

Insights

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Accounting

A Review of the Fair Value Hierarchy under Statement No. 157

FASB Statement No. 157, *Fair Value Measurements*, defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. To increase consistency and comparability in fair value measurements and related disclosures, Statement No. 157 establishes a fair value hierarchy, which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. Following is a brief review of the fair value hierarchy; however, Statement No. 157 should be consulted in its entirety for complete guidance.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, except as follows:

- If the reporting entity holds a large number of similar assets or liabilities that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.
- In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

- Quoted prices for similar assets or liabilities in active markets.
- Quoted prices for identical or similar assets or liabilities in markets that are not active.
- Inputs other than quoted prices that are observable for the asset or liability.

- Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.

Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). The reporting entity's own data used to develop unobservable inputs should be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

As explained above, the level is determined by the inputs used to determine fair value. There are some misperceptions about how to determine where in the hierarchy a fair value measurement falls. For example, one misperception is that the valuation model utilized affects the level determination. Instead, one must analyze the inputs used in the model to determine their significance and the hierarchy level. The inputs with the most significance will determine the level of the fair value measurement.

Another misperception is that the higher the risk is, the lower in the hierarchy the fair value measurement falls. For example, if the counterparty credit risk is high and that input is significant, it has been assumed that the fair value measurement is Level 3. However, the correct answer is based on how observable the counterparty credit risk is. If an entity's credit-risk rating is published and/or available from many sources, that would be considered observable and a Level 2 input, therefore making the fair value measurement a Level 2. However, if the risk rating is determined using data gathered by a client and not from observable sources, the input would be Level 3.

Electing the Fair Value Option at the Effective Date of Statement No. 159

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115*, provides all entities with an option to choose, at specified election dates, to measure selected financial assets and liabilities at fair value. The following items are eligible for the irrevocable fair value measurement option established by Statement No. 159:

- Recognized financial assets and financial liabilities except:
 - An investment in a subsidiary that the entity is required to consolidate
 - An interest in a variable interest entity that the entity is required to consolidate
 - Employers' and plans' obligations (or assets representing net overfunded positions) for pension benefits, other postretirement benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined
 - Financial assets and financial liabilities recognized under lease accounting

- Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions
- Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders' equity, including "temporary equity"
- Firm commitments that would otherwise not be recognized at inception and that involve only financial instruments
- Nonfinancial insurance contracts and warranties that the insurer can settle by paying a third party to provide those goods or services
- Host financial instruments resulting from separation of an embedded nonfinancial derivative instrument from a nonfinancial hybrid instrument

Statement No. 159 is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. At the effective date, an entity may elect the fair value option for eligible items that exist at that date. For an entity that has a calendar fiscal year, the election of the fair value option was available on January 1, 2008 for eligible items that existed on that date. Therefore, the ability to elect the fair value option for eligible items that existed on January 1, 2008 is no longer available for calendar year-end companies. Entities should retain evidence documenting the election of the fair value option for eligible items, including those for which the option was elected upon the adoption of Statement No. 159.

The Statement is available in full at <http://www.fasb.org/pdf/fas159.pdf>.

Reducing Complexity in Reporting Financial Instruments

The Financial Accounting Standards Board (FASB) has issued an Invitation to Comment on *Reducing Complexity in Reporting Financial Instruments*. The Invitation to Comment seeks input on whether there is a need for the FASB to add a project to simplify and improve standards for measurement of financial instruments and, if so, what kind of projects or approaches should be considered. This document also describes how current measurement requirements cause complexity, discusses ways it might be reduced in the intermediate term, and suggests how using a single measurement attribute such as fair value could reduce complexity. The Invitation to Comment includes a discussion paper issued by the International Accounting Standards Board, *Reducing Complexity in Reporting Financial Instruments*, which 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.

The [FASB's Invitation to Comment](#) is available for comment until September 19, 2008.

Application of the Two-Class Method to Master Limited Partnerships

At its March 26, 2008 meeting, the Financial Accounting Standards Board (FASB) ratified the final consensus reached at the March 12, 2007 Emerging Issues Task Force (EITF) meeting for EITF Issue No. 07-04, "Application of the Two-Class Method under FASB Statement No. 128, 'Earnings per Share,' to Master Limited Partnerships". Master limited partnerships (MLPs) often issue multiple classes of securities that participate in partnership distributions based on a formula. A typical MLP consists of a general partner interest (GP), publicly traded limited partner units (LPs), and incentive distribution rights (IDRs). IDRs are a type of limited partner interest; however, they are nonvoting interests that do not represent ownership in the MLP. The Task Force reached a consensus that this Issue would be applicable to all MLP arrangements regardless of whether the IDRs are a separate interest or embedded in the GP interest.

