, and other types of troubled debt restructurings will have to be evaluated on their merits. Flowcharts 7-5 and 7-6 are designed to illustrate the major accounting and reporting consequences of these four types of troubled debt restructurings. Flowchart 7-5 deals with the restructuring from the viewpoint of the debtor, and Flowchart 7-6 is from the viewpoint of the creditor. Specific provisions of SFAS No. 15, as reflected in the flowcharts, will be discussed under the debtor and creditor captions below.

### Troubled Debt Restructuring—Debtor Accounting

As indicated above, the discussion of debtor accounting for a troubled debt restructuring will incorporate the four basic types of restructurings. Each type of restructuring will be treated separately. After the four general types have been discussed, some additional accounting complications will be addressed, followed by the required disclosures specified in SFAS No. 15.

### Transfer of Assets in Full Settlement

One possible way to effect a debt restructuring is for the debtor to transfer assets to the creditor (Block 2). When such a restructuring occurs, it still is necessary to determine if the transaction qualifies for *troubled* debt restructuring treatment. The transaction will be considered a troubled debt restructuring only if the fair value of the assets transferred is not equal to or greater than the carrying amount of the payable (Block 3). When the fair value of the asset transferred is less than the carrying amount of the payable, the creditor has made a concession to the debtor. This is a basic requirement of troubled debt restructuring.

The determination of fair value of the asset transferred is discussed by SFAS No. 15, as amended by SFAS No. 157. SFAS No. 157 amends Paragraph 13 of SFAS

<sup>2</sup> EITF No. 96-22 states that when a debt under a troubled debt restructuring classified as a modification of terms is divided into two or more debts during the restructuring process, the creditor should treat each separately when determining disclosure requirements.

<sup>3</sup> EITF No. 89-15 states that a transaction with the same creditor, where an entity issues

new debt in exchange for old debt and the terms under the new debt are more advantageous than the terms under the old debt, but less advantageous than the terms that could be received by the creditor from other debtors, should be accounted for as a modification of terms under the provisions of SFAS No. 15.

Using the information from Table 7-24, the following journal entry is required on January 1, 20X6 to recognize the impairment loss from the troubled debt restructuring.

Bad Debt Expense	378,233	
Allowance for Bad Debts		378,233

The entry to the allowance account is for \$378,233, but the balance in the allowance account after this entry is \$428,233. The allowance for bad debts is a contra account to the note receivable, and if the allowance balance is not used to write off a portion of the note receivable in future years, the allowance account will be reversed against the note receivable at the end of the life of the note.

Interest income will be recognized each accounting period using the effective interest method (i.e., an application of a constant effective interest rate (10%, which is the effective rate in the original note) to the unrecovered present value of the future cash receipts). The difference between the cash interest received and interest income will be an adjustment to the note receivable account. Table 7-25 shows the cash interest, interest income, and receivable adjustment for the remaining four-year life of the note.

**Table 7-25**  
Computation of Interest Income and Receivable Adjustment

	Cash Interest	Interest Income	Receivable Adjustment	Present Value Balance
				<sup>a</sup> \$1,571,767
December 31, 20X6	<sup>b</sup> \$108,000	<sup>c</sup> \$157,177	<sup>d</sup> \$49,177	<sup>e</sup> 1,620,944
December 31, 20X7	108,000	162,095	54,095	1,675,039
December 31, 20X8	108,000	167,504	59,504	1,734,543
December 31, 20X9	108,000	173,457	65,457	1,800,000
Totals	<u>\$432,000</u>	<u>\$660,233</u>	<u>\$228,233</u>	

<sup>a</sup> Present value amount taken from Table 7-24.

<sup>b</sup>  $\$1,800,000 \times 6\% = \$108,000$ .

<sup>c</sup>  $\$1,571,767 \times 10\% = \$157,177$ .

<sup>d</sup>  $\$157,177 - \$108,000 = \$49,177$ .

<sup>e</sup>  $\$1,571,767 + \$49,177 = \$1,620,944$ .

In Table 7-25, interest income is computed using the effective interest rate of 10%. The difference in the interest income recognized using the 10% effective rate and the cash interest using the revised 6% rate is an increase in the note receivable balance. The entry required for 20X6 for recognition of interest income and receivable adjustment is as follows:

Cash	108,000	
Note Receivable	49,177	
Interest Income		157,177

Entries for the remaining three years will be the same except for the amounts. The amounts for the entries for 20X7–20X9 are shown in Table 7-25. Upon receipt of the principal amount of \$1,800,000 at the end of the life of the note, Creditor, Inc. must remove the allowance for bad debts of \$428,233 (Table 7-24) established at the date of restructuring and prior years because it was not used for any write-offs subsequent to restructuring. In addition, the balance in the note account of \$2,228,233 (\$2,000,000 original balance + \$228,233 receivable adjustment from Table 7-25) must be removed. The entry required at the end of the life of the note is presented below.

