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Financial Reporting Update

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FINANCIAL REPORTING UPDATE

by
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[Introductory note: Norman N. Strauss is a partner of Ernst & Young LLP. He is the firm's National Director of Accounting Standards and a member of the firm's Accounting and Auditing Committee. His duties include consultation on accounting issues and developing the firm's positions and publications on accounting matters. He is a CPA and a member of the American Institute of Certified Public Accountants. He has a B.B.A. ('63) and an M.B.A. ('69) from Baruch College.

Mr. Strauss is Ernst & Young's representative on the FASB's Emerging Issues Task Force. He has previously served as chairman of the AICPA's Accounting Standards Executive Committee (AcSEC) and chaired or served on various other Task Forces of AcSEC, including Task Forces on the Conceptual Framework of Accounting, LIFO, and Accounting for Stock Options. He is also a member of the Financial Reporting Committee of the Institute of Management Accountants and the FASB's Impairment of Assets Task Force. He also was a member of the FASB's Cash Flow Task Force. Mr. Strauss has frequently lectured to many business organizations on various accounting topics, has been published in the *Journal of Accountancy* and elsewhere, and has taught at NYU's Stern Graduate School of Business Administration.]

INTRODUCTION

It is a pleasure for me to present an accounting update at Baruch College tonight. The FASB and AICPA have been very busy for the past few years, issuing quite a few new accounting and disclosure standards and proposals. What I plan to do is update you on implementation issues for the newest standards on earnings per share, stock compensation, asset impairments, environmental remediation liabilities, and critical FASB and AICPA projects currently under way, such as derivatives and hedging, consolidations, segment reporting, comprehensive income, and internal-use software, which may significantly affect corporate reporting in the future. I'll finish with a discussion on the future of financial reporting. Now, on to the first topic on financial instruments.

FINANCIAL INSTRUMENTS

For eleven years, the FASB has been working on various aspects of its Financial Instruments project. This year, it explicitly acknowledged that its goal is to eventually require the recording of all financial instruments at fair value. To move toward that goal, the Board worked this year on hedging and derivatives and on transfers of financial assets. As a result, it has given you plenty of material to absorb.

Let's start with derivatives. Risk management and hedging are common activities through all of industry today, so the Board's project is going to have a significant impact on many companies. Because problems with derivatives continually make headlines, it's no surprise that the FASB had to act to develop an accounting model on hedging and derivatives. And the new approach the Board selected is extremely complex and controversial.

The FASB issued its Exposure Draft last June, and it took 100 pages to explain the proposed rules. Shortly after that, the FASB staff had to issue twenty more pages of Questions and Answers to try to explain it even better. The bottom line of its proposal is that it will cause a significant change in the hedge accounting model that is in use today.

In drafting the proposed accounting standard, the Board set out to rectify four perceived problems with existing guidance for derivatives and hedging:

1. *Incomplete accounting guidance.* Existing accounting guidance is limited and narrow in scope. FASB statements govern only the accounting for futures contracts and foreign currency forwards and similar types of contracts. In addition, the AICPA drafted a paper discussing accounting for options more than ten years ago, but it is not authoritative and it was never finalized. A few EITF issues address some specific derivatives issues, but there is no overall accounting model and there is no FASB guidance that specifically addresses the most rapidly growing derivatives market-interest rate swaps.
2. *Inconsistent accounting guidance.* Despite the fact that little guidance exists, what does exist is often contradictory. In fact, accounting treatment may differ simply based on the type of contract utilized, whether it be a foreign currency forward or a futures contract or an interest rate swap.
3. *Complex accounting guidance.* The lack of one comprehensive accounting standard has resulted in the development of numerous analogies to other guidance, which also has led to confusion,
4. *Lastly, the effects of derivatives are not transparent.* Different approaches result in different measurements of derivatives. Some derivatives may be recorded on the balance sheet while others may not. For example, interest rate swaps are not recorded as assets or liabilities even though their values are changing all the time because of fluctuating interest rates. Users of financial statements say they find it difficult to figure out the related effects of derivatives on a company's results.

The FASB believes its proposal will rectify each of these perceived problems. The entire proposal is based on four key FASB decisions about derivatives.

1. Derivatives are assets and liabilities and should be reported in the financial statements because they are rights or obligations that may be settled in cash.

2. Fair value is the most relevant measurement of financial instruments and the only relevant measurement for derivatives. Ultimately, as I said, the Board expects that all financial instruments will be recorded at fair value. The derivatives proposal is simply an interim step on that road.

3. Only assets or liabilities should be reported in the financial statements. Bottom line: the FASB does not believe that deferral accounting is appropriate for derivatives. In its view, deferring a loss on the balance sheet as an asset violates its conceptual framework, even though that loss may be part of a hedging strategy.

4. Finally, the FASB will allow a form of special hedge accounting. However, because special accounting provisions would permit companies to delay the recognition of derivative gains and losses, the requirements to meet the so-called "hedged criteria" are very strict.

Having set that foundation, the proposal would establish the accounting and disclosure requirements for all companies for all hedging and derivative activities.

Before I get into the proposed rules, I should start by answering the question, what is a derivative? Classically defined, a derivative is a financial instrument that derives its value from the price movements of an underlying index. That underlying index may be an interest rate, foreign currency price, commodity price, or almost any other price index.

The proposal would refine that definition somewhat. First, the proposal would continue the classic definition, stating that the holder (or writer) of the derivative has the right (or obligation) to participate in some or all of the price changes of a reference index. Under the definition, any contract that requires ownership or delivery of the underlying instrument would not qualify as a derivative. This is intended to scope out plain purchase contracts for raw materials. On the other hand, if settlement of the contract *could* result in a net cash payment, it is a derivative.

The Board then went a little further, having observed that some securities, such as structured notes, often act like derivatives by experiencing big swings in value when the underlying indices change. So the proposal includes many structured notes in the definition of a derivative. As a result, even if the financial instrument meets no other criteria for a derivative, it would be classified as a derivative if its cash flows are subject to erratic changes. Those changes must result from either using a multiple or some other means to magnify the effects of a change in the price index. Consider an oil-indexed bond where the interest payment is based upon a multiple of the change in the price of a barrel of oil. Because of the multiplying feature, this contract would be considered a derivative.

Now let's get into the accounting. The proposal would establish one basic rule: all derivatives would be recognized and measured at fair value regardless of the purpose or intent for holding the derivative. This rule represents a dramatic change from current practice and is intended to ensure that the effects of derivatives used by a company are clearly visible to users of the financial statements. Thus, all off-balance-sheet derivatives in practice today, such as interest rate swaps, would be recorded as assets or liabilities and be carried at fair value. Now, the big question is, how should those changes in value be recorded?

Although the FASB probably would like to require that these changes be recognized in income, it decided it couldn't go that far quite yet. The FASB reluctantly recognized a need for some type of special hedge-like accounting for those derivatives that are used as part of risk management activities.

The FASB identified three different hedge relationships, and the proposed accounting is different for each. Changes in fair value for derivatives not qualifying for one of these three categories would be recognized in income. The three hedging categories are:

- Hedges of changes in fair value;
- Hedges of changes in cash flow; and
- Hedges of a foreign currency exposure of a net investment in a foreign operation.

A fair value exposure is a potential exposure to earnings resulting from changes in the fair value of all asset or liability. A typical example would be the change in value of a fixed-rate, long -- term debt obligation. This could be hedged by swapping it to a variable interest rate. A fair value hedge also can cover assets, such as investments or inventories, and firm commitments.

A cash flow exposure is a potential exposure to earnings resulting from future variable cash flows, for example, interest obligations on a floating-rate debt obligation or a commercial paper program. Interest rates could be swapped from variable to fixed. Other examples would be the exposure to price changes for a commodity to be used in a company's operations in the future or anticipated sales in a foreign currency. These are referred to as forecasted transactions.

The foreign currency exposure of a net investment in a foreign subsidiary represents risk that changes in the value of the investment in a foreign subsidiary will be impacted by the changes in the foreign exchange rate of the subsidiary's local (functional) currency as compared to the parent's reporting currency.

Derivatives hedging fair value, cash flow, or foreign currency exposures still would be recorded at fair value. However, the "special accounting" rules would permit companies to reduce their impact on earnings. But every benefit has a price. In order to use these "special accounting" provisions, companies would be required to meet several hurdles known as the "hedge criteria." So, before I get into the accounting for hedging, I should first discuss these criteria. There are all extensive number of hedge criteria, including ten for fair value hedges and eight for cash flow hedges.

Many of the hedge criteria are somewhat generic, applying to each of the three types of hedge situations. For example, each hedge transaction would be required to be consistent with the company's established risk management policy and would have to be formally documented, and the change in fair value or cash flows of the derivative would have to move substantially in all equal and opposite direction as the same changes for the hedged item or transaction. Others are very specific, such as a prohibition in most cases to use written options as a hedge. And, most important, this is all optional; hedge accounting only applies if management designates the derivative as a hedge at inception.

Now let's review the various accounting treatments. First, remember that the derivative must always be measured and recorded at fair value. The special accounting simply addresses how those fair values -- and any changes in those fair value -- are recorded in earnings.

For fair value hedges, the related change in the unrealized gain or loss on the derivative would be recognized immediately in earnings. "Special accounting" would permit companies to simultaneously recognize the gain or loss on the hedged item in earnings. But companies would only be permitted to recognize the gain or loss on the hedged item for the risk being hedged to the extent that it offsets the gain or loss on the derivative.

The special accounting for cash flow hedges is also peculiar. The derivative would still be recorded at fair value in the balance sheet. But the related gain or loss would be recorded in equity rather than earnings. The gains and losses on the derivative would only be recorded in earnings when the forecasted transaction was originally projected to occur. Thus, this approach may cause volatility in equity.

Not only are changes in values of the derivative recorded in equity, but they also are considered to be a component of comprehensive income. Later, we will talk about another FASB proposal that would require that a Statement of Comprehensive Income be presented as a basic financial statement. That proposal is perhaps even more controversial than this one!

In the third hedging category, the proposal also permits special accounting for multinational companies that have foreign exchange exposure related to their net investment in foreign operations. The proposal generally continues current practice as defined by Statement 52. Accordingly, derivatives, as well as cash instruments, can continue to be used to hedge net investments. Changes in their fair value arising from foreign currency fluctuations will continue to be recognized in the translation adjustment in stockholders' equity.

Well, those are the three hedging categories. But there is one more category, and that's the "all other" derivative category. Any derivative not qualifying for or designated as a hedge falls into this category. This means that changes in fair value of these derivatives are recognized immediately in income.

Any FASB statement would be incomplete without a multitude of disclosure requirements, and this proposal is no exception. The approach in the Exposure Draft is to require details, such as the objectives for holding the derivative and gain or loss information by category. So, there would be separate disclosures for fair value, cash flow, and net foreign investment hedges, as well as for "all other" derivatives. In addition, the SEC recently issued a new rule that would significantly increase the disclosures about derivatives and other financial risks.

The FASB held public hearings on the proposal in November [1996] and plans to finalize the proposal in the second quarter of 1997. They have recently been making several changes to the proposal, which would retain some of the more traditional hedging approaches, but it looks as if all derivatives will be going on the balance sheet at fair value. As planned, the proposal would apply to all entities, and all companies would have to adopt the proposal for years beginning in 1998.

I have one more financial instrument topic to cover briefly. The FASB has been developing accounting guidance for transfers of financial assets and extinguishments of liabilities since late 1993. This effort, commonly referred to as the Securitizations Project, resulted in the issuance of Statement 125 last summer. It was effective January 1, 1997, but certain transactions impacting mostly broker-dealers were deferred until 1998.

The Statement provides new accounting and reporting rules for the sale, securitization, and servicing of receivables and other financial assets. The basic issue is whether a transfer of financial assets is a sale or a financing. Essentially, any transfer of a financial instrument by any type of entity is included in the scope of Statement 125. As a result, the statement impacts transactions ranging from the multibillion dollar market for credit card securitizations to transfers of trade receivables by commercial and industrial companies.

Under the new rules, some transactions that are currently recorded as sales of assets (and, therefore, are off balance sheet) will have to be treated as financing transactions unless the transaction structures are revised. The current requirements are basically in Statement 77, which is superseded by Statement 125, and entirely new criteria are replacing it. Statement 125 looks to control; if you no longer control the receivables, take them off the books.

Sales are distinguished from financings under the new rules based on whether the assets are legally placed beyond the reach of the seller and, more importantly, beyond the reach of its creditors. Transfers that do not meet this condition would be accounted for as financing transactions.

Additionally, the transferee must have the right to pledge or exchange its interest in the transferred assets. If that right is restricted by the seller, the transaction would be accounted for as a financing.

Finally, if a transferor maintains some control over the transferred assets, the transfer could not be accounted for as a sale. Such a control feature might include agreements requiring the transferor to repurchase the assets.

The conditions just described must all be met for a transaction to qualify for sales treatment.

These criteria are far more stringent than current practice, which focuses on whether a transfer purports to be a sale and surrenders control over the economic benefits of the receivables. Statement 125 places a much greater emphasis on legal and physical control over a transferred asset.

Assuming a transfer can be recognized as a sale, the Statement requires that the seller use a "financial components" approach to measure the gain or loss on the transaction. Under this approach, a seller would record at fair value whatever new instruments it obtains, such as a recourse obligation or puts and calls to reacquire the receivables. Then the seller would derecognize financial assets for which control has been surrendered based on the relative fair value of the components transferred and those retained. One impact of this accounting treatment is that the gain or loss from the sale is likely to be different than the amount determined under the old rules.

Statement 125 covers various other topics such as selling receivables to a special purpose entity (which can be a sale when certain criteria are met), loan participation transactions, repurchase agreements, and security lending transactions. In addition, it clarifies when debt is extinguished and it supersedes Statement 76 -- there will be no more in-substance defeasances. The new rules are complex, and companies that are involved in these type of transactions will have to spend time learning them.

AGGREGATION AND DISAGGREGATION

In this section, I will first discuss aggregating or consolidating financial statements, and then we will switch to disaggregating them and presenting segment information. Besides derivatives, these are the Board's two biggest projects. The basic standard on consolidations, one of the oldest accounting standards, was issued in 1959, and even though we may take how to consolidate for granted, the Board believes radical change is necessary. Under present practice, majority ownership is the threshold for consolidation. However, the Board, in an Exposure Draft it issued in October 1995, proposes revising the old standard and replacing it with a control-based consolidation policy. Under the Board's approach, an investing company would consolidate all entities it controls, even if it owns less than 50 percent of the stock, unless control is temporary at the time an entity becomes a subsidiary. This means more subsidiaries would be consolidated.

Control would be broadly defined as the power over another entity's assets, that is, the power to use or direct the use of those assets to achieve the objectives of the controlling entity. Under this definition, each situation would require a subjective assessment of the specific facts and circumstances to determine if effective control exists and if consolidation is required. The Board received 125 comment letters on the proposal, held public hearings, and is currently redeliberating the issues and hopes to move the project along. However, because most letters opposed the proposal, it is not clear at this time whether the next step is a final statement, a revised Exposure Draft, a breakup of the project into pieces, or discontinuance of the entire project. With that introduction, let me summarize what the proposal calls for.

The Exposure Draft addresses both consolidation policy and procedures and covers all businesses regardless of legal form, including partnerships, special purpose entities, trusts, and not-for-profit entities. The bottom line is that if the proposal is issued, it would increase the number of subsidiaries that are consolidated.

Companies generally would be consolidated if they are legally controlled, that is, over 50 percent of the voting common stock is owned by an investor. That certainly isn't controversial. However, the Board is introducing a new concept of effective control. The ED identifies six circumstances that generally would lead to a presumption that effective control over an entity exists. If any of those circumstances are present and in the absence of evidence to the contrary, there would be a presumption that the entity should be consolidated. Those circumstances are as follows:

1. Ownership of a large minority voting interest (approximately 40 percent) and no other party or organized group of parties has a significant interest.

   The proposed Statement would require consolidation of a 40-percent-owned entity in circumstances where an investor has effective control because no other party or group of parties has a significant interest to override the decisions of the 40 percent investor. I believe that if you own 40 percent, you don't really have control and the over-50-percent ownership rule is much better. Why change it if it's not broken?

2. An ability demonstrated by a recent election to dominate the process of nominating candidates for another entity's governing board.

3. Unilateral ability to obtain a majority voting interest through ownership of securities that may be converted into a majority voting interest at the option of the holder.

   Under the proposal, the unilateral ability to take control, say by converting convertible debt, represents a current ability to take control of another entity at will.

Therefore, you might consolidate a company even though you currently own no voting stock.

4. A relationship with an entity that provides substantially all future net cash inflows or other future economic benefits to its creator.

   This presumption relates to special purpose entities (SPEs), and this is one area where I believe the FASB should provide additional guidance because of all of the new SPEs being formed.

5. A unilateral ability to dissolve an entity.

6. Lastly, a sole general partnership interest in a limited partnership. As a result of restrictions and limitations relating to the liabilities of limited partners, a general partner usually is deemed to have effective control of the limited partnership even if it has an insignificant ownership interest. The Board believes even a one percent general partner would consolidate the partnership if it has control.

As if this isn't enough, effective control also may exist in circumstances other than those in which a presumption of control exists. The ED describes nine indicators that suggest that control can be exercised, and these would have to be evaluated to see if consolidation is necessary.

That's the overall approach on consolidation policy. The proposal would require many difficult judgment calls, and I believe it's much too subjective to be operational. Now let's see what the Board wants to do with the basic consolidation procedures.

One of the most controversial consolidation procedure issues relates to the treatment of minority interest in the consolidated financial statements. The Board decided that a minority interest, which most companies present between liabilities and equity, should be classified in the stockholders' equity section of the balance sheet. In addition, in a major change in income statement reporting, minority interest, which the Board has renamed "noncontrolling interest" (because it may be more than 50 percent), would be presented as a deduction after consolidated net income to compute "net income attributable to the controlling interest." This income statement treatment would be similar to that of dividends on preferred stock.

Intercompany transactions and gains and losses would continue to be eliminated, and that's about the only thing the Board isn't trying to change. The Exposure Draft would change the accounting for partial acquisitions, and now the Board is thinking that goodwill would be attributed to the controlling and noncontrolling interests. This means that if you buy 60 percent of a company, the amount of goodwill you record would approximate what it would have been if you bought 100 percent.

Furthermore, changes in a parent's ownership that occur after a subsidiary is acquired that do not result in a loss of control would be accounted for as transactions in the equity of the consolidated entity and no gain or loss would be recognized. The same accounting would apply if the subsidiary issues its stock to others. The amount of the change in a parent's proportionate ownership interest in a subsidiary would be reported as an increase or decrease in additional paid-in capital and as a corresponding decrease or increase in the noncontrolling interest.

I believe the existing consolidation rules are not broken and do not need the FASB's proposed fix. Existing standards in this area are not seriously flawed, and financial statement users have no pressing need or desire for changes of the type being proposed by the FASB. We will have to wait and see what happens.

Another hot topic on the FASB's agenda is the disaggregated disclosure project. In January 1996, the

Board issued an Exposure Draft on reporting disaggregated information about a business enterprise. The proposed statement would require that public business enterprises report financial and descriptive information about their operating segments. The proposal would replace the current industry segment disclosure requirements contained in FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise.*

The proposal was developed in close coordination with the Accounting Standards Board of the Canadian Institute of Chartered Accountants that issued an essentially identical proposal in Canada. In addition, the International Accounting Standards Committee issued a proposal in December 1995, entitled *Reporting Financial information by Segment*, but it is more like Statement 14 than the Board's proposal. The FASB will continue to meet with the Canadian Board and the IASC to attempt to minimize the differences between their proposals.

The FASB's proposed statement would be effective for fiscal years beginning in 1997, and it hopes to issue a final statement in the second quarter of 1997.

One main reason for this project is that many users of financial statements have complained loud and clear that segment reporting needs improvement. Let's take a look at the differences between the current and proposed approach to reporting segment information. FASB Statement 14 requires annual disclosure of disaggregated information on two bases: by industry and by geographic area. Statement 14 has been criticized, primarily by analysts, who believe that many companies give inadequate segment information, and too many enterprises contend that they are in only one segment and thus not subject to segment reporting at all. In addition, critics say that the current segment reporting approach in the footnotes is (1) inconsistent with the way management describes the business in the text of the annual report and MD&A, (2) that it does not provide enough information, and (3) that segment information is not provided on a quarterly basis.

Due to these criticisms, the Board decided that the industry segment approach of Statement 14 can't be saved, and, therefore, it developed a whole new approach. In what could be a radical change for some companies, the FASB concluded that there should be much more detailed segment reporting and that segment reporting should be driven by the way an enterprise is managed rather than by defined industry segments. Under this approach, commonly referred to as the "management approach," a company would disclose information about operating segments that would correspond to the way the company is organized and the way financial results are evaluated internally by management. In other words, internal reporting would be the sole basis for external segment reporting. The Board believes that this approach to segment reporting would allow financial statement users to better understand the enterprise's performance, better assess its prospects for future net cash flows, and make more informed judgments about the enterprise as a whole.

Operating segments under the proposal are revenue producing components of the enterprise for which separate financial information is produced internally. These segments are subject to evaluation by the chief operating decision maker, a new FASB term, in deciding how to allocate resources. This means an operating segment could be a division, a department or subsidiary. The decision maker may be an individual, such as a CEO or COO, or a group, such as an executive committee, if decision-making authority rests with that group. A business unit's separate financial statements must be reviewed internally by the decision maker and the unit must have an individual in charge who reports directly to the decision maker (unless the decision maker is in charge of the business unit) in order to qualify as an operating segment.

Under this approach, there will be much less comparability than in current practice because many companies in the same business manage themselves differently. For example, a company that is managed by product line and a company that manages by geographic locations will hardly report comparable segment information.

The "first level" of disclosures for each operating segment would include detailed information about balance sheet and income statement items. The level of detail to be disclosed depends on whether the information is included in the financial report used by the decision maker. Some of the disclosures would be new, such as significant non-cash items, income tax expense, interest income, and interest expense.

In addition to all this disclosure, unfortunately, the Board also has decided to require a "second level" of disclosure of revenues by products and services for all segments that are not based on products and services, even if this information was nor regularly reviewed by the company's management. For example, if management reports internally based on geographic locations, it still would have to provide product information in the footnotes. And if it reports by product, geographical information may be necessary.

And, in another important change, limited quarterly segment reporting would be required. Analysts believe that this is the single most important item needed to improve existing segment reporting, and the FASB is giving it to them.

Conceptually, the management approach may seem logical. In fact, many companies initially supported the management approach, but that support faded because of the details required to be disclosed by the proposal. I believe existing rules generally provide adequate guidance for industry and geographic segment disclosures, and, in my view, the proposed volume of disclosures is excessive. Furthermore, if the management approach is really viable, it seems that a second level of disclosure would not be necessary. If management does not need the information to manage its business, users of financial statements should not need it either.

I also believe every effort should be made by the Board to reconcile differences with the IASC. If the two standard setters can't reconcile differences on a disclosure standard, it suggests that there may not be much hope for harmonizing other U.S. and international accounting standards.

Based on where we are today, although there will be some changes, it looks as if the FASB will be going forward with a final statement adopting the management approach sometime in 1997.

OTHER ACCOUNTING RULES AND PROPOSALS

Now I'll go over several final rules and proposals. In late 1995 the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and it was effective for 1996. Statement 121 requires certain long-lived assets to be classified in one of two categories: held-for-use or to-be--disposed-of. All held-for-use assets, like property, plant, and equipment, must be tested for impairment if there are indicators that the assets are impaired. That recovery test is performed by comparing the undiscounted cash flows expected from the asset to its carrying amount. If the carrying amount is more than the undiscounted cash flows, the asset is impaired and its carrying amount is reduced to the fair value of the asset. If an asset is to-be--disposed-of and its carrying amount is greater than the asset's fair value, then the carrying amount is reduced to that fair value.

We surveyed companies that have already reported Statement 121 impairment losses to see what kind of disclosures they have been making, and much of it is what you might expect. For example, impairment indicators that have been disclosed include weak sales, increased competition, excess capacity due to restructurings, and operating results much worse than expected.

Companies also commented on how they calculated fair value. Some mentioned third-party appraisals and others stated they used the present value of future cash flows. One company added that "considerable management judgment is necessary to estimate future cash flows, and actual results could vary."

On that last point, if a company's estimate of cash flows is just a little more than book value, for instance, $10.1 million for an asset with a book value of $10 million, and no loss is recorded, the AICPA's SOP 94-6 on risks and uncertainties requires an "early warning" signal that the company came pretty close, and who knows what might happen next quarter.

Disclosure also is required that adopting Statement 121 caused an accounting change. One company said it now measures impairment on a property-by-property basis rather than in the aggregate. Another mentioned using a retail store-by-store basis rather than larger groupings. And, if the impact of adoption is material, expect a fourth paragraph in the auditor's report mentioning the accounting change.

Regarding income statement presentation, many companies presented the charge as a separate line item, using captions like "write-down of equipment" or "impairment charges." One company labeled the charge, as "carrying value reduction of property, plant, and equipment," which is a subtle way to say the same thing.

My last point on disclosure is that some companies managed to add a positive note to the impairment by stating that the charge will provide a noncash benefit in the future from reduced depreciation, and they even quantified it.

Although Statement 121 hasn't been around very long, there have been several implementation issues. Some were discussed by the EITF, but a consensus wasn't reached, so the FASB added a project to its agenda to address various impairment questions. Examples of the ten to fifteen issues that may be addressed include:

- How to apply the Statement 121 approach for recognizing impairment to all goodwill.
- Whether APB 30 on discontinued operations should be amended to say that assets to be disposed of should be measured the same as under Statement 121.
- When does an asset move from the held-for-use category to the to-be-disposed-of classification? This is a potential problem if the asset will be used for a while before being sold.
- Lastly, If you buy a business with three divisions and you plan to sell one within a year, how do you do the lower of cost or fair value calculations?

Another FASB standard that affected companies in 1996 is the FASB's controversial Statement No. 123, *Accounting for Stock-Based Compensation.* Under the Board's new fair value method, the fair value of stock options are measured on the date of grant. This amount is then recognized as compensation expense over the service period (generally the vesting period). Fortunately, Statement 123 will let companies recognize that amount in pro forma net income and earnings per share rather than in the income statement.

To determine the fair value of a stock option, the standard requires that an option pricing model, such as the Black-Scholes model or a binomial model, be used to value options at the date of grant. The calculations are complex, but fortunately computer software is available to crunch the numbers.

Option pricing models require the use of several input variables. Three of these input variables are easy to determine -- the current price of the underlying stock, the exercise price of the option, and the risk-free interest rate during the expected life of the option. But the other three are subjective -- the expected life of the option, that is, when the option holders are expected to exercise the option; expected dividends on the stock during the option life; and the expected volatility of the underlying stock price. Volatility of a stock rezlates to how much a stock price might fluctuate. The greater the volatility, the greater the value of an option.

Although the FASB is encouraging companies to apply the new fair value method and recognize compensation expense in the income statement, companies are still permitted to continue with the APB 25 measurement approach, provided that they disclose pro forma net income and EPS information "as if" the new fair value approach had been adopted. The vast majority of companies stuck to the current accounting under APB 25 and made the pro forma disclosures which are required for 1995 as well as 1996 grants. In addition, pro formas are presented for both 1995 and 1996. It will be interesting to see what the analysts will do with the pro forma information or if disclosing significantly lower pro forma earnings will impact stock prices.

On a brighter note, last month the FASB issued Statement 128 on earnings per share in an effort to simplify the EPS calculation and promote international harmonization for public companies. Under the FASB's Statement, primary earnings per share will be replaced with a new, simpler calculation called "basic earnings per share." Basic EPS will be calculated by dividing income attributable to common shareholders by the weighted average shares outstanding during the period. In a significant change from current practice, it will not include the effects of any dilutive securities such as stock options or convertible debt. This will substantially reduce the complexity of the current primary EPS calculation. The existing calculation of fully diluted earnings per share will not change much but is renamed "diluted earnings per share." This will reflect the dilutive impact of options and convertible debt.

Generally, the new basic earnings per share calculation will produce a higher earnings per share number than the present primary EPS calculation because it does not reflect dilution from stock options and convertible debt instruments. However, the new diluted earnings per share could be similar to fully diluted earnings per share. One big question for preparers is, which number will the investors and capital markets focus on and what would be the effect on stock prices?

Statement 128 is effective December 31, 1997, and is essentially the same as the new IASC Standard No. 33.

Now, let's move on to a new standard that was issued in late 1996 and will have an impact on companies in 1997. SOP 96-1, *Environmental Remediation Liabilities,* was issued by the AICPA through its Accounting Standards Executive Committee, or AcSEC. Like the FASB, AcSEC also establishes accounting standards, but only if the FASB clears them. While AcSEC often addresses industry-specific issues, such as banking, real estate, and insurance, its new standard on environmental liabilities will have a widespread impact on many companies.

The SOP consists of an overview of federal environmental laws, accounting guidance on issues relating to the recognition, measurement, and disclosure of environmental liabilities, and audit guidance. The objective of the SOP is to improve and narrow the way existing accounting guidance is applied to the recognition of the enormous costs of environmental remediation, including the cleanup of superfund sites. This could result in earlier recognition of environmental liabilities for many companies.

Environmental remediation involves a sequence of events occurring over a long period of time that are designed to clean up past contamination. Because of the nature of this process, determining when to recognize an environmental liability can be difficult. To help make that determination, the SOP uses the current guidance in FASB Statement 5, *Accounting for Contingencies,* as its framework. Consistent with Statement 5, the environmental claim must be asserted or be probable of assertion in order to be accrued. Because of the legal framework of most remediation claims, AcSEC concluded that if a company had any association with a site, there is an expectation that the outcome of an asserted claim or a probable unasserted claim will be unfavorable. In other words, the company is going to have to pay something.

To promote consistency, the SOP also contains benchmarks to be considered when evaluating the existence and amount of an environmental remediation liability. Those benchmarks for a Superfund cleanup include six events beginning with the identification and verification of a company as a potentially responsible party (PRP) and ending with cleaning it up and monitoring afterwards. The SOP tells you when to start recording a liability.

Even though a company may be unable to reasonably quantify the total costs of the remediation effort, it should still record a liability for part of it. Companies, in other words, should accrue the best estimate of the costs to be incurred.

The SOP also tells us how to measure the liability. In addition to incremental direct costs of the remediation effort, the SOP requires the accrual of costs of compensation and benefits for employees who are expected to devote time directly to the remediation effort.

The SOP also requires that measurement of the liability be based on enacted laws and existing regulations. Discounting would be allowed but only if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable, which is expected to be a rare occurrence. For the companies that are one of several PRPs for a given site, the SOP also clarifies that a company should determine its allocable share of the liability based on its best estimate of the method and percentage that ultimately will be allocated among the PRPs. Finally, the SOP provides guidance on measuring recoveries. Insurance claims would have to be probable of recovery before they could be recognized.

The SOP is effective beginning in 1997, and this will result in many companies changing how they record environmental liabilities. The effect of initially applying the SOP will be included in continuing operations as a change in accounting estimate. Thus, companies that have to record additional environmental cleanup liabilities will take a hit to operating income in 1997.

Now let's discuss several proposed rules.

One of the FASB's most controversial proposals is on reporting comprehensive income. Opposition has been overwhelming, and I'll discuss why.

First, a little background. Comprehensive income is defined in the FASB conceptual framework as, essentially, all changes in shareholders' equity exclusive of transactions with owners (such as capital investments and dividends). Thus, comprehensive income includes net income plus changes in certain assets and liabilities that are reported directly in equity. Examples are unrealized gains and losses on available-for-sale securities, translation adjustments on investments in foreign subsidiaries, and certain changes in minimum pension liabilities. As I mentioned before, the FASB's Exposure Draft on derivatives would require gains and losses on hedges of forecasted transactions also to be included in comprehensive income.

Although comprehensive income has been part of the FASB's conceptual framework for years, the Board has not required that it be presented separately. However, as the Board has added more items as direct adjustments to stockholders' equity, some financial statement users have complained about the difficulty of identifying these amounts.

In a radical change in practice, the Board would require that amounts for total comprehensive income and comprehensive income per share be reported in a basic financial statement with equal prominence as net income and earnings per share. Those amounts could either be reported in a single statement with net income or in a separate statement of comprehensive income.

Many believe that presenting net income and comprehensive income with equal prominence will cause substantial confusion for financial statement users. For those reasons, all overwhelming majority of respondents to the proposal (including Ernst & Young) vehemently oppose it. As a result, the FASB has agreed to make significant changes before it is finalized.

In another FASB project, what started out as accounting for nuclear decommissioning costs by public utilities has turned into an Exposure Draft on closure and removal obligations for everyone. Under the

Exposure Draft, closure and removal obligations incurred at the time all asset is constructed or shortly thereafter, such as all offshore drilling rig that has to be removed when there is no more oil left or cleaning up a landfill, would be recorded as a liability using the present value of the estimated cash flows. So, the estimated costs of closing down a nuclear plant in 40 years would have to be recognized as a liability up front. That liability would be capitalized as part of the asset's basis and depreciated.

My next topic is accounting for costs of developing or obtaining internal-use software. In recent years, organizations have spent tremendous amounts of money and time on developing and acquiring internal use software. However, there are no accounting rules on whether the costs should be expensed or capitalized, and, as a result, recently AcSEC issued a proposed standard addressing this issue. Under the proposed rules, companies would be required to capitalize internal use software. This would be a change in practice for the majority of companies that expense these costs as incurred. Capitalized costs would include:

- External direct costs (such as purchased software);
- Payroll and payroll-related costs for employees directly associated with and devoting time to the project; and
- Related interest costs.

However, allocated overhead and training costs could not be capitalized.

Capitalization would begin after management, with the relevant authority, approves and commits funding to a computer software project and believes that it is probable that the project will be completed and the software will be used to perform the function intended. In addition, the project would no longer be in the R&D stage.

The capitalized costs would be amortized over the estimated useful life of the software in a systematic and rational manner. In a breath of fresh air, the proposed rules would produce no new disclosure requirements. If adopted as proposed, the rules would be effective for costs incurred beginning in 1998.

While we're speaking of software costs, in July 1996 the EITF addressed how to account for Year 2000 costs -- the costs required to make computers functional when the ball drops at the stroke of midnight on New Year's Eve 1999.

Year 2000 conversion costs are a business issue with which I'm sure you are all familiar. Most computer systems based on two-digit years (e.g., "96" for 1996) are not programmed to consider the start of a new century, unless they have been recently modified. Systems that process Year 2000 transactions with the year "00" may encounter significant processing inaccuracies and even inoperability. For example, systems that are not Year 2000 compliant could produce accounts receivable aging reports that are inaccurate, miscalculate the pay-out schedules on debt, or cause a vendor to miss a customer product shipment because the shipping date is invalid.

Many companies will incur significant time and expense to fix this software problem. Some analysts predict that expenditures will exceed $400 billion worldwide. Now is the time for companies to address this issue -- there will be no extending this deadline. The EITF concluded, at the urging of the SEC, that Year 2000 costs should be expensed as incurred. However, if a company buys a whole new system and throws the old one out, then it is not covered by this consensus and may follow its normal policy for software capitalization.

AcSEC also is working on accounting for start-up costs, which include costs of opening new retail stores and developing new products. AcSEC would require most kinds of start-up costs to be expensed as incurred. AcSEC is also addressing such topics as software revenue recognition and the movie industry. You'll need to keep an eye on AcSEC projects to stay up to date.

In addition to the normal standard-setting activities, there have been some developments that, In the long term, may significantly impact the future of financial reporting. I'll briefly mention some of them now.

An Invitation to Comment was issued by the FASB to solicit views on recommendations that were made to standard setters by the AICPA Special Committee on Financial Reporting and the Association for Investment Management and Research (AIMR). These recommendations deal with such subjects as developing a comprehensive model of business reporting, reporting separately core and noncore activities, associating auditors with nonfinancial information, and promoting forward-looking disclosures.

While I do not support any fundamental change to the present financial reporting model, I believe action is necessary to address the "disclosure overload" problem that exists today. The FASB should take the initiative in instituting a comprehensive review of existing disclosure requirements with the objective of ensuring that only decision-critical and cost-effective information is required to be disclosed.

In addition, the FASB and its parent organization, the Financial Accounting Foundation (the "Foundation"), have undergone some internal changes. In response to an SEC request in 1996, the Foundation agreed to approve four more "public interest" representatives with SEC approval of such appointees. For a while, there was some concern about whether standard setting was going to stay in the private sector, but this compromise settled things down and perhaps will strengthen the Board's independence. Also, the FASB has completed a review of its goals, objectives, and processes and updated its strategic plan to try to enhance the standard-setting process. Among other things, the strategic plan sets a goal to complete projects within three years, which will be quite an undertaking for the FASB. At the same time, it will attempt to promote international harmonization.

Well, there sure were plenty of topics to cover. Users and preparers contended with new rules on impairment of long-lived assets and stock options, and in 1997 we have new rules on transfers of assets, environmental remediation, and EPS. In addition, there are proposed rules on consolidation, segments, comprehensive income, closure and removal costs, and internal-use software, and, between the FASB and SEC, there is plenty happening with derivatives.

Because many of these projects will continue to be discussed, debated, and finalized in 1997, I encourage you to keep an eye on them. They could have a significant impact on financial reporting for many companies.

Thank you for attending today. I hope I helped you keep up to date and that you have enjoyed the presentation.