When the IDRs are a separate LP interest, the IDRs would represent a participating security and therefore the MLP would allocate current-period earnings to the LP, GP, and IDR holder using the two-class method. When current-period earnings are in excess of cash distributions, undistributed earnings should be allocated to the GP, LPs, and IDR holder as if the undistributed earnings were available cash. When cash distributions are in excess of current-period earnings, net income (or loss) should be reduced (or increased) by distributions to the GP, LPs, and IDR holder. The resulting hypothetical loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement. This consensus assumes that the IDR holder does not have a contractual obligation to share in the losses of the MLP.

When the IDR is embedded in the GP interest, the IDR would not be considered a participating security; however, the MLP would still apply the two-class method to the interests of the GP and LPs (although the GP's earnings allocation would include the rights of the IDR). Undistributed earnings should be allocated to the GP (including the distribution rights of the embedded IDR) and LPs as if the undistributed earnings were available cash. When the IDR is embedded in the GP interest, net income (or loss) should be reduced (or increased) by distributions to the GP (including the distribution rights of the embedded IDR) and LPs. The resulting hypothetical loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement.

The guidance in this Issue is effective in the first fiscal year beginning after December 15, 2008, including the interim periods within that fiscal year.

Tentative Conclusions Reached on Three EITF Issues

At its March 12, 2008, meeting, the Emerging Issues Task Force (EITF) reached tentative conclusions on three EITF Issues, which are summarized as follows:

- *EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock"*
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, specifies that a contract (that would otherwise meet the definition of a derivative under that Statement) issued or held by the reporting entity that is both indexed to its own stock and classified in stockholders' equity in its statement of financial position should not be considered a derivative financial instrument for purposes of applying that Statement. Issue No. 07-5 provides tentative guidance for determining whether an equity-linked financial instrument (or an embedded feature) is indexed to an entity's own stock, using a two-step approach. First, the instrument's contingent exercise provisions, if any, must be evaluated, followed by an evaluation of the instrument's settlement provisions. If finalized, the guidance in this Issue would be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years.
- *EITF Issue No. 08-3, "Accounting by Lessees for Nonrefundable Maintenance Deposits"*
Certain lease agreements include provisions requiring the lessee to make deposits with the lessor to financially protect the lessor if the lessee does not properly maintain the leased asset. This Issue addresses whether lessees should account for nonrefundable maintenance deposits as a deposit or as contingent rental expense, and tentatively concludes that nonrefundable maintenance deposits should be accounted for as a deposit asset. The scope of this Issue is limited to nonrefundable maintenance deposits paid by a lessee under an arrangement accounted for as a

lease. If finalized, this Issue would be effective for fiscal years beginning after December 15, 2008, including interim periods within those fiscal years.

- *EITF Issue No. 08-4, "Transition Guidance for Conforming Changes to Issue No. 98-5, 'Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios'"*

The objective of this Issue is to provide transition guidance for conforming changes made to Issue No. 98-5 that resulted from Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," and FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. This transition guidance is unique in that the current changes reflect matters that should have been addressed in the past, but were missed. Issue No. 08-4 tentatively concludes that conforming changes made to Issue No. 98-5 that result from Issue No. 00-27 and Statement No. 150 will be effective for financial statements issued for fiscal years ending after December 15, 2008.

Also, at the March EITF meeting the SEC Observer announced that revisions to EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities," were made to include the SEC staff's views regarding the interaction between Topic D-98 and FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. Minutes of the March 12, 2008 EITF meeting are available at http://www.fasb.org/eitf/03-12-08_mtg_minutes.pdf.

Public Sector

Proposed Changes to Concepts Statement No. 2

An important component of public sector financial reporting is information about service efforts and accomplishments (SEA). Such information provides insight into how effectively and efficiently state and local governments utilize resources to achieve their missions on behalf of their citizens. To bring its conceptual framework up to date on advances made by governments in reporting SEA information, the Governmental Accounting Standards Board (GASB) has proposed changes to Concepts Statement No. 2, *Service Efforts and Accomplishments Reporting*. The proposed amendments also would clarify the role of the GASB in SEA reporting.

To enhance a common understanding of the elements, characteristics, limitations, and methods of communicating SEA performance information, the GASB proposes to modify four sections of Concepts Statement No. 2 (*Purpose and Scope*, *The Elements of SEA Reporting*, *Limitations of SEA Information*, and *Enhancing the Usefulness of SEA Information*). The proposed changes to the *Purpose and Scope* section would clarify that it is beyond the scope of the GASB to establish the goals and objectives of state and local government services, develop specific nonfinancial measures or indicators of service performance, or set standards for service performance. Some provisions of the *Developing Reporting Standards for SEA Information* section have been interpreted in ways that cause confusion, and therefore the GASB proposes to eliminate that section from the Concepts Statement entirely.

The Exposure Draft is available for comment until July 3, 2008 at http://www.gasb.org/exp/ED_SEA.pdf.

