

Public Company *Insights*

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Is your company's policy up to snuff?

In the current economic environment, it's common for disgruntled shareholders, investors and other interested parties to file lawsuits or claims against a public company's directors and officers — exposing their personal assets to significant risk. Even innocent parties can be overwhelmed by the cost of mounting a defense.

Many public companies indemnify directors and officers against certain liabilities and legal expenses that arise in the course of their duties. But indemnification may not be a viable option if a company is struggling financially or has filed for bankruptcy. In that case, directors and officers (D&O) insurance provides a vital safety net.

Must-have checklist

Even if your company has D&O coverage, that policy doesn't necessarily provide full protection from personal liability. The terms of D&O policies vary widely, so it's important to review your company's policy to ensure it provides the coverage you expect.

Even if a director or officer ultimately prevails, the cost of defending a lawsuit can be devastating.

In particular, scrutinize these items:

Scope of coverage. Superior D&O policies provide broad coverage of not only formal court proceedings, but also formal and informal government inquiries. In many situations, including SEC investigations, the bulk of a defendant's legal expenses are incurred before a formal claim is filed.



Full severability. The insurance company may attempt to rescind a D&O policy if a company's application (including its financial statements and certain other documents) contains material misrepresentations. A severability clause prevents the insurer from denying coverage to "innocent" directors or officers by imputing those misrepresentations to them. In other words, the insurer must treat each covered party separately and rescind coverage only for those with knowledge that the application or financial statements were false.

Priority of payments. If your D&O policy also provides entity coverage (see "Ordinary and extraordinary coverage" on page 3), a priority of payments, or "order of payments," provision is critical. In the event that your company becomes

insolvent, this provision specifies that the policy proceeds first go to pay for the defense of individual directors and officers and then, if anything is left, to pay for your company's defense.

A bankruptcy court could rule that a D&O policy providing entity coverage is an asset of the bankruptcy estate, thus making it unavailable to directors and officers. Bankruptcy courts are more likely to give directors and officers access to the proceeds if the policy contains a priority of payments clause or endorsement. Of course, the most effective way to protect directors and officers in the event of bankruptcy is to purchase a separate D&O policy — often referred to as a “Side A” policy — that doesn't also cover your company.

Advanced defense costs. Even if a director or officer ultimately prevails, the cost of defending a lawsuit can be devastating. Be sure that your policy requires the insurer to pay directors' and officers' defense costs as they're incurred rather than after the claim has been resolved.

Final adjudication. D&O policies typically exclude coverage for *deliberate* dishonest, fraudulent or criminal acts or omissions, or for conduct that results in improper personal gain (such as insider trading). But good policies provide directors and officers with a defense until there is a *final adjudication* establishing such deliberate misconduct.

Modified insured vs. insured exclusion. The “insured vs. insured” exclusion denies coverage when one insured party files a lawsuit against another. To prevent the insurer from denying coverage for claims brought by a bankruptcy trustee, be sure your policy contains an exception for such claims.

Zero retention. Ideally, your D&O policy will require a low or no retention amount (essentially, a deductible) for claims against individual directors and officers.

Ordinary and extraordinary coverage

Typically, directors and officers (D&O) insurance for public companies includes three types of coverage in a single policy:

- ▶ “Side A” pays defense costs as well as settlements or judgments for individual directors and officers to the extent they are not indemnified by the company (either for legal or financial reasons).
- ▶ “Side B” reimburses the company for indemnifying directors and officers.
- ▶ “Side C” covers claims against the company itself.

Most, but not all, corporate D&O policies include all three, so be sure you know what (and who) is covered, and whether you might need the additional protection of a “stand-alone” Side A policy. (See “Priority of payments” in the main article.)

Also determine whether your policy provides “broad form company liability” coverage. Some policies provide only “named peril” protection, which is limited to specific types of liability (such as employment claims) or certain types of claimants (such as employees or customers).

Plug the holes

Now is a good time to take inventory of your D&O program to ensure that your directors and officers have protection against personal liability.

In addition to looking for the policy provisions described above, check that your policy limits are appropriate in light of your company's activities, loss history and risk profile. If you find holes in your D&O coverage, consider modifying or supplementing your existing policies.

Tough times, tough policy

As a sluggish economy and intense regulatory scrutiny continue to challenge public companies, it's critical that you be able to attract and retain talented independent directors. A comprehensive D&O insurance program can help you do that. ■

Merger mysteries

Accounting for business combinations

A weak economy has caused merger and acquisition activity to slow over the past two years, but business combinations may be on the verge of a comeback. If your company is contemplating M&A activity in the near future, now is a good time to review the applicable accounting standards.

