

Insights

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Accounting

Guidance on Debt Modifications and Restructurings

The current economic environment has forced many borrowers and lenders to come to the table and renegotiate the terms of existing loans. Borrowers may be seeking to do so because they are not able to meet current loan covenants or cash flow requirements under their loans. Lenders may be willing to have the conversation with borrowers because they realize it may be in their best interests to reconsider the terms of a loan instead of (a) forcing the borrower to find another lender or file for bankruptcy or (b) foreclosing on any collateralized assets. As a result of the renegotiations, the borrower and lender may agree to modify or restructure an existing loan or exchange one loan for another. The degree of change introduced by the modification, restructuring, or exchange depends on any number of factors, first and foremost being the financial condition and prospects of the borrower.

Naturally, there are accounting implications when the borrower and lender agree to modify or restructure an existing loan or exchange one loan for another. The accounting implications differ depending on whether the borrower's or lender's accounting is being considered.

Fundamentals of Debt Modifications and Restructurings is a document developed by McGladrey & Pullen's National Professional Standards Group to assist middle market companies in determining the appropriate accounting by a borrower for a debt modification, exchange or restructuring. Depending on the facts and circumstances, a number of different accounting outcomes could result for the borrower. Often a significant amount of judgment must be exercised in identifying the appropriate accounting outcome.

Prior to the Financial Accounting Standards Board (FASB) releasing its Accounting Standards Codification, the relevant accounting literature on how to account for the modification, restructuring, or exchange of loans was scattered throughout a number of different pronouncements. With release of the Codification, the relevant accounting literature on the accounting for the modification, restructuring, or exchange of loans has been combined into primarily two sections of the Codification. Fundamentals of Debt Modifications and Restructurings includes a section that summarizes the relevant accounting literature and general concepts applicable to the accounting for a modification, restructuring, or exchange of loans. Another section of the document includes several examples of how to apply this guidance. The document also maps the relevant guidance to both the Codification and the applicable predecessor (i.e., pre-Codification) literature.

Fundamentals of Debt Modifications and Restructurings is available at http://mcgladrey.com/Resource_Center/fundamentals_debt_modification.pdf.

Carryforward of a Reporting Unit's Fair Value when Testing Goodwill for Impairment

Goodwill is recorded as a result of many business combinations. For years, goodwill was amortized over a period of not more than 40 years. Beginning in 2001, goodwill was no longer amortized, but rather tested for impairment. Due to the unique nature of goodwill, the test for impairment is complex. FASB Accounting Standards Codification (ASC) Topic 350, Intangibles – Goodwill and Other, (from FASB Statement No. 142, Goodwill and Other Intangible Assets) requires goodwill to be tested for impairment at least annually using a two-step process. The focus of step one is to identify potential impairment by measuring the fair value of a reporting unit and comparing this fair value to the reporting unit's carrying amount.

Measuring the fair value of a reporting unit may be a time-consuming process and can involve the use of a third-party valuation specialist. However, ASC 350 allows in certain situations for the fair value of a reporting unit to be carried forward from that used in the prior-year test, rather than being newly determined each year. The criteria that must be met to carryforward a fair value determination include all of the following:

- The assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination;
- The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin; and
- Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit is remote.

The first criterion is only likely to be met for a reporting unit in a stable, mature industry as the assets and liabilities of most other reporting units are likely to change more than insignificantly from period to period. The second and third criteria are high hurdles to meet and are very subjective as there are no specific thresholds to determine whether a reporting unit passed the step one test by a substantial margin in the prior year or that it is remote that step one of the goodwill impairment would fail during the current year. Given the changes that have occurred in the economy over the past few years, the stringent nature of these criteria as well as the difficulty in supporting the assertion that they have been met, we would expect that it would be atypical for a company to be allowed to carryforward a fair value determination of a reporting unit from the prior year. If a company does believe they meet all of these criteria, this conclusion should be supported by the relevant evidence and documented in detail.

Auditing

COSO Releases Study on Fraudulent Financial Reporting

On May 20, 2010, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released a study, "Fraudulent Financial Reporting: 1998-2007: An Analysis of U.S. Public Companies". The study examined nearly 350 financial statement fraud allegations investigated by the SEC over a ten-year period. Among other interesting conclusions, the study results showed that:

- Financial fraud affects companies of all sizes, with the median company having assets and revenues just under \$100 million.
- The median fraud was \$12.1 million. More than 30 of the fraud cases each involved misstatements/misappropriations of \$500 million or more.
- Revenue frauds accounted for over 60 percent of the cases.
- 26 percent of the companies engaged in fraud changed auditors during the period examined compared to a 12 percent rate for companies with no fraud.
- News of an SEC or Department of Justice investigation resulted in an average 7.3 percent abnormal stock price decline. News of an alleged fraud resulted in an average 16.7 percent abnormal stock price decline in the two days surrounding the announcement.
- Companies engaged in fraud often experienced bankruptcy, delisting from a stock exchange, or asset sale.
- In nine out of ten cases the SEC named the Chief Executive Officer and/or Chief Financial Officer for alleged involvement. Within two years of the completion of the SEC investigation, about 20 percent of CEOs/CFOs had been indicted, and over 60 percent of those indicted were convicted.

“Fraudulent Financial Reporting: 1998-2007: An Analysis of U.S. Public Companies” is available in full at <http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf>.

Forms 272, 173, and 272.01 Updated

Form 272, Checklist for Disclosures, and Form 173, Checklist for Interim Disclosures, have been updated through March 31, 2010. The checklists incorporate the disclosure requirements in effect as of March 31, 2010, including the disclosure requirements of the following:

- Accounting Standards Update (ASU) No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements;
- ASU No. 2010-08, Technical Corrections to Various Topics;
- ASU No. 2010-09, Subsequent Events (Topic 855) – Amendments to Certain Recognition and Disclosure Requirements;
- ASU No. 2010-11, Derivatives and Hedging (Topic 815) – Scope Exception Related to Embedded Credit Derivatives; and
- EITF Issue No. 08-9, “Milestone Method of Revenue Recognition”

In addition, Form 272 was also updated to include the disclosure requirements of the following:

- ASU No. 2009-15, Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing; and
- ASU No. 2010-02, Consolidation (Topic 810) – Accounting and Reporting for Decreases in Ownership of a Subsidiary-a Scope Clarification

Form 272.01, Incremental Checklist for Disclosures, has been updated to include disclosure requirements issued as of March 31, 2010 which may have become effective subsequent to March 31, 2009. This MS Word document is an abbreviated form and is designed for use as a “bridge document” between the March 31, 2009 version of the Checklist for Disclosures and the current version. This form is designed to be used as a practical expedient for engagement teams that completed Form 272, Checklist for Disclosure, as part of the prior-year engagement. These incremental disclosures should be considered in addition to the relevant disclosure requirements included in the March 31, 2009 version of Form 272. This incremental checklist can be used in place of Form 272 provided the criteria specified in Form 272.01 are met.

Engagement teams completing this document should review the March 31, 2009 Checklist for Disclosures completed in the prior year, verify the disclosures are still appropriate, and retain both forms in the engagement file. Collectively, these two documents provide the support for the current year’s disclosures. The intent is to reduce the time required to complete the checklist without compromising engagement quality. In certain instances, it may be necessary to recomplete some or all of Form 272. Please refer to the instructions on Form 272.01 for more information.

Engagements that did not previously complete the March 31, 2009 Checklist for Disclosures (or its equivalent) or do not meet the criteria specified in Form 272.01 should complete the latest version of the full Checklist for Disclosures.



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