

Insights

January 27, 2009

A biweekly audit and accounting publication

Accounting

Impairment Guidance Amended

If the fair value of an available-for-sale or held-to-maturity debt security is less than its cost basis at the measurement date, U.S. generally accepted accounting principles (GAAP) require that the reporting entity assess the impaired security to determine whether the impairment is other than temporary. U.S. GAAP has two models for determining whether the impairment of an available-for-sale or held-to-maturity debt security is other than temporary:

- For debt securities that are beneficial interests in securitized financial assets within the scope of Emerging Issues Task Force (EITF) Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," an impairment is considered other than temporary if, based on the reporting entity's best estimate of cash flows that a market participant would use in determining the current fair value of the beneficial interest, there has been an adverse change in those estimated cash flows. Issue No. 99-20 therefore requires the use of market participant assumptions regarding future cash flows, which cannot be overcome by management judgment regarding the probability of collecting all cash flows previously projected.
- Debt securities that are not within the scope of Issue No. 99-20 must apply FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Statement No. 115 indicates that an impairment is other than temporary because it is probable that the holder will be unable to collect all amounts due according to the contractual terms. Statement No. 115 does not require exclusive reliance on market participant assumptions regarding future cash flows, thereby permitting the use of reasonable management judgment of the probability that the holder will be unable to collect all amounts due.

Some constituents have indicated that because Issue No. 99-20 requires entities to use market participant assumptions regarding future cash flows without consideration of the probability that all cash flows will be collected, the application of Issue No. 99-20 in a dislocated market automatically results in an other-than-temporary impairment (OTTI) any time the fair value is less than cost. Due to this and other concerns, the Financial Accounting Standards Board (FASB) has issued FASB Staff Position (FSP) No. EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20*, to amend the impairment guidance in Issue 99-20. The intent of the FSP is to reduce complexity and achieve more consistent determinations as to whether other-than-temporary impairments of available-for-sale or held-to-maturity debt securities have occurred by aligning the impairment guidance in Issue No. 99-20 with that of Statement No. 115.

The FSP does not amend the requirement in Statement No. 115 and Issue No. 99-20 to apply the OTTI guidance and disclosures in FSP No. FAS 115-1 and 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, SEC Staff Accounting Bulletin Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*, and other related literature to all debt securities classified as available-for-

sale and held-to-maturity, including beneficial interest in securitized financial assets. The FSP is effective for interim and annual reporting periods ending after December 15, 2008, with prospective application required. The FSP is available in full at http://www.fasb.org/pdf/fsp_eitf99-20-1.pdf.

Assumptions Used to Calculate Long-Duration Policy Benefit Liability

FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires insurance companies to determine best estimate assumptions (with a provision for adverse deviation) at contract inception for calculating the long-duration policy benefit liability. These original assumptions must continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the “lock-in concept”) unless a premium deficiency exists. Premium deficiency situations can exist when:

- The present value of future payments for benefits and related expenses less the present value of future gross premiums (both determined using revised assumptions based on actual and expected experience) exceed the existing liability for future policy benefits reduced by unamortized acquisition costs.
- The liability on a particular line of business is not deficient in the aggregate, but circumstances are such that profits would be recognized in early years and losses in later years.

Certain insurance contracts classified as FASB Statement No. 60 long-duration insurance contracts may include provisions that allow for premium rate increases by class of customer, subject to regulatory approval. Policies with these provisions may include long-term care, Medicare supplements, and certain other guaranteed renewable contracts. The question has been raised as to whether an insurance company, in calculating the long-duration policy benefit liability, is permitted to “unlock” its original FASB Statement No. 60 assumptions after contract inception for collected, approved, or expected premium rate increases in situations other than in premium deficiency.

The American Institute of Certified Public Accountants recently issued TIS Section 6300.36, “Prospective Unlocking,” to address this question. This TIS concludes that policyholder benefit liability assumptions cannot be unlocked for collected, approved, or expected premium rate increases for long-duration insurance contracts that allow for premium rate increases by class of customer, other than in the premium deficiency situations described above. TIS 6300.36 is available in full at http://www.aicpa.org/download/acctstd/TIS_section_6300-36_Pro Prospective_Unlocking.pdf.

AcSEC Releases Draft Issues Paper on Valuation of Interests in Alternative Investments

Investor entities are faced with several challenges in applying the provisions of FASB Statement No. 157, *Fair Value Measurements*, to their interests in alternative investments. The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) therefore has issued a draft issues paper, *FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments*. The draft issues paper discusses how to estimate the fair value of alternative investments in accordance with the provisions of Statement No. 157. The primary focus of the paper is how to consider net asset value (NAV) in the approach to fair value measurement.

Alternative investments are defined as investments in private investment funds that meet the definition of an “investment company” under the provisions of the AICPA Audit and Accounting Guide, *Investment Companies*. These investments include interests in hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles and funds of funds, as well as bank common/collective trust funds and other similar funds. Alternative investments are not registered with the SEC and, thus, are available only to sophisticated investors, often institutions. For various tax and regulatory reasons, sponsors of alternative investments do not permit investors in the funds to transfer their interests without the sponsor’s permission. Accordingly, there is no organized market for trading interests in alternative investments, transactions are infrequent and difficult to complete, and, to the extent any transactions occur directly between investors, there is extremely limited, if any, transparency as to transaction prices.

To assist with the estimation of fair value of interests in alternative investments, auditors and management of investor entities currently usually use the guidance in applicable AICPA industry audit and accounting guides (including the Investment Companies Guide), Interpretation No. 1 of AU Section 332, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist", or the nonauthoritative practice aid, *Alternative Investments - Audit Considerations*. That practice aid noted that a readily determinable fair value does not exist for many alternative investments, which, in many cases, makes the task of estimating fair value the biggest single challenge in financial reporting related to alternative investments.

The AcSEC draft issues paper focuses on estimating the fair value of alternative investments in fund-of-funds and direct investments in funds that are not traded in active markets. Jay Hanson, Chair of AcSEC and Director of Accounting for McGladrey & Pullen, believes the issues paper will be helpful to management of investor entities as they implement the provisions of Statement No. 157 in estimating the fair value of their interests in alternative investments. He concluded, "This issues paper focuses on certain aspects of alternative investments that should be meaningful to management of the investor entity in carefully considering how third-party input is used in estimating fair value."

The draft issues paper is available for comment until February 27, 2009 at http://www.aicpa.org/download/acctstd/Alternative_Investments_Draft_Issues_Paper-01-09-09-FINAL.pdf.

Guidance Proposed for Statement No.133 Scope Exception for Embedded Credit Derivatives

Paragraph 14B of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, states:

"Changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the issuing entity shall not be considered an embedded derivative under this Statement. The concentration of credit risk in the form of subordination of one financial instrument to another shall not be considered an embedded derivative under this Statement."

To resolve some potential ambiguity about the breadth of this scope exception, the Financial Accounting Standards Board (FASB) Derivatives Implementation Group has issued proposed Implementation Issue No. C22, *Scope Exceptions: Exception Related to Embedded Credit Derivatives*. This proposed implementation guidance addresses how to determine, under paragraph 14B of Statement No. 133, which embedded credit derivative features, including those in collateralized debt obligations (CDOs) and synthetic CDOs, are considered not to be embedded derivatives that must be analyzed under paragraphs 12 and 13 of Statement No. 133 for potential bifurcation and separate accounting. Proposed Issue No. C22 concludes that the embedded credit derivative feature related only to the concentration of credit risk in the form of subordination of one financial instrument to another should not be considered an embedded derivative that is subject to the application of paragraphs 12, 13, and 14A. Thus, those embedded credit derivative features do not need to be analyzed under those paragraphs for potential bifurcation from the host contract and separate accounting as a derivative. However, the proposed guidance also states that other embedded credit derivative features, including those in some CDOs and synthetic CDOs, are considered embedded derivatives subject to the application of paragraphs 12, 13, and 14A (including analysis of whether the economic characteristics and risks of the embedded credit derivative features are clearly and closely related to the economic characteristics and risks of the host contract), provided that the overall contract is not a derivative in its entirety under paragraph 6 of Statement No. 133.

If finalized, the proposed implementation guidance would be effective on the first day of an entity's first fiscal quarter beginning after December 15, 2008. The proposed guidance is available for comment until February 13, 2009 at http://www.fasb.org/derivatives/01-14-09_C22.pdf.

McGladrey & Pullen Comments on Proposed FSPs

Recently, the Financial Accounting Standards Board (FASB) proposed FASB Staff Position (FSP) No. FAS 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*. McGladrey & Pullen, LLP issued a letter of comment in which we supported the FASB's objective of amending and clarifying FASB Statement No. 141(R), *Business Combinations*, to address implementation issues that have been raised regarding the recognition and measurement of assets acquired and liabilities assumed in a business combination that arise from contingencies. Overall we believe the proposed FSP is necessary to make the provisions of Statement No. 141(R) more operational to account for contingencies acquired in a business combination. We generally support the proposed FSP's overall method of accounting for pre-acquisition contingencies; however, we believe the final FSP should explicitly state that all litigation-related contingencies should be accounted for in accordance with FASB Statement No. 5, *Accounting for Contingencies*. Additionally, we believe that subsequent accounting complexities would be reduced if there were a single accounting model for the initial recognition and measurement, subsequent accounting, and disclosure of all contingencies, including those acquired or assumed in a business combination and those that arise in the normal course of business.

The FASB also recently issued proposed FSP No. FAS 107-a, *Disclosures about Certain Financial Assets: An Amendment of FASB Statement No. 107*. McGladrey & Pullen, LLP issued a letter of comment in which we stated that we do not support the proposed FSP as we do not agree it will achieve the FASB's objective of increasing comparability of information about certain financial assets that have related economic characteristics but have different reporting measurement attributes. Our concerns identified in the letter include:

- The proposed effective date should be delayed, preferably to years ending after December 15, 2009.
- The "incurred loss" measurement is not understood by those users, preparers, or auditors who have not had to apply FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*.
- Questioning whether incurred loss information is useful information.

Our letters of comment are available in full at www.fasb.org/ocl/fasb-selectproject.php.

PCFRC Meets

The Private Company Financial Reporting Committee (PCFRC) held its regularly scheduled meeting in Norwalk, Connecticut on January 8 and 9, 2009. The main focus of the meeting was to hold a face-to-face meeting with the members of the Financial Accounting Standards Board (FASB) and some of its staff. In addition, the PCFRC also discussed the status of FASB projects and activities, and its plans related to providing the FASB with input on those projects.

Prior to meeting with the FASB, the PCFRC discussed the disclosure requirement in paragraph 10 of FASB Staff Position (FSP) No. FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*. That paragraph requires entities that elect to defer the application of FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, to explicitly disclose that fact and their policy for evaluating uncertain tax positions for each set of financial statements where the deferral applies. The PCFRC was concerned that companies may have missed this disclosure requirement (as it was not in the related Exposure Draft) and may be under the mistaken assumption that there are no new disclosure requirements.

The PCFRC also discussed proposed FSP No. FAS 107-a, *Disclosures about Certain Financial Assets: An Amendment of FASB Statement No. 107*. Certain PCFRC members expressed that the timing of the release of the proposed FSP was a concern to private companies. The proposed FSP was issued on December 24, 2008 with a proposed effective date of interim and annual reporting periods ending after December 15, 2008. PCFRC members

discussed that the proposed FSP appears to be directed at responding to concerns about public companies rather than private companies, but given the scope of the proposed FSP, many private companies may find themselves within its scope.

During its meeting with the members of the FASB and selected staff, the following were discussed:

- FIN 48 deferral - Both parties expressed frustration related to that particular project.
- Frequency of meetings - FASB Chairman Bob Herz stated that the PCFRC and FASB should meet at least annually, and more often as situations dictate.
- PCFRC User Panel - FASB members noted they found input of the User Panel on FIN 48 to be very helpful. FIN 46(R) - The PCFRC discussed issues related to the applicability and requested inclusion in future standards of examples specific to private companies.
- SEC IFRS Roadmap - The PCFRC will provide its comments to the FASB for inclusion in the FASB's comment letter.
- Financial Statement Presentation Project - The PCFRC expressed concerns about this project, stating that it seems to be driven by concerns of equity analysts who follow public companies and not by concerns of lenders, etc. who analyze financial statements of private companies. Certain PCFRC members believe the proposed statement, if finalized, will result in a large cost of adoption/application without a corresponding benefit for private companies.

After its meeting with the FASB, the PCFRC briefly discussed developments in other projects including the Leases Project, the proposed FSP on discontinued operations, loss contingencies, and proposed FSP 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*.

Additional discussion was held on the Financial Statement Presentation Project, during which a number of concerns were voiced. It was noted that the International Accounting Standards Board (IASB) provided an election in its standard for private companies not to apply this proposal. FASB staff present noted that, in their view, the election was a procedural issue and the IASB may indeed make the standard applicable to private companies through other avenues. Certain PCFRC members reiterated their concerns related to the costs of application, which they saw to include use of the direct cash flow method, reconciliations of cash flows, and disaggregation, as well as requirements to purchase/modify software, and train and educate employees. The PCFRC decided to submit comments to the FASB, with a focus on the applicability to nonpublic enterprises.