Clarifying fair value

The measurement of fair value under Generally Accepted Accounting Principles has been widely discussed in recent months. The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, in late 2006, but controversy over the new standard didn't heat up until the economy cooled in 2008.

Many companies expressed concern that SFAS 157 (now covered under FASB Accounting Standards Codification™ (ASC) Topic 820, *Fair Value Measurements and Disclosures*) would require them to value assets at fire-sale prices, even in the absence of liquidation plans. To ease such

concerns, FASB issued a series of FASB Staff Positions (FSPs) and Accounting Standards Updates (ASUs) clarifying that market prices need not be relied on in situations where the market for an asset is inactive and evidence exists that quoted prices reflect forced liquidations or distressed sales. In those cases, internal data, such as cash-flow projections, can be used.

SFAS 141(R) requires companies to recognize acquired assets and assumed liabilities at fair value.

Despite new guidance, measuring fair value can be challenging — particularly in an M&A context. For example, SFAS 142 (now found under ASC Topic 350, *Intangibles — Goodwill and Other*) requires companies to test acquired goodwill annually for impairment and to write goodwill down if its

carrying amount exceeds its implied fair value. The implied fair value of goodwill is generally equal to a business unit's fair value less the fair value of its net assets, including any unrecognized intangible assets.

Contingent consideration conundrum

SFAS 141(R) (now found under ASC Topic 805, *Business Combinations*), which took effect in 2009,



requires companies to recognize acquired assets and assumed liabilities at fair value. This can significantly affect an acquiring company's balance sheet and earnings.

The impact is particularly dramatic when contingent considerations, such as earnout agreements, are part of a transaction. In the past, the portion of the purchase price that was contingent on the acquired company achieving certain earnings targets wasn't recognized until the contingency was resolved. Under current rules, however, payments tied to future performance are recognized at their acquisition-date fair value — despite uncertainty over whether they'll be paid.

Suppose, for example, that a buyer agrees to increase the purchase price by \$1 million if the seller meets its earnings targets for the two years following the acquisition. If the buyer's management estimates the probability of meeting those targets at 50%, then 50% of the earnout payment, or \$500,000, should be included in the acquired company's fair value (discounted to present value). Postacquisition changes in fair value are then recognized in income, which creates earnings volatility.

Assets and liabilities

SFAS 141(R)'s rules regarding contingent assets and liabilities also have been controversial. Originally, the statement required companies to record contractual contingencies, such as warranties, at their acquisition-date fair value. Noncontractual contingencies, such as pending litigation, were to be recorded at fair value if they were *more likely than not* to result in an asset or liability. The statement also required companies to constantly revalue contingent assets and liabilities and follow a complex methodology for recognizing changes in their fair value.

Companies, however, criticized this treatment, claiming that it would force them to disclose confidential litigation information and possibly waive attorney-client privilege. FASB responded with FSP No. FAS 141(R)-1, which backs away from some of the changes made by SFAS 141(R).



FSP FAS 141(R)-1 makes several important changes, including:

- ▶ Eliminating the distinction between contractual and noncontractual contingencies,
- ▶ Requiring recognition of acquired contingent assets and liabilities if their acquisition-date fair value “can be determined during the measurement period,” noting that the fair value of a warranty obligation often can be determined,
- ▶ Providing for a contingent asset or liability whose value can't be determined to be recorded if 1) it's *probable* (as opposed to “more likely than not”) that an asset existed or a liability was incurred on the acquisition date, and 2) the amount can reasonably be estimated, and
- ▶ Eliminating the procedures for postacquisition measurement, instructing acquirers to “develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature.”

In general, the FSP is expected to reduce the number of contingencies that must be recorded.

Stay tuned

FSP FAS 141(R)-1 is intended as only a temporary solution, and further developments can be expected in the months and years ahead. In the meantime, you may find that you need greater assistance from outside valuation and other financial professionals to ensure you're accounting correctly for your acquisitions. ■

Revenue gets the recognition it deserves

Recently, the Financial Accounting Standards Board (FASB) finalized two new revenue recognition rules that affect companies. The rules are part of a broader effort by FASB and the International Accounting Standards Board (IASB) to clarify principles for recognizing revenue and develop a joint revenue recognition standard.

