

February 23, 2010

Accounting

Guidance on Debt Classification

Because of today's economic environment, more and more questions have arisen with respect to the classification of debt as current or noncurrent when a borrower presents a classified balance sheet. Many of these questions involve: (a) the borrower's violation of debt covenants; (b) the borrower obtaining a waiver for its violation of a debt covenant; (c) the loan agreement including a subjective acceleration clause, lock-box arrangement, and/or a due-on-demand clause; and (d) the borrower's expected long-term refinancing of what would otherwise be considered a short-term obligation. Proper classification of debt as current or noncurrent is important to a variety of parties (*e.g.*, lenders, potential lenders, sureties, auditors, rating agencies, *etc.*) for a variety of reasons (*e.g.*, assessing the borrower's compliance with debt covenants, assessing the borrower's liquidity and its ability to continue as a going concern, establishing credit ratings for the borrower, *etc.*). McGladrey & Pullen's National Professional Standards Group has developed a document, *Fundamentals of Debt Classification*, to assist middle market companies in determining whether a borrower should classify debt as current or noncurrent in the balance sheet.

Prior to the Financial Accounting Standards Board (FASB) releasing its *Accounting Standards Codification*, the relevant accounting literature on debt classification was scattered throughout a number of different pronouncements. With release of the Codification, the relevant accounting literature on the classification of debt as current or noncurrent has been combined into primarily two sections of the Codification. *Fundamentals of Debt Classification* includes a section that summarizes the relevant accounting literature and general concepts applicable to debt classification. Another section of the document includes more than 15 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 Classification is available on the McGladrey & Pullen Web site at http://mcgladrey.com/Resource_Center/fundamentals_debt_classification.pdf.

Assigning Assets and Liabilities that Relate to Multiple Reporting Units when Testing Goodwill for Impairment

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. A reporting unit is defined in ASC 350 as an operating segment or one level below an operating segment (component). McGladrey & Pullen's National Professional Standards Group has developed a white paper to assist in determining how assets and liabilities that relate to the operations of multiple reporting units should be assigned to each reporting unit to determine its carrying amount. The white paper also addresses the impact of this assignment on the determination of the fair value of each reporting unit.

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The white paper, *Assigning Assets and Liabilities that Relate to Multiple Reporting Units when Testing Goodwill for Impairment*, is available on the McGladrey & Pullen Web site at http://mcgladrey.com/Resource_Center/assigning_assets_liabilities.pdf.

Financial Institutions

SBA Loan Sale Accounting Issue

A financial institution may originate a loan on which it obtains a Small Business Administration (SBA) guarantee. The SBA will guarantee up to 90 percent of the loan. After origination, the institution may sell (transfer) the guaranteed portion of the SBA loan on the secondary market. At the date the guaranteed portion of the SBA loan is sold, the institution certifies that: (a) the institution has no knowledge of default by the borrower or likelihood of default; (b) the institution has paid the SBA the guaranty fee; (c) the loan is properly closed and fully disbursed; and (d) the institution acknowledges that it has no authority to unilaterally repurchase the guaranteed interest.

The guaranteed portion of the loan may be sold at par, at a premium, or at a discount. When an SBA loan is sold at a premium, there are accounting consequences that should be considered. Under the standard SBA loan sale agreement (SBA Form 1086), there is a 90-day warranty period during which the institution would be required to refund any premium received. For example, if the borrower prepays the loan for any reason within 90 days, the institution must refund any premium received. Also, if the borrower fails to make the first three monthly payments due after the sale (transfer) date and the borrower enters uncured default within 275 calendar days, the institution must refund any premium received.

FASB Statement No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*, (FASB ASC Topic 860) as its title implies, amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Among the many changes made by this amendment to Statement No. 140, one change in particular may impact the ability of the institution to recognize the transfer of a receivable until after the 90-day warranty period has expired. That change specifically requires that the portion transferred qualify as a participating interest. Paragraph 26G of Statement No. 140 as amended (ASC 860-10-55-17L) states, "In certain transfers, recourse is provided to the transferee that requires the transferor to reimburse any premium paid by the transferee if the underlying financial asset is prepaid within a defined time frame of the transfer date. Such recourse would preclude the transferred portion from meeting the definition of a participating interest. However, once the recourse provision expires, the transferred portion shall be reevaluated to determine if it meets the participating interest definition."

When financial institutions adopt Statement No. 166 in the first quarter of 2010, they likely will not be able to recognize gain on sales of the guaranteed portion of SBA loans when those loans are sold at a premium since in that case the recourse precludes the transferred portion from meeting the definition of a participating interest. The transaction should be accounted for as a borrowing. After the expiration of the warranty period, the transfer should be re-evaluated to determine whether the conditions in Statement No. 140 have been met in order to achieve sales treatment. The gain on sale could be recognized at that point.

All sales of SBA guaranteed loans need to be evaluated in accordance with the guidance in amended Statement No. 140 to determine the appropriate accounting treatment. The amendments to Statement No. 140 that are contained in Statement No. 166 are effective at the beginning of the first annual reporting period that begins after November 15, 2009.

SEC

Item 4 in Forms 10-K and 10-Q to Be Deleted Effective February 28, 2010

Currently, Item 4 in Part II of Form 10-Q and Item 4 in Form 10-K require the disclosure of the results of any matter that was submitted to a vote of shareholders during the fiscal quarter covered by either the Form 10-Q or Form 10-K with respect to the fourth fiscal quarter. Recently, the SEC issued Release No. 33-9089, which deleted this requirement to disclose shareholder voting results on Forms 10-Q and 10-K. (Other requirements of Release No. 33-9089 are discussed in the article immediately below.) Effective February 28, 2010, such voting results will instead be required to be disclosed in new Item 5.07 on Form 8-K within four business days after the end of the meeting at which the vote was held. Therefore, a Form 10-K filed on or after February 28, 2010 should remove existing Item 4 in Part 1 and redesignate Items 5 through 15 as Items 4 through 14. Similarly, a Form 10-Q filed on or after February 28, 2010 should remove existing Item 4 in Part II and redesignate Items 5 and 6 as Items 4 and 5. Release No. 33-9089 is available in full at <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

Proxy Disclosure Enhancements

Recently, the SEC adopted rules requiring enhanced and additional disclosure in proxy statements, annual reports, registration statements, and other reports. The amendments will require registrants to make new or revised disclosures regarding the following, among other matters:

- Compensation policies and practices that present material risks to the company - Reporting companies, other than smaller reporting companies, must discuss their compensation policies and practices for all employees to the extent that risks arising from such compensation policies and practices are reasonably likely to have a material adverse effect on the registrant.
- Grants of stock and option awards to executive officers and directors - Disclosure regarding stock and option awards in the Summary Compensation Table and Director Compensation Table now must be based on the aggregate grant date fair value of the awards computed under FASB Accounting Standards Codification Topic 718, *Compensation – Stock Compensation*. This replaces currently mandated disclosure of the annual expense of such equity awards for financial statement purposes.
- Director and nominee qualifications and legal proceedings - For each director and nominee, the companies must disclose, among other matters, the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director.
- Board leadership structure – The new rules require a company to include disclosure of its board's leadership structure and the reasoning behind that structure.
- The board's role in managing risk - Companies must describe how the board of directors oversees risk management—for example, whether through a review by the entire board or a committee of the board.
- Potential conflicts of interest of compensation consultants who advise companies and their boards of directors - The new rules require additional information about compensation consultants' fees and conflicts of interest.

The rule amendments generally will be effective for all proxy statements and annual reports filed, and for registration statements declared effective, on or after February 28, 2010. Boards of directors and their compensation and nominating committees are encouraged to become familiar with the new rules, which are available in Release No. 33-9089 at <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

SEC Guidance Regarding Disclosure Related to Climate Change

For some companies, the regulatory, legislative, and other developments related to climate change could have a significant effect on operating and financial decisions, including those involving capital expenditures to reduce emissions and, for companies subject to “cap and trade” laws, expenses related to purchasing allowances where reduction targets cannot be met. Companies that may not be directly affected by such developments could nonetheless be indirectly affected by changing prices for goods or services provided by companies that are directly affected and that seek to reflect some or all of their changes in costs of goods in the prices they charge. In addition to legislative, regulatory, business, and market impacts related to climate change, there may be significant physical effects of climate change that have the potential to have a material effect on a registrant’s business and operations, such as:

- Effects that impact a registrant’s personnel, physical assets, supply chain, and distribution chain. They can include the impact of changes in weather patterns, such as increases in storm intensity, sea-level rise, melting of permafrost and temperature extremes on facilities or operations.
- Changes in the availability or quality of water, or other natural resources on which the registrant’s business depends, or damage to facilities or decreased efficiency of equipment.
- Physical changes associated with climate change that decrease consumer demand for products or services; for example, warmer temperatures could reduce demand for residential and commercial heating fuels, service, and equipment.
- Financial risks associated with climate change that arise from physical risks to entities other than the registrant itself. For example, climate-change-related physical changes and hazards to coastal property can pose credit risks for banks whose borrowers are located in at-risk areas.
- Dependence on suppliers that are impacted by climate change, such as companies that purchase agricultural products from farms adversely affected by droughts or floods.

Recently, the SEC published an interpretive release to provide guidance to public companies regarding their obligations under existing federal securities laws and regulations to consider climate change and its consequences as they prepare disclosure documents to be filed with the SEC and provided to investors. The interpretive guidance describes the most pertinent non-financial statement disclosure rules that may require disclosure related to climate change, such as those related to the registrant’s description of its business, legal proceedings, and risk factors, and management’s discussion and analysis of financial condition and results of operations. The interpretive guidance also addresses the application of those rules to the disclosure of certain specific climate-change-related matters, such as:

- The impact of legislation and regulation
- International accords
- Indirect consequences of regulation or business trends
- Physical impacts of climate change

The interpretive release is available in full at <http://www.sec.gov/rules/interp/2010/33-9106.pdf>.

International

IASC Revises Constitution

The Trustees of the International Accounting Standards Committee (IASC) Foundation, the oversight body of the International Accounting Standards Board (IASB), recently announced enhancements to their governance arrangements, which are aimed at enhancing public accountability, stakeholder engagement, and operational effectiveness. Among other changes, the Trustees agreed to the following major revisions in the IASC Foundation's Constitution, which are effective March 1, 2010:

- Emphasis on adoption of International Financial Reporting Standards (IFRSs) - The Constitution will emphasize that convergence is a strategy aimed at promoting and facilitating the adoption of IFRSs, but is not an objective by itself.
- A commitment to a "principle-based" approach - The Constitution will call for IFRS based upon clearly articulated principles.
- Names in use across the organization to be streamlined - The names in use across the organization will be more closely aligned with the standards. The IASC Foundation will become the IFRS Foundation, as soon as the practical arrangements can be made. The interpretations committee and advisory council will be known as the IFRS Interpretations Committee and IFRS Advisory Council, respectively. Stakeholders supported retaining the name of the IASB, and the Trustees concurred.
- Introduction of three-yearly public consultations on the IASB's technical agenda - In addition to consulting the Trustees and its advisory council annually on the existing and future agenda, the IASB will undertake a three-yearly public consultation on its future technical agenda.
- Specific designation of investors - The new Constitution specifically identifies investors as a target audience for financial information (in addition to other participants in the world's capital markets and other users of financial information).
- Improved language to account for a broad range of stakeholders, both by type and location - The Constitution will note the need to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings.
- A requirement for due process and the introduction of an emergency procedure - The Constitution will include a provision for an accelerated due process only in the most exceptional circumstances and only after approval by at least 75 percent of the Trustees.

An annotated version of the Constitution showing all revisions is available at <http://go.iasb.org/annotatedconstitution>.