SEC

Quarterly MD&A Disclosures Regarding Statement No. 157

Public entities must discuss in Management's Discussion and Analysis (MD&A) any known trends or any known demands, commitments, events, or uncertainties reasonably expected to have a material favorable or unfavorable impact on results of operations, liquidity, and capital resources. Under FASB Statement No. 157, *Fair Value Measurements*, judgment must be applied in using unobservable (Level 3) inputs to determine the fair value of assets and liabilities, and use of them can have a material effect on results of operations, liquidity, and capital resources, where, for example, the fair value determined falls within a broad range. As a result, the SEC's Division of Corporation Finance recently identified a number of disclosure issues related to Statement No. 157 that public entities may wish to consider in preparing MD&A for their Form 10-Qs.

Per the SEC, if the use of unobservable inputs is material, MD&A disclosure should discuss how the unobservable inputs were determined and how the resulting fair value of assets and liabilities and possible changes to those values, impacted or could impact results of operations, liquidity, and capital resources. Depending on the circumstances, the following disclosures may be relevant in preparing MD&A:

- The amount of assets and liabilities measured using significant unobservable inputs as a percentage of the total assets and liabilities measured at fair value.
- The amount and reason for any material increase or decrease in Level 3 assets and liabilities resulting from transfer of assets and liabilities from, or into, Level 1 or Level 2.
- If a material amount of assets or liabilities was transferred into Level 3 during the period, a discussion of:
 - The significant inputs that management no longer considers to be observable; and
 - Any material gain or loss recognized on those assets or liabilities during the period, and, to the extent that amount is excluded from the realized/unrealized gains (losses) line item in the Level 3 reconciliation, the amount excluded.
- With regard to Level 3 assets or liabilities, a discussion of, to the extent material:
 - Whether realized and unrealized gains (losses) affected results of operations, liquidity, or capital resources during the period, and if so, how;
 - The reason for any material decline or increase in the fair values; and
 - Whether management believes the fair values diverge materially from the amounts management currently anticipates realizing on settlement or maturity. If so, disclose why and provide the basis for management's views.
- The nature and type of assets underlying any asset-backed securities.

In addition, regardless of how assets and liabilities were classified within the hierarchy of Statement No. 157, certain additional information should be provided in MD&A on Form 10-Q, if not already provided in Form 10-K. See further guidance at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm>.

FASB Codification Now Includes Some SEC Content

The Financial Accounting Standards Board (FASB) has released selected portions of SEC and SEC staff content in the *FASB Accounting Standards Codification*. The SEC sections contain content related to matters within the basic financial statements. However, the sections do not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance. For example, the Codification does not include content related to matters outside of the basic financial statements, such as Management's Discussion and Analysis, or auditing or independence matters. The Codification does not change the SEC content; instead it includes the content reorganized into roughly 90 accounting topics to more closely align with the non-SEC content.

Although the Codification content is not yet approved as authoritative, constituents are encouraged to use the online Codification Research System to provide feedback on whether the Codification content accurately reflects existing U.S. generally accepted accounting principles (GAAP) for nongovernmental entities. Users who register at <http://asc.fasb.org/register> are able to review the Codification free of charge and provide specific content-related feedback at the individual paragraph level as well as general system-related feedback. When using the Codification to research accounting issues during the verification period, users are advised to verify research results using their existing resources for the currently effective literature.

The FASB has recorded a webcast that discusses and demonstrates the use of the Codification. The one-hour webcast, *The Move to Codification of U.S. GAAP*, is archived for free access by the public. [Click here](#) to register for the archived webcast.

Form 8-K Interpretations

The SEC has issued Form 8-K interpretations, which include questions and answers of general applicability and interpretive responses regarding particular situations. The new interpretations replace the Form 8-K interpretations in the July 1997 *Manual of Publicly Available Telephone Interpretations*, the June 13, 2003 *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures*, and the Nov. 22, 2004 *Form 8-K Frequently Asked Questions*. The Form 8-K interpretations are available in full at <http://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm>.

International

Discussion of Accounting for Post-Employment Benefits

The International Accounting Standards Board (IASB) has published for public comment a discussion paper on International Accounting Standard (IAS) 19, *Employee Benefits*. The paper sets out the IASB's preliminary views on how the accounting for some post-employment benefits, including pensions, could be improved. The discussion paper addresses concerns that the accounting model set out in IAS 19 is inadequate and should be reviewed. Constituents have pointed out that:

- The deferral of the recognition of gains and losses leads to misleading figures in the balance sheet;
- The multiple options for deferring recognition lead to poor comparability across companies;
- The lack of clarity in the definitions of benefit promises lead to inconsistencies and poor comparability for those benefit promises that include a promised return on contributions linked to an asset or an index;

- The required measurement method is inadequate for those benefit promises that include a promised return on contributions linked to an asset or an index.

The IASB's preliminary views on how to address these issues are to remove the options for deferred recognition of gains and losses in defined benefit plans and to introduce a new classification of benefit promises into contribution-based promises and defined benefit promises, with a new measurement attribute for contribution-based promises. The IASB plans to redeliberate the issues and publish an exposure draft of proposed amendments to IAