

# Insights

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## Accounting

### Disclosures about Derivative Instruments and Hedging Activities

Because use and complexity of derivative instruments and hedging activities have increased significantly over the past several years, the Financial Accounting Standards Board (FASB) has issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, to require enhanced disclosures about derivative instruments and hedging activities. The new standard has revised financial reporting for derivative instruments and hedging activities by requiring more transparency about:

- How and why an entity uses derivative instruments;
- How derivative instruments and related hedged items are accounted for under Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and
- How derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows.

Statement No. 161 requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also requires entities to provide more information about their liquidity by requiring disclosure of derivative features that are credit risk-related. Further, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. Examples of the required disclosures are provided in the standard.

The new standard is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged.

Statement No. 161 is available in full at [fasb.org](http://fasb.org).

### A Reminder Regarding the Assessment of Other-Than-Temporary Impairment

In accordance with generally accepted accounting principles, management of a company that is a holder of individual debt securities classified as either available-for-sale or held-to-maturity must determine whether a decline in fair value below the amortized cost basis is other than temporary. In assessing whether a decline is other-than-temporary, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, indicates that if it is probable that the investor will be unable to collect all amounts due (i.e., principal and interest) according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as a new cost basis. It should be observed that a decline in fair value assessed to be other than temporary should not be interpreted to mean a permanent impairment (or decline).

The assessment of whether a decline in fair value is other than temporary should be determined by management for each reporting period (annual and interim periods). Whether management determines that a decline in fair value of a security below cost is temporary or other-than-temporary, it must document the decision process to support that conclusion. Appropriate documentation would include, but not be limited to, an analysis of the security's market value (e.g., amount and duration of decline), the rating of the security available from external sources, the financial performance of the issuer, and trends in the issuer's industry. It should be noted that for securities such as

collateralized mortgage obligations, this analysis also should include an evaluation of the liquidity of the underlying collateral.

FASB Staff Position (FSP) No. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, describes three steps that management should use in determining when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. In applying the first step, an investment is impaired if the fair value of the investment is less than its cost. For a cost-method investment for which a fair value has not been estimated, the FSP provides impairment indicators, which should be used in evaluating whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment. When the cost or carrying value of an investment is impaired, then step two of the FSP is applied.

Step two requires an assessment of whether the impairment is either temporary or other than temporary. An investor must apply guidance that is pertinent to the determination of whether an impairment is other than temporary, such as paragraph 16 of Statement No. 115, paragraph 6 of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets."

Step three provides that when it is determined that the impairment is other than temporary, then an impairment loss must be recognized in earnings equal to the entire difference between the investment's cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. In periods subsequent to the recognition of an other-than-temporary impairment loss for debt securities, an investor should account for the other-than-temporary impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment.

### **Application of Purchase Accounting**

The application of purchase accounting can often involve difficult questions. One of these may be the proper basis for the measurement of the net assets acquired. This can be an issue when the acquired entity's owners receive ownership interests of the acquiring entity as consideration (continuing ownership interest), or when the acquiring entity purchases less than 100% of the ownership interests of the acquired entity (e.g., there remains a minority or noncontrolling interest in the acquired entity).

However, before considering the application of purchase accounting, a determination must be made as to whether the accounting is being evaluated from the perspective of the acquiring entity or the acquired entity. If the focus is on the accounting by the acquired entity in its financial statements, this does not give rise to purchase accounting considerations. Instead, the only consideration for the acquired entity is whether it should apply push-down accounting (in some cases involving public entities, push-down accounting is required). This article will focus on accounting for an acquisition by the acquiring entity not involving entities under common control (e.g., the acquiring entity and acquired entity are not under the control of the same individual (or entity) or close family members).

Accounting for an acquisition of an entity is done in only one of two ways. One is the application of leveraged-buyout (LBO) accounting under EITF Issue No. 88-16, "Basis in Leveraged Buyout Transactions". The other way is the application of FASB Statement No. 141, Business Combinations.

To apply LBO accounting, the following conditions must be met:

1. A newly-formed company (NEWCO) acquires all of the outstanding shares of the acquired entity (OLDCO) in a single or series of related and anticipated transactions.
2. NEWCO must have had no substantive prior operations.
3. The acquisition must be highly leveraged.
4. The acquisition must result in a change in control of OLDCO.

Only when these four conditions have been met may LBO accounting be applied. When LBO accounting cannot be applied, Statement No. 141 must be applied to all other acquisitions. The fundamental difference between the two

accounting methods involves the measure of the net assets acquired when there is a continuing ownership interest in the acquiring entity by the owners of the acquired entity. The following examples will help illustrate this point:

#### Example 1

1. NEWCO is formed to acquire 100 percent of the outstanding shares of OLDCO in a single transaction.
2. The transaction is highly leveraged (e.g., 70 percent from proceeds of a bank loan and 30 percent from the proceeds of the sale of NEWCO stock).
3. OLDCO shareholders will receive cash and 20 percent of the shares of NEWCO in exchange for their OLDCO shares.

In this example, the conditions of LBO accounting have been met. Accordingly, the transaction must be accounted for in accordance with Issue No. 88-16. LBO accounting results in a new basis for the 80 percent interest in OLDCO acquired by the new owners while the continuing ownership interest (20 percent) is recorded at the OLDCO shareholders' historical carrying value.

#### Example 2

Assume the same transaction discussed in Example 1 except the transaction is not highly leveraged. In this case, the transaction is not in the scope of Issue No. 88-16, and Statement No. 141 must be applied. The application of Statement No. 141 to that transaction results in the acquisition being accounted for at full fair value. That is, the sum of the cash paid to acquire the 80 percent interest in OLDCO and the fair value of the 20 percent interest represented by the shares issued by NEWCO in exchange for OLDCO shares should be used to record the acquisition.

#### Example 3

1. NEWCO acquires 80 percent of the shares of OLDCO for cash.
2. The remaining 20 percent of OLDCO is retained by existing OLDCO shareholders and NEWCO is issuing consolidated financial statements.

In NEWCO's consolidated financial statements, OLDCO is recorded based on the acquisition price paid for the 80 percent interest, and the 20 percent noncontrolling interest is recorded at the historical carrying value recorded by OLDCO (partial purchase method or step-acquisition accounting). The basis in OLDCO's net assets recorded by NEWCO is the same as in Example 1. However, the accounting treatment does differ from Example 1 because there is a noncontrolling interest outstanding while in Example 1 there was no noncontrolling interest as 100 percent of the shares of OLDCO were acquired. As a result, a noncontrolling interest must be recorded by NEWCO in its financial statements in this example. Furthermore, in this example Issue No. 88-16 cannot be applied by NEWCO (regardless of whether the transaction is highly leveraged or not) as all of the shares of OLDCO were not acquired.

#### Future

If the transactions in Examples 1 and 3 were to occur in annual reporting periods beginning after December 15, 2008 (the effective date of FASB Statement No. 141 (revised 2007), Business Combinations, which replaces Statement No. 141 and nullifies Issue No. 88-16), the accounting treatment would differ. The accounting treatment for Example 1 would change to be consistent with that in Example 2. The accounting treatment for Example 3 would be at full fair value calculated using the fair value of the 80 percent acquired and the fair value of the 20 percent noncontrolling interest.

### **Employers' Disclosures about Postretirement Benefit Plan Assets**

The Financial Accounting Standards Board (FASB) has issued proposed FASB Staff Position (FSP) No. FAS 132(R)-a, Employers' Disclosures about Postretirement Benefit Plan Assets. If finalized, the proposed FSP would amend FASB Statement No. 132 (revised 2003), Employers' Disclosures about Pensions and Other Postretirement Benefits, to revise employers' disclosures about postretirement benefit plan assets. The proposed amendments to the guidance regarding these disclosures include:

- A principle for disclosing the fair value of categories of plan assets based on the types of assets held in the plan;

- Categories of plan assets that, if significant, should be disclosed;
- Disclosures about the nature and amount of concentrations of risk arising within or across categories of plan assets; and
- Disclosures about fair value measurements similar to those required by FASB Statement No. 157, Fair Value Measurements.

Additionally, the proposed FSP includes a technical amendment to Statement No. 132(R) that would require a nonpublic entity to disclose net periodic benefit cost. This technical amendment would be effective upon issuance of the final FSP. The disclosures about plan assets required by the proposed FSP would be applied on a prospective basis for fiscal years ending after December 15, 2008. Earlier application of the provisions of the FSP would not be permitted.

The proposed FSP is available for comment until May 2, 2008 at [fasb.org](http://fasb.org).

## Auditing

### Results of National Business Ethics Survey

The Ethics Resource Center has completed its 2007 National Business Ethics Survey, which is a measurement of trends in workplace ethics, and a guide in identifying ethics risks and measures of program effectiveness. The results of the survey, which are available in full at [ethics.org](http://ethics.org), suggest that although the number of formal ethics and compliance programs is on the rise, ethical misconduct is still very high. Conflicts of interest, abusive behavior, and lying pose the most severe ethics risks to companies today.

Among other findings, the survey shows that:

- 56 percent of employees surveyed at U.S. public and private companies had personally observed violations of company ethics standards, policy, or the law, with many observing multiple violations.
- Employees are reluctant to report observations for fear of retaliation or belief that reporting would not lead to corrective action, with 42 percent of employees who witnessed misconduct not reporting it through any company channel.
- Less than 40 percent of employees are aware of comprehensive ethics and compliance programs at their companies.

The survey concludes that coupling a strong ethical culture with a tough ethics and compliance program is the path to the greatest reduction in ethics risk. In addition, the survey identifies the characteristics that comprise an effective ethical culture. By many indications in the survey, what seems to matter most is the extent to which leaders intentionally make ethics a part of their daily conversations and decision-making, supervisors emphasize integrity when working with their direct reports, and peers encourage each other to act ethically.

The survey results have important implications for both management and auditors. Management should consider strengthening ethics policies, doing more to inform and educate employees about Company policies and expectations, encouraging employees to report unethical behavior and taking swift and severe action against violators. Auditors should assess the effectiveness of the Company's ethical policies and procedures and consider this assessment in assessing the risks of material misstatement due to fraud and in designing further audit procedures that are responsive to those assessments.

## International

### **Reducing Complexity in Reporting Financial Instruments**

The existing requirements for the reporting of financial instruments are widely regarded as difficult to understand, interpret, and apply. In response to this concern, the International Accounting Standards Board has published for public comment a discussion paper, Reducing Complexity in Reporting Financial Instruments. The discussion paper analyzes the main causes of complexity in reporting financial instruments and proposes possible intermediate approaches to address some of them, including amending or replacing existing reporting requirements. This document is the first stage in a project which aims to replace International Accounting Standard 39, Financial Instruments: Recognition and Measurement, with a principle-based standard. The discussion paper also sets out the arguments for and against a possible long-term approach that would use one measurement method for all types of financial instruments within the scope of a financial instruments standard.

The discussion paper is available for comment until September 19, 2008 at [iasb.org](http://iasb.org).

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