Cash	1,800,000	
Allowance for Bad Debts	428,233	
Note Receivable		2,228,233

Example 7-21 related to a modification of terms and was a straightforward situation with no existing discounts, premiums, accrued interest or other unamortized items. Example 7-22 incorporates some of these unamortized items into the computation. Assumptions for Example 7-22 are as follows.

**Example 7-22**  
Modification of Terms

1. Creditor, Inc., a December 31 year-end enterprise, has a \$350,000, 8%, six-year note receivable from Debtor, Inc. that was issued January 1, 20X4. The market rate of interest on the date the note was issued was 10%. Amortization of the note receivable discount from 20X4–20X9 is presented below.

	Cash Interest	Interest Income	Discount Amortization	Investment in Note Receivable
				\$319,513
December 31, 20X4	\$28,000	\$31,951	\$3,951	323,464
December 31, 20X5	28,000	32,346	4,346	327,810
December 31, 20X6	28,000	32,781	4,781	332,591
December 31, 20X7	28,000	33,259	5,259	337,850
December 31, 20X8	28,000	33,785	5,785	343,635
December 31, 20X9	28,000	34,365	6,365	350,000
Totals	<u>\$168,000</u>	<u>\$198,487</u>	<u>\$30,487</u>	

2. On January 1, 20X6, because of economic problems faced by Debtor, Inc., Creditor, Inc. is willing to accept the payment of \$100,000 per year for the next four years in place of the original note. On this date, there is \$28,000 of accrued interest on the note, and as noted from the preceding table, the note has a \$22,190 (\$350,000 – \$327,810) unamortized discount.
3. Creditor, Inc. has a \$15,000 allowance for bad debts related to this note that was established in a prior accounting period.

and equity features and include convertible debt, debt with non-detachable stock purchase warrants, and debt with detachable stock purchase warrants. The basic thrust of APB Opinion No. 14 is to determine when it is appropriate to account for the debt and equity elements of these securities on an individual basis.

The discussion that follows will treat separately each of the securities specifically identified in APB Opinion No. 14.

### Convertible Debt<sup>1</sup>

<sup>1</sup> EITF No. 85-29 covers several issues related to convertible debt that has a put premium. The put option discussed in EITF No. 85-29 is considered a form of guarantee covered by the provisions of FASB Interpretation No. 45. See a discussion of Interpretation No. 45 in Chapter 7. SFAS No. 133 in Chapter 12 may require this type of security to be classified as a derivative. EITF No. 85-29 states that SFAS No. 155 amends SFAS No. 133 and allows for fair value accounting for some hybrid instruments that would generally be bifurcated. EITF No. 98-5 covers the following accounting issues: valuation of embedded beneficial conversion features in convertible securities, recognition and measurement of embedded conversion features if the features are valued separately, and accounting for convertible securities where the conversion ratios adjust when specific future events occur. Instruments within the scope of FSP APB 14-1 are excluded from the scope of EITF No. 98-5. See EITF No. 98-5 (as amended by FSP APB 14-1) for details about the conclusions. EITF No. 08-8 clarifies whether a financial instrument for which the payoff to the counterparty is based, in whole or in part, on the stock of an entity's consolidated subsidiary is indexed to the reporting entity's own stock. If it is, the financial instrument may qualify for the first part of the scope exception in paragraph 11(a) of SFAS No. 133. It may also fall within the scope of EITF No. 00-19. EITF No. 00-27 states that the intrinsic value model used in EITF No. 98-5 should be retained in considering the valuation of embedded beneficial conversion options. In addition, EITF No. 00-27 covers several other issues related to convertible instruments. SFAS No. 150 impacts the accounting for a convertible instrument where the beneficial conversion option terminates after a specified period of time and the instrument is then mandatorily redeemable. At the time the security becomes mandatorily redeemable, it is classified as a liability under the provisions of SFAS No. 150. See a detailed discussion of SFAS No. 150 in Chapter 12. See

more details in EITF No. 00-27. EITF No. 01-1 states that EITF No. 96-18 should be used to determine the measurement date when a convertible instrument is exchanged for goods and services or a combination of goods, services, and cash. In addition, distributions paid or payable under such an instrument should be treated as financing costs when the instrument is considered issued. Prior to time of issuance, the distributions should be accounted for as part of the goods or services. EITF No. 01-1 also states that the instrument and the agreement for the goods and services should be assessed to determine whether separate pricing is equal to fair value. If a freestanding instrument has an embedded derivative, the equity classification requirements of EITF No. 00-19 are not applicable if the instrument is a conventional convertible debt issue and the value of the conversion option may only be realized by the holder upon receipt of the entire proceeds in a fixed number of shares or equivalent amount of cash at the exercise of the option. EITF No. 05-2 states that the equity classification exceptions in EITF No. 00-19 are still applicable for conventional convertible debt instruments. SFAS Nos. 160 and 141(R) amend ARB No. 51 related to noncontrolling interests in subsidiaries. However, SFAS No. 160 does not impact the conclusions reached in EITF No. 00-19 other than changing the wording from "minority interest" to "noncontrolling interest." SFAS No. 141(R) removes part of the wording from Paragraph 3 of EITF No. 00-19. In addition, EITF No. 05-2 states that an instrument where the option to convert into a specified number of shares or equivalent amount of cash by the holder and is based on the passage of time or a contingent factor is classified as a conventional convertible debt instrument when applying the provisions of EITF No. 00-19. EITF No. 06-6 supersedes EITF No. 05-7 and states that any change in fair value of a conversion option embedded in a convertible debt issue should not be included in the cash flow test when determining

Convertible debt<sup>2</sup> is debt that can be changed into common stock of the entity issuing the debt security, or an affiliated enterprise, and generally is issued at a

(footnote continued)

whether the debt issue terms of the old and new debt are substantially different for purposes of determining whether the convertible debt has been extinguished in accordance with the provisions of EITF No. 96-19 when the change in fair value is a result of a modification of the convertible debt issue. When the cash flow test does not conclude that a modification or exchange has occurred, a separate analysis must be performed; and if the change in fair value of the embedded option is at least 10% of the old debt's carrying value just prior to the modification, extinguishment accounting should be applied. When extinguishment accounting is not appropriate, the carrying amount of the debt instrument should be reduced and paid-in-capital should be increased for the increase in fair value of the embedded option. EITF No. 05-8 states that when a company issues convertible debt with a beneficial conversion feature, a difference in financial accounting and tax basis is created as both a debt and equity instrument are created for financial accounting purposes and only a debt instrument is created for tax purposes. The difference in basis is accounted for as a taxable temporary difference when computing deferred taxes and is reported as an adjustment to paid-in-capital.

<sup>2</sup> FSP APB 14-1 applies to convertible debt instruments that may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless SFAS No. 133 requires the embedded conversion option to be separately accounted for as a derivative. Issuers of instruments that FSP APB 14-1 applies to should separately account for the liability and equity components in a manner that reflects the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. For the liability component, the issuer should amortize the excess of the principal amount over the carrying amount to interest cost using the interest method, as described in paragraph 15 of APB Opinion No. 21. The equity component (i.e., the conversion option) is not remeasured as long as it continues to meet the conditions for equity classification in EITF No. 00-19. Upon derecognition, for instruments within the scope of FSP APB 14-1, the issuer should allocate the consideration transferred and transaction costs incurred to the extinguishment of the liability component and the reacquisition of the equity

component. FSP APB 14-1 also establishes new requirements for issuers to disclose the terms of convertible debt instruments within its scope and explain how the instruments have been reflected in the issuer's financial statements. EITF No. 06-7 states that convertible debt issued with an embedded conversion option may initially meet the requirements for bifurcation under SFAS No. 133; however, subsequent to initial accounting, the requirements for bifurcation may no longer be met. When a convertible debt issue no longer meets the requirements for bifurcation, the liability's carrying amount should be reclassified as stockholders' equity. The entity should continue to amortize any unamortized debt discount. If subsequent to reclassification as stockholders' equity the conversion option is exercised, any unamortized debt discount existing at the date of exercise should be charged to interest expense. In addition, if the debt issue is extinguished for assets such as cash subsequent to the reclassification as stockholders' equity the reacquisition price should be allocated to equity and debt as follows: (1) at the date of extinguishment, an amount equal to the fair value of the conversion option is allocated to equity, and (2) the remaining part of the reacquisition price is allocated to the debt for extinguishment gain or loss computations. The following disclosures are required for a debt instrument meeting the conditions of EITF No. 06-7: (1) description the changes that caused the conversion option to no longer meet the bifurcation requirements of SFAS No. 133 and (2) the amount of the reclassification to stockholders' equity. EITF No. 05-1 addresses the accounting requirements for a debt instrument that will be convertible when an issuer exercises a call option associated with the debt instrument. EITF 05-1 states that no gain or loss is reported when an equity issue is used to settle a debt instrument, because the settlement is considered to be a conversion if at the issuance date of the debt instrument there was a substantive conversion feature. However, if there was no substantive conversion feature, the settlement of the debt with the equity issue is accounted for as a debt extinguishment. The fair value of the equity issue is considered part of the debt's reacquisition price. A conversion feature is classified as a substantive conversion feature for the purpose

Securities that participate in dividend distributions with common stockholder, such as fully participating or partially participating preferred stock, should be included in the earnings per computation, if dilutive, using the assumed converted (if converted) procedure (Paragraph 61). See a detailed discussion of the if converted procedure in the analysis of convertible securities.

When a company has two or more classes of common stock (or common stock and participating nonconvertible preferred stock) with different rates of dividends, and no class of stock has senior rights over the other class of stock, such as dividend preferences or preferences upon liquidation, the two-class procedure should be used when computing earnings per share. The two-class procedure is applied as follows: dividends from all classes of stock are used to reduce income from continuing operations, and the remaining income after deducting dividends is allocated to each class of stock based on its right of participation in the income, assuming that all income is distributed. Both basic and diluted earnings per share is computed, if required, for each class of stock by following the earnings per share procedures discussed in the previous sections (Paragraph 61).<sup>8</sup>

(footnote continued)

method does not require a basic and diluted presentation for securities other than common stock, any form of participation in undistributed earnings of a security would constitute participation, participating securities would include all potential common shares that have a current right to participate in earnings of the entity, undistributed earnings should be allocated to the participating security based on contractual participation rights, and undistributed earnings should continue to be allocated to the participating nonconvertible security even in periods of losses that would be antidilutive. See EITF No. 03-6 (as amended by FSP EITF 03-6-1) for more details. EITF No. 04-12 discusses whether equity-based compensation is participating securities. The Task Force removed this issue from its agenda.

<sup>8</sup> EITF No. D-98 states that when an entity has redeemable common stock that can be redeemed at an amount other than fair value, any change in the carrying value of the security is incorporated into the earnings per share computation using the two-class procedure. However, the two-class procedure would not be used if the security is redeemable at fair value as fair value redemption is not equivalent to a preferential distribution. EITF No. 07-4 discusses how a master limited partnership (MLP) should allocate current earnings to the general partner (GP), limited

partners (LP), and to holders of incentive distribution rights (IDRs), if appropriate, when applying the two-class method of computing earnings per share under the provisions of SFAS No. 128. The Task Force reached the following consensus: (1) the issue applies to MLPs where the incentive distribution is an equity distribution, (2) the issue applies to all distributions whether the incentive distribution is separate or embedded in the interest of the general partner, (3) when cash distributions are less than current earnings and the incentive distribution rights are separate, the undistributed earnings should be allocated to the GP, LP, and IDRs based on the contract terms of the agreement, and if the IDR is embedded in the GP, allocation should be made to the GP and the LP using the contractual agreement distribution formula for cash available, and (4) when cash distributions are greater than current earnings, adjustments should be made to net income of the holders and any distributions in excess of earnings should be allocated to the holders based on their contractual obligation to share in losses. In issue 2, above, current-period earnings are allocated to the GP, LP, and IDR using the two-class method when the IDR is a separate interest. If the IDR is embedded in the GP, the IDR is not considered a participating security, and current earnings are allocated using the two-class method to the GP (rights of the IDR are included in the GP) and LP.

To illustrate the two-class procedure, assume the facts in Example 9-10.

**Example 9-10  
Two-Class Common**

1. Ward, Inc. (Ward), a December 31 year-end company, is computing earnings per share for 20X6.
2. Ward has 10,000 shares of 8%, \$50 par value fully participating nonconvertible preferred stock.
3. Ward had 100,000 common shares with a par value of \$10 outstanding on January 1, 20X6. No common or preferred shares were sold or repurchased during 20X6.
4. Ward had no potentially dilutive securities during 20X6.
5. Ward paid \$150,000 in dividends to both preferred and common shareholders, and income after tax for 20X6 was \$450,000.

Ward has a simple capital structure and will only report basic earnings per share, because it has no potentially dilutive securities. The first step in determining the allocation of earnings to preferred and common stocks in the EPS computation is to determine the allocation of the \$150,000 in dividends declared for 20X6. Because the preferred stock is fully participating, both common and preferred receive an equal percentage times their par value times the number of shares. First, dividends of \$40,000 ( $\$50 \times 8\% \times 10,000$  shares) will be allocated to the preferred stock. Second, dividends of \$80,000 ( $\$10 \times 8\% \times 100,000$  shares) will be allocated to common. The balance of the dividends of \$30,000 ( $\$150,000 - \$40,000 - \$80,000$ ) will be allocated one-third to preferred and two-thirds to common. The one-third and two-thirds allocation is based on the ratio of the balance in the capital accounts of the stock. Preferred has a balance of \$500,000 ( $\$50 \text{ par} \times 10,000$  shares) and common has a balance of \$1,000,000 ( $\$10 \text{ par value} \times 100,000$  shares). Therefore, the \$30,000 remaining dividend balance is allocated \$10,000 ( $1/3 \times \$30,000$ ) to preferred and \$20,000 ( $\$30,000 \times 2/3$ ) to common. The allocation of the \$150,000 in dividends is computed as follows:

	Preferred Stock	Common Stock
\$50 par $\times$ 8% = \$4.00 $\times$ 10,000 shares .....	\$40,000	\$80,000
\$10 par $\times$ 8% = \$.80 $\times$ 100,000 shares .....	10,000	
1/3 to preferred ( $\$30,000 \times 500,000/1,500,000$ ) .....	<u>10,000</u>	20,000
2/3 to common ( $\$30,000 \times 1,000,000/1,500,000$ ) .....	\$50,000	<u>\$100,000</u>
Total .....	<u>\$100,000</u>	<u>\$100,000</u>

Ward had earnings of \$450,000 for 20X6 and distributed \$150,000 in dividends, leaving undistributed earnings of \$300,000. The \$300,000 in undistributed earnings must be allocated to preferred and common based on the fully participating feature. Therefore, the undistributed earnings should be allocated to preferred

more of the total fair value of the leased property, the land element and the building element will be treated as separate units of leased property.

Even though ownership does not transfer to the lessee, the Example 10-17 lease qualifies as a capital lease because the lease term of five years is more than 75% of the economic life of the building and the two risk-transfer criteria are met. Cost is equal to fair value of the property at inception of the lease; therefore, the Example 10-17 lease is a direct financing lease.

Because the lease is a capital lease, and the land element is 25% or more of the total fair value of the assets, the MLP must be divided between the land element and the building element. The procedure for dividing the MLP requires that the fair value of the land be discounted at the lessee's incremental borrowing rate to determine the portion of the MLP that will be associated with the land. This is accomplished as follows:

Fair Value of Land	\$100,000	=	\$23,586
Present Value Factor <sup>a</sup>	4.23972		

<sup>a</sup> Present value factor for an annuity due at 9% for five periods. See Appendix A, Table III.

The \$23,586 will be the portion of the total MLP associated with the land element of the lease. The difference between the MLP assigned to the land and the total MLP will be the MLP assigned to the building portion of the lease. The difference is determined in the following manner:

Rental Payment Required	\$78,000
Less: Executory Costs	3,000
	<u>\$75,000</u>
MLP Assigned to Land	(23,586)
MLP Assigned to Building	<u>\$51,414</u>

Once the MLP associated with the building element has been determined, the next step is to calculate the gross investment and unearned income. These two amounts are determined as follows:

MLP Assigned to Building	\$51,414
Number of Lease Payments	x 5
Gross Investment in Lease	\$257,070
Less: Fair Value of Building	<u>211,240</u>
Unearned Income	<u>\$45,830</u>

Based upon the information developed above, the following entry would be required at inception of the lease:

Minimum Lease Payment Receivable	257,070	
Unearned Income		45,830
Building		<u>211,240</u>

The land element of the lease is treated as an operating lease. Income would be recognized as the periodic rental payment is received.

To amortize the unearned income over the lease term, using the interest method, the implicit interest rate relating to the building portion of the lease must be determined. In the absence of a computer program to calculate the interest rate, the following formula will provide the present value factor that corresponds with the new effective rate:

$$X = \frac{M - UI}{P}$$

- Where:
- X = Present value factor of an annuity
  - M = Total minimum rental payments applicable to building
  - UI = Unearned income
  - P = Periodic minimum rental payment applicable to building.

Given the information above, the formula will provide the following results:

$$X = \frac{\$257,070 - \$45,830}{\$51,414} = 4.10861$$

The answer of 4.10861 represents the present value factor for an annuity due for five periods. Using Table III in Appendix A, move across the 5 periods row until a present value factor close to 4.10861 is found. The actual implicit interest rate is somewhere between 10% and 11%. To obtain the exact rate, it will be necessary to interpolate or to use the trial-and-error method. For the Example 10-17 lease, the implicit interest rate is 10.9069%, which was derived through the use of a computer program. Given this interest rate, Table 10-21 shows the proper income recognition for the lease.

Table 10-21  
Lease Amortization Schedule

Period	Annual Rental	Annual Interest Income	Principal Reduction	Present Value of Year-End Balance
Initial Value				<sup>a</sup> \$211,240
1	\$51,414	<sup>b</sup> \$17,432	<sup>c</sup> \$33,982	<sup>d</sup> 177,258
2	51,414	13,726	37,688	139,570
3	51,414	9,615	41,799	97,771
4	51,414	5,057	46,357	51,414
5	51,414	-0-	51,414	-0-
	<u>\$257,070</u>	<u>\$45,830</u>	<u>\$211,240</u>	

<sup>a</sup> Fair value and cost of building at inception of lease.

<sup>b</sup>  $(\$211,240 - \$51,414) \times 10.9069\% = \$17,432$ .

<sup>c</sup>  $\$51,414 - \$17,432 = \$33,982$ .

<sup>d</sup>  $\$211,240 - \$33,982 = \$177,258$ .

**Table 11-6**  
Calculation of Deferred Asset Gains or Losses

<b>20X6</b>	
DAG/(L) =	$((\$1,100,000 - \$169,750 + \$169,750) - \$1,025,000) - (11\% \times \$1,025,000)$
DAG/(L) =	$\$75,000 - \$112,750$
DAG/(L) =	$\$37,750$ (loss)
<b>20X7</b>	
DAG/(L) =	$((\$1,325,000 - \$223,908) + \$223,908) - \$1,100,000 - (11\% \times \$1,130,200)$
DAG/(L) =	$\$225,000 - \$124,322$
DAG/(L) =	$\$100,678$ (gain)
<b>20X8</b>	
DAG/(L) =	$((\$1,450,000 - \$269,907 + \$269,907) - \$1,325,000) - (11\% \times \$1,267,108)$
DAG/(L) =	$\$125,000 - \$139,382$
DAG/(L) =	$\$14,382$ (loss)

As shown in Table 11-6, the actual return on plan assets exceeds the expected long-term rate of return on market-related value of plan assets only for 20X7. When the actual return exceeds the expected return on the market-related value of plan assets, a deferred gain is recognized. In years 20X6 and 20X8, the expected return on assets exceeded the actual return and a deferred loss is recognized for both years.

By using the information from Tables 11-5 and 11-6, the net gain or loss component of pension expense can be computed, as shown in Table 11-7.

**Table 11-7**  
Calculation of Net Gain or Loss Component of Pension Expense

	20X6	20X7	20X8
Amortization of Net Loss from Table 11-5 .....	\$0 <sup>1</sup>	\$5,730	\$6,789
Deferred Gain/(Loss) from Table 11-6 .....	<u>(37,750)</u>	<u>100,678</u>	<u>(14,382)</u>
Net Gain/(Loss) Component of Pension Expense ...	<u><u>\$(37,750)</u></u>	<u><u>\$106,408</u></u>	<u><u>\$(7,593)</u></u>

<sup>1</sup> The net loss subject to amortization for 20X6 was not computed in Table 11-5 because by definition there is no gain or loss on the initial adoption of SFAS No. 87.

The net gain or loss component of pension expense for 20X6 consists of only the deferred asset loss of \$37,750. Because the deferred asset loss is the part of the loss not included in the market related value of plan assets, the deferred loss is deducted in the computation of pension expense. In 20X7 the deferred asset gain of \$100,678 is added to the amortization of net loss of \$5,730. Deferred asset gains (the part of the asset gain or loss not included in the market related value of plan assets) are added to net loss amortizations and deducted from net gain amortizations. Deferred asset losses are accounted for in the opposite manner. The net gain or loss component of \$106,408 is added as a component of pension

expense in 20X7. In 20X8 the deferred asset loss of \$14,382 is deducted from the net loss amortization of \$6,789. The net gain or loss component of \$7,593 is deducted as a component of pension expense. The deferred asset gain or loss when combined with the actual return in the pension expense computation causes the actual return to equal the expected return on plan assets.

The last component of pension expense to consider is amortization of the pension obligation or asset created at the inception of SFAS No. 87. The pension asset or obligation is calculated using the information from Example 11-7, Item 2, and the formula developed in the general discussion. The formula is:

$$(A)/O = APBOT - (AFPAT + APC - PPC)$$

- (A)/O = Net asset or net obligation established at initial adoption of SFAS No. 87.
- APBOT = Actual projected benefit obligation on the date of transition to SFAS No. 87.
- AFPAT = Actual fair value of plan assets on the date of transition to SFAS No. 87.
- APC = Balance in the pension liability account on the date of transition to SFAS No. 87.
- PPC = Balance in the pension asset account on the date of transition to SFAS No. 87.

The computation of the asset or obligation at initial adoption of SFAS No. 87 is made below:

$$(A)/O = \$1,200,000 - (\$1,025,000 + \$0 - \$0)$$

$$(A)/O = \$1,200,000 - \$1,025,000$$

$$(A)/O = \$175,000 \text{ (obligation)}$$

There is no balance sheet asset or obligation at the time of initial adoption of SFAS No. 87, as noted by the zeros in the preceding formula. Therefore, because the projected benefit obligation of \$1,200,000 exceeds the fair value of the plan assets, the \$175,000 difference is a pension obligation. The obligation is amortized over the average remaining service life of the employee group of 14 years. The average remaining service life is given in Example 11-7, Item 2(d). The amortization for 20X6, 20X7, and 20X8 is computed in Table 11-8.