Financial Institutions

Tax Accounting Implications of Compensation Limitation

The Emergency Economic Stabilization Act of 2008 allocated up to \$700 billion for the U.S. Treasury to buy mortgages and other troubled assets owned by financial institutions under a new Troubled Asset Relief Program (TARP). Under this program, the U.S. Treasury established a voluntary Capital Purchase Program (CPP) to encourage U.S. financial institutions to build their capital base, which in turn is expected to increase the capacity of those institutions to lend to U.S. businesses and consumers and to support the U.S. economy. Pursuant to the CPP, the U.S. Treasury will purchase up to \$250 billion of senior preferred shares on standardized terms, which will include warrants for future Treasury purchases of common or preferred stock.

Entities that participate in CPP become subject to new executive compensation limitations and corporate governance standards. Also, participants in CPP are subject to a new deduction limitation under the Internal Revenue Code, which limits the annual federal income tax deduction for compensation paid to certain executives to \$500,000 per executive. The CPP provisions apply to both publicly traded and privately held entities. While the CPP authority period is expected to end on December 31, 2009 (or through October 3, 2010 if extended), the executive compensation provisions will continue to apply to all subsequent years during which the Treasury holds an equity or debt position in the entity.

For financial reporting purposes, the tax effect from derecognizing previously accrued current and deferred tax benefits should be recorded as income tax expense in the first interim period in which an entity becomes subject to the new limitation. In future periods, the tax effect of the \$500,000 annual limitation should be anticipated in the calculation of the estimated annual effective tax rate used to compute the tax provision during interim reporting periods. The new limitation needs to be considered in measuring deferred tax assets for any applicable compensation-related temporary differences such as those related to stock option awards.

Under the new limitation, share-based payments are considered to be compensation. Therefore, the accounting for the income tax effects of share-based awards will necessitate making a determination of whether the compensation expense recognized in accordance with FASB Statement No. 123 (revised 2004), Share-Based Payment, is expected to be deductible in light of the new limitation. If the compensation expense is not expected to be deductible, a deferred tax asset should not be recognized.

International

Leases: IFRS vs. U.S. GAAP

This article is the eleventh in a series of articles that takes our readers on a journey through International Financial Reporting Standards (IFRS) with a special focus on the standards' quintessential feature: they are principles-based. In this article, we provide an overview of some of the most significant differences between IFRS and U.S. generally accepted accounting principles (GAAP) with regard to leases. Actual differences in the accounting treatment between the two frameworks depend on specific circumstances.

Under IFRS, International Accounting Standard (IAS) 17, *Leases*, is the primary standard that deals with the accounting for lease arrangements. In addition to IAS 17, there are three interpretations that form the core IFRS literature on leases. On the other hand, U.S. GAAP regarding lease accounting includes much more voluminous and detailed guidance. In U.S. GAAP literature FASB Statement No. 13, *Accounting for Leases*, represents the pivotal standard, but it is surrounded by a multitude of other standards and interpretations. In total, more than fifty documents regulate accounting for leases under U.S. GAAP. At a glance, the disparity of the volume of literature provides a sound indication of what is at the core of the differences between the two frameworks: a diametrically opposed approach in terms of "principles vs. rules."

Both frameworks distinguish between "capital leases" ("finance leases" in IFRS terms) and "operating leases." Generally, under U.S. GAAP if, at its inception a lease meets one or more of the following four criteria, the lease must be classified as a capital lease by the lessee:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term is equal to 75 percent or more of the estimated economic life of the leased property.

- The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the leased property over any related investment credit retained by the lessor.

Under IAS 17, a lease arrangement is classified as a finance lease when substantially all risks and rewards incidental to ownership have been transferred. This general principle is assessed via a series of indicators, which are similar to those in U.S. GAAP, with some additional ones. However, differently from U.S. GAAP, IFRS indicators do not contain any numeric thresholds. In other words, if the lease term is 77 percent of the estimated economic life of the leased asset, this by itself does not automatically trigger classification as a capital lease. Indicators are meant to help preparers in exercising their judgment in order to comply with the overarching general principles.

According to IAS 17, when determining the present value of minimum lease payments, the discount rate to be used is the interest rate implicit in the lease. If this determination is not practical, the lessee's incremental borrowing rate must be used. On the other hand, U.S. GAAP states that the incremental borrowing rate must be used, but it can be replaced by the implicit rate computed by the lessor if certain conditions are met.

Other differences can arise in cases where the leased item comprises both a land and a building component or where sale and leaseback transactions are in place. In such situations, both frameworks include different and more detailed guidance, which could lead to a different accounting treatment. A thorough and meaningful analysis of differences can be done only given specific arrangements. As already highlighted in previous articles, IAS 17 also interacts with many other standards. This can lead to a series of other differences that are indirectly triggered by those standards. In particular, IAS 16, *Property, Plant and Equipment*, might further significantly increase the gap between IFRS and U.S. GAAP.

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