Accounting & Audit Advisor

Reporting loans from defined contribution plans

Update

By CPAmerica A&A Technical Consultant Thomas A. Ratcliffe, Ph.D., CPA

The Financial Accounting Standards Board released updated guidance in September 2010 that covers the classification and measurement of participant loans in defined contribution plans.

The guidance, Accounting Standards Update (ASU) 2010-25, *Reporting Loans to Participants by Defined Contribution Pension Plans*, represents a consensus of the FASB Emerging Issues Task Force. It amends the current guidance in FASB Accounting Standards Codification (FASB ASC) Topic 962, *Plan Accounting – Defined Contribution Pension Plans*.

Essentially, participant loans represent an extension of credit to plan participants by their defined contribution plans.

Included among the reasons the guidance was developed are:

- Inconsistency in how participant loans have been measured and reflected in financial statements.
- The issue of measuring pension plan investments at fair value when the guidance in FASB ASC 820, *Fair Value Measurements and Disclosures*, comes into play.

Prior to the need to use FASB ASC 820, the fair value of a plan investment was defined as the amount the plan reasonably could expect to receive in a current sale of assets. Quoted market prices were used as the measurement approach when those prices were available.

In practice, most participant loans have been carried at amortized cost, which has been considered to be a good-faith approximation of fair value using the aforementioned definition.

Using FASB ASC 820, the fair value of plan investments is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants as of the measurement date. As such, plans no longer may assume that the outstanding

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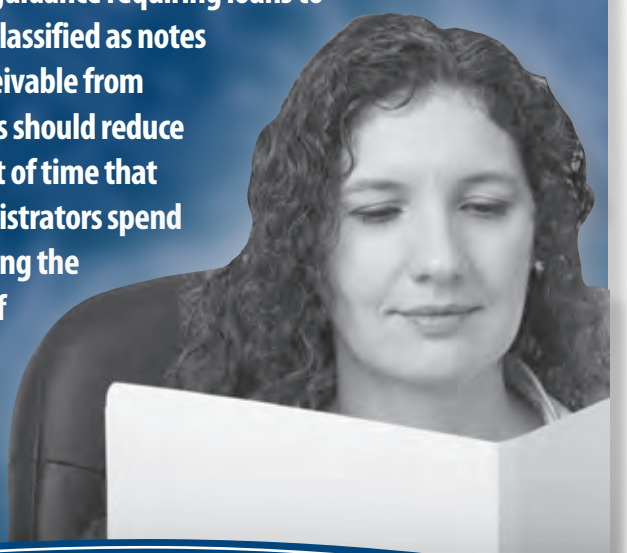
The guidance requiring loans to be classified as notes receivable from participants should reduce the amount of time that plan administrators spend on estimating the fair value of participant loans.



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Different purposes require different CPA reports

By guest columnists Michael Redemske, CPA, and David J. Papandria, CPA

It's important to find the proper balance between the cost of your CPA's services and the level of assurance the users of the financial statements require.

Before making decisions involving a company, business owners, managers and third parties usually study the company's financial statements. And third parties are particularly interested in what the external auditor has to say about those statements.

A CPA can provide various levels of service related to a company's financial statements. But not all CPAs' reports are the same. In addition to audits, CPAs can provide two other levels of service for unaudited financial statements – reviews and compilations.

Many companies provide their financial statements, along with the CPA's report, to lenders, investors, suppliers and customers. Informed readers of the report will gain varied levels of comfort, based on the type of service provided.

Businesses should work with their external auditors to determine the appropriate level of service required.

Audit Engagements

Auditing is the highest level of financial statement service a CPA can provide. Some of the more important auditing procedures include:

- Evaluating the internal control system
- Testing documentation supporting account balances
- Observing the physical inventory count
- Confirming accounts receivable

In addition, the auditors' tests provide reasonable assurance that the financial statements are not materially misstated as a result of fraud or errors in accounting.

Ideally, auditors will provide an unqualified, or clean, opinion on the company's financial statements. An unqualified opinion will contain language such as "the financial statements present fairly in all material respects" and "in conformity with generally accepted accounting principles" (GAAP).

If auditors are unable to render an unqualified opinion, they may issue a qualified opinion. Some reasons opinions may be qualified include scope limitations and departures from GAAP.

A qualified opinion due to a scope limitation alerts the reader that the auditors are not able to provide an opinion on one or more material items that affect the overall fairness of the financial statements. If the scope limitation is severe enough, the auditors may disclaim an opinion on the overall financial statements.

A qualified opinion because of a departure from GAAP indicates that, except for a particular item or items, "the financial statements are fairly presented."

However, if the auditors conclude that the departures from GAAP are so significant that the financial statements, overall, are not fairly stated, they must issue an adverse opinion. An adverse opinion will include language describing what the auditors believe is materially misstated in the financial statements.

Review Engagements

Review engagements provide less assurance to the reader of the financial statements because the CPA does not perform any audit testing procedures. Rather, the CPA inquires as to the accounting practices and principles used by the business, the procedures for recording and accumulating financial information, and the actions taken at owners' or directors' meetings.

As part of a review, the CPA also performs analytical procedures, such as comparing the financial statements to those of prior periods and studying the financial statements to discern relationships that do not conform to expectations.