**Table 11-8**  
Calculation of Amortization of Pension Obligation

(a) Pension Obligation	(b) Service Life	(c) = (a)/(b) Amortization		
		20X6	20X7	20X8
\$175,000	14 Years	\$12,500	\$12,500	\$12,500

Using information from Tables 11-1, 11-2, 11-3, 11-7, and 11-8, pension expense for 20X6, 20X7, and 20X8 is summarized below in Table 11-9.

\$240,000 prior service cost is put in other comprehensive income (closed to accumulated other comprehensive income) in the period of the amendment and is removed as it is amortized to postretirement cost. There is no amortization in 20X6 because the plan was not amended until year-end. Table 11-33 shows prior service cost amortization over the three-year period.

**Table 11-33**  
Calculation of Amortization of Prior Service Cost<sup>1</sup>

(a) Prior Service Cost	(b) Service Life	(c) = (a)/(b) Amortization		
		20X6	20X7	20X8
\$240,000	20 Years	\$0	\$12,000	\$12,000

<sup>1</sup> Information taken from Example 11-16, Items 3(g) and 4.

Because the prior service cost increased the accumulated benefit obligation, the \$12,000 annual amortization is added when computing the postretirement cost.

The fourth element of postretirement cost is the actual return on postretirement plan assets. Table 11-34 shows the calculation of the return on plan assets for the three years under consideration.

**Table 11-34**  
Calculation of Return on Plan Assets<sup>1</sup>

	20X6	20X7	20X8
Fair Value of Plan Assets at End of Year	\$ 1,380,000	\$ 1,605,000	\$ 1,770,000
Plus: Benefit Payments	78,000	258,000	240,000
Deduct: Contributions	(180,000)	(210,000)	(200,000)
Adjusted Fair Value of Plan Assets at End of Year	\$ 1,278,000	\$ 1,653,000	\$ 1,810,000
Fair Value of Plan Assets at Beginning of Year	(1,230,000)	(1,380,000)	(1,605,000)
Actual Return on Assets	\$ 48,000	\$ 273,000	\$ 205,000

<sup>1</sup> Information taken from Example 11-16, Items 2, 3(d), (h), and (i).

Because fair values of plan assets have increased in each of the three years, the actual return is positive (a gain) and is deducted in the computation of postretirement cost. For any year that fair value decreases, actual return on assets is negative (a loss) and is added as a component of postretirement cost.

The fifth component of postretirement cost is the deferred asset gain or loss. The reader may wish to review the formula for computation of the deferred asset gain or loss in the general discussion before reviewing this calculation. The deferred asset gain or loss is computed in Table 11-35 using a tabular format.

**Table 11-35**  
Computation of Deferred Asset Gain or Loss<sup>1</sup>

	20X6	20X7	20X8
Actual Return on Plan Assets (Table 11-34)	\$48,000	\$273,000	\$205,000
Expected Return:			
Market-Related Value of Plan Assets	\$1,230,000	\$1,436,250	\$1,545,469
Expected Long-Term Rate of Return	10%	10%	10%
Expected Return	(123,000)	(143,625)	(154,547)
Deferred Asset Gain/(Loss)	<u>\$ (75,000)</u>	<u>\$ 129,375</u>	<u>\$ 50,453</u>

<sup>1</sup> Information taken from Example 11-16, Items 2(c), 3(f), and (k).

The \$75,000 deferred loss in 20X6 is deducted in the postretirement cost calculation and the deferred gains in 20X7 and 20X8 are added in the computation. Gains and losses related to the market-related value concept are handled in reverse to normal gains and losses, because the purpose of the market-related value concept is to reduce volatility of the postretirement cost. The deferred asset gain or loss when combined with the actual return in the postretirement expense computation causes the actual return to equal the expected return on plan assets.

The next component of postretirement cost is amortization of the net gain or loss. The net gain or loss calculation is a very complex computation and will require frequent reference back to the Example 11-16 assumptions and will require reference back to the formula and tabular format in the general discussion. The net gain or loss is composed of four parts: the difference between the projected and actual beginning-of-period accumulated postretirement benefit obligation, the difference between the projected and actual beginning-of-period fair value of plan assets, the unamortized gain or loss (included in accumulated other comprehensive income) carried forward to the current year from prior years, and the difference between the beginning-of-period fair value and market-related value of plan assets. The gain or loss is computed for 20X7 and 20X8 in Table 11-36 using the tabular format developed in the general discussion and is divided into the four components listed, above. No gain or loss is computed for 20X6, the year of transition. By definition, there is no gain or loss on the date of initial adoption of SFAS No. 106, because any gain or loss at date of transition is included in the transitional asset or obligation. Because the date of transition is January 1, 20X6 and the gain or loss is computed as of the beginning of the accounting period, there is no gain or loss for 20X6.

3. Other than forecasted transactions associated with variable interest payments on existing instruments, disclose the maximum time period for which the enterprise is hedging future cash flow risk for forecasted transactions.
4. The amount of the reclassification of gains and losses to net income from accumulated other comprehensive income when a cash flow hedge is discontinued because the entity has determined that it is not probable that the forecasted transaction will occur.

The information, above, is required for both the instrument and the hedged transaction (Paragraph 45(b)).

The following disclosure information related to presentation of comprehensive income and accumulated other comprehensive income is required (Paragraphs 46 and 47):

1. The net gain or loss from instruments classified as cash flow hedges should be disclosed separately in other comprehensive income when the gains and losses qualify for presentation in other comprehensive income.
2. The following should be disclosed in accumulated other comprehensive income from derivative gains and losses:
  - a. Beginning and ending accumulated gain or loss from derivative activity.
  - b. Net change in the gain or loss from hedges during the current accounting period.
  - c. Amount of any reclassifications from accumulated other comprehensive income to net income on a net basis.

In addition to the preceding disclosures, the FASB encourages entities to disclose similar quantitative information about nonfinancial liabilities and assets and financial instruments that are related to the derivative instrument by activity. SFAS No. 149 states that certain derivatives that include items such as up-front cash payments or off-market terms may have a financing component that should be included in the cash flow statement as a financing activity using the provisions of SFAS No. 95. (See a detailed discussion of cash flow financing activities in Chapter 1.)

This completes the disclosures required by SFAS No. 133, as amended by SFAS No. 161. However, SFAS No. 107, as amended by SFAS No. 133, requires additional disclosures for all financial instruments.

#### Disclosure Requirements Under Statement Nos. 107 and 126

SFAS No. 107, as amended by SFAS Nos. 126, 133 and 157 specifies disclosure requirements for all financial instruments (see the preceding discussion for a definition of a financial instrument). The disclosure requirements relate to fair market value requirements and disclosures associated with a concentration of credit risk. SFAS No. 157 amends SFAS No. 107 relative to fair value. In addition, SFAS No. 157 provides additional fair value disclosure requirements. See a detailed discussion SFAS No. 157 in this chapter.

When an enterprise discloses fair value information, the fair value of one instrument should not be netted with the fair value of another instrument, unless netting or offsetting is allowed under current accounting standards. FASB Interpretation Nos. 39 and 41 provide guidelines as to when the fair value of different financial instruments may be offset. (See a detailed discussion of FASB Interpretation Nos. 39 and 41 in Chapter 7.) Fair value and carrying amounts should be presented in a summary table, cross referenced to other fair value information if presented in separate footnotes. In addition, the fair value and carrying amounts of financial instruments should be divided into assets and liabilities so that it is clear to the reader of the statements as to which fair values and carrying amounts represent assets and liabilities and the relationship of the carrying amounts to the amounts reported in the balance sheet (SFAS No. 133, Paragraph 532).

In some cases, it may not be practicable to determine the fair value of some financial instruments. It may not be practicable to estimate or determine fair value when an enterprise has to incur excessive costs to determine the fair value amount. It might not be practicable to determine fair value on an individual security basis, but it may be cost effective to estimate fair value on a group basis. In some cases, it may be practicable to determine fair value for only a part of a class of financial instruments. In such cases, fair value for the part should be disclosed. Therefore, the precision of fair value estimates and the actual practicability of determining fair value is affected by the costs that would be incurred to estimate the required information. When it is not practicable to estimate fair value, the enterprise must provide specific disclosure requirements (SFAS No. 107, Paragraph 14).

Some instruments are excluded from the disclosure requirements of SFAS No. 107. The following financial instruments are not required to present fair value disclosures in accordance with SFAS No. 107 (Paragraph 8) as amended by SFAS No. 163:

1. Pension, postretirement, and post-employment obligations of employers and pension plans under SFAS Nos. 35, 87, 106, 112, 132(R), and 158.
2. Stock purchase plans, share-based payment plans, and deferred compensation plans covered by the provisions of APB Opinions No. 12 and SFAS No. 123(R).
3. Debt that is substantively extinguished as defined by SFAS No. 140.
4. Insurance contracts (including financial guarantee insurance contracts within the scope of SFAS No. 163) under SFAS Nos. 60 and 97. Investment contracts and financial guarantees are not excluded from SFAS No. 107.
5. Leases under the provisions of SFAS No. 13, as amended. Lease obligations guaranteed by a third party and canceled lease contingent obligations are covered by SFAS No. 107.
6. Unconditional purchase obligations under SFAS No. 47.
7. Obligations and rights under warranties.