International recognition

In late 2008, FASB and IASB issued a joint discussion paper entitled *Preliminary Views on Revenue Recognition in Contracts With Customers*. Revenue is a critical measure of performance for financial statement users, but U.S. Generally Accepted Accounting Principles (GAAP) contain numerous standards that govern revenue recognition, many of which are industry-specific and some of which produce conflicting results. The International Financial Reporting Standards (IFRS), on the other hand, contain a simpler framework but fail to provide guidance on certain issues, such as revenue recognition for “multiple-element” arrangements. (See below.)

The joint project, then, aims to develop a single, contract-based revenue recognition model. It’s based on the idea that companies enter into contracts with customers under which they obtain payment rights and assume performance obligations to provide various goods and services. Under the boards’ joint proposal, a company would recognize revenue when it has satisfied a performance obligation. Generally, that would occur when a customer takes physical possession of a good or receives a promised service.

For many companies, the proposed framework won’t require major changes to their accounting practices, but in some industries the impact may be significant. For example, under many



long-term construction and manufacturing contracts, companies recognize revenue as they perform the contract — even though the customer hasn’t yet received the goods or services. In those cases, the proposed recognition principle would defer revenue until the customer receives the promised goods or services.

2 new rules

FASB recently issued two Accounting Standards Updates (ASUs) that explain changes to FASB Accounting Standards Codification™ (ASC) that will allow some companies to recognize revenue sooner:

1. ASU 2009-13, *Multiple-Deliverable Revenue Arrangements*. This update covers amendments that apply to multiple-element sales, such as a product bundled with a maintenance or support agreement. Under current rules, unless a company has “vendor-specific objective evidence” of the value of individual elements, it’s required to defer revenue recognition for the entire sale over the life of the contract. The amendments give companies greater flexibility to estimate the sales prices of various components and recognize revenue as each component is delivered.

2. ASU 2009-14, *Certain Revenue Arrangements That Include Software Elements*. This update reports on a new rule that allows sellers of smart phones, digital music players and other devices that include both hardware and software to recognize revenue in the same manner as other tangible products, rather than having to apply the software revenue recognition rules. The new rule applies when a tangible product's software and nonsoftware components function together to deliver the product's essential functionality.

In review

The changes reported in these two ASUs, which also include detailed disclosure requirements, take effect for revenue arrangements entered into or materially modified in fiscal years beginning after June 15, 2010 (although earlier adoption is permitted). FASB and IASB are currently reviewing comments on their revenue recognition paper and plan to publish an exposure draft of a new standard sometime in 2010. ■

How subsequent events affect your financial statements

Financial statements provide a snapshot of your company's financial condition on the balance sheet date. But in the real world, a company's assets, liabilities and net worth are in a constant state of flux. What happens when, after your financial statements are prepared, events occur that have a material impact on the numbers?

Historical treatment

For many years, auditing standards have addressed the treatment of events that occur between the date of the financial statements and the date of the auditor's report. Recently, however, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 165, *Subsequent Events*, incorporating these concepts into the accounting literature.

SFAS 165 — now known as Accounting Standards Codification™ (ASC) Topic 855, *Subsequent Events* — doesn't make significant changes to the principles that apply to subsequent events. But it does underscore management's responsibility for identifying and disclosing such events.

To recognize or not to recognize

SFAS 165 defines "subsequent event" as one that occurs after the balance sheet date but before the financial statements are issued (or, for nonpublic companies, "available to be issued"). Statements are considered "issued" when they're widely distributed to shareholders and other financial statement users in a format compliant with U.S. Generally Accepted Accounting Principles.

There are two types of subsequent events:

- 1. Recognized.** These are events that provide additional evidence about conditions that existed on the balance sheet date.
- 2. Nonrecognized.** These are events that provide evidence about conditions that didn't exist on the balance sheet date, but arose after it.

The first type must be recorded in the financial statements. The second type need not be recorded, but may have to be disclosed in the footnotes to ensure that financial statements aren't misleading.

Here's an example: Suppose a major customer files for bankruptcy after your balance sheet date but before you issue your financial statements. That's a recognized subsequent event you should consider in determining the amount of uncollectible trade accounts receivable in your financial statements. If, instead, a devastating fire occurring after your balance sheet date puts the customer out of business, it's considered a nonrecognized subsequent event (assuming the customer was financially healthy on the balance sheet date).

Monitor events

Financial statements must now contain disclosure of the date through which subsequent events have been reviewed and included in the financial statements. To be sure that subsequent events are treated properly in your financial statements, monitor events between the balance sheet date and the issuance date. Then evaluate those events for potential recognition or disclosure.