Based on those inquiries and analytical procedures, the CPA is able to express only negative assurance on the financial statements. Negative assurance means the CPA found nothing unfavorable or suspect during the review.

Because a review engagement is substantially less in scope than an audit, the CPA cannot express an opinion on the fairness of the financial statements taken as a whole.

Compilation Engagements

In a compilation engagement, the CPA will assemble the financial statements and consider whether they are in appropriate form and free from obvious material errors. Because of the even more limited scope of compilation procedures, the CPA's report disclaims any degree of assurance on the financial statements.

Although audits provide the highest degree of assurance, they tend to cost significantly more than reviews or compilations. It's important to find the proper balance between the cost of your CPA's services and the level of assurance the users of the financial statements require.

Proposed Guidance

Lease accounting will undergo major overhaul

By CPAmerica A&A Technical Consultant Thomas A. Ratcliffe, Ph.D., CPA

A new way of accounting for leases is in sight – for both lessors and lessees.

The Financial Accounting Standards Board and the International Accounting Standards Board, in August 2010, released their joint proposal for changing how to account for leases.

New Accounting Model

When the proposed guidance is finalized, the bright-line-based model of accounting for leases will go away, and a right-of-use model will be introduced. And, importantly, in using the new model, the concept of operating leases will be eliminated from the accounting technical literature.

While the two boards have not yet reached a conclusion as to when the new guidance will become effective, they do have a plan in place to issue the final guidance in June 2011.

One of the key reasons that the planned guidance needs to be understood sooner rather than later is that all outstanding leases as of the date of initially implementing the guidance will be subject to the new accounting model. There will be no grandfathering in of existing lease arrangements, and prior-period financial statements presented for comparative purposes will need to be recast using a simplified retrospective approach.

One Accounting Method

Current accounting and reporting standards related to leasing include capital leases and operating leases. The planned new guidance will establish one method of accounting for leases that will include the requirement to recognize assets and liabilities in financial statements associated with all lease arrangements.

The thinking is that, through use of the single method of accounting for leases, more complete and comparable financial reporting will result. Also, single-method accounting will significantly reduce structuring opportunities for achieving particular accounting results.

Using current accounting requirements, financial statement users are required to estimate the effect of operating leases on leverage and other financial metrics of reporting entities.

By bringing lease arrangements onto the balance sheet, users no longer would need to estimate the effects of operating leases when calculating these metrics. For this reason, it is believed that financial statements will provide users with a more accurate view of the reporting entities' liabilities and future cash flows.

Changes for Lessees and Lessors

Both lessor and lessee entities will need to address significant changes that may be summarized as follows:

Lessees

The lessee entity needs to recognize an asset representing the right to use the underlying (leased) asset for the lease term along with a liability to make lease payments.

Lessors

The lessor entity needs to recognize an asset representing the right to receive lease payments. Depending on exposure to risks or benefits associated with the underlying asset, the lessor will need to recognize a lease liability while continuing to recognize the underlying asset, or derecognize the rights in the underlying asset transferred to the lessee and continue to recognize a residual asset representing the right to the asset at the end of the lease term.

Essentially, from the lessee perspective, without regard to any criteria, there will be a need to recognize the right to use the asset and the obligation to make lease payments.

As such, arrangements currently in place that result in off-balance-sheet treatment should be evaluated in light of the new guidance. Thus, statements of financial position will need to reflect the assets and liabilities.

Participant loans *continued from front*

principal balance of a loan approximates fair value. Plans would need to use the valuation framework in FASB ASC 820.

Estimating fair value of participant loans requires highly subjective assumptions about market interest rates, credit risks and other assumptions. As such, the Emerging Issues Task Force undertook this issue to see if some practical solution could be developed.

Prior to being amended by the recent update, the guidance in FASB ASC 962 contained the requirement that participant loans in defined contribution plans be classified as plan investments. As noted previously, those investments generally need to be measured at fair value.

As amended by the update, the guidance now requires participant loans to be classified as notes receivable and valued at their outstanding principal amount, plus accrued but unpaid interest. Additionally, no valuation reserves should be determined.

The guidance requiring loans to participants to be classified as notes receivable from participants should serve to reduce the amount of time that plan administrators spend on estimating the fair value of participant loans using observable and unobservable inputs.

Classifying these types of loans as notes receivable from participants also acknowledges that participant loans are unique from other types of plan investments. Participants taking out these loans essentially borrow against their own individual vested benefit balance.

The Emerging Issues Task Force concluded that it would be more meaningful to measure participant loans at their unpaid principal balance, plus any accrued but unpaid interest, rather than using the fair value measurements in FASB ASC 820. Participant loans cannot be sold by the benefit plan.

Additionally, if a participant were to default on a loan, the participant's account would be reduced by the unpaid balance of the loan. There would be no effect on plan investment returns or any account balance of other participants.

The amendments provided in ASU 2010-25 become effective for fiscal years ending after Dec. 15, 2010, and early implementation is permitted. Either way, when the guidance is implemented, it needs to be applied retrospectively to all prior periods presented.

In finalizing the guidance in ASU 2010-25, the Emerging Issues Task Force decided to permit early adoption to allow the application of the guidance to be reflected in 2009 financial statements that are included in Form 5500 when those statements have not yet been filed by reporting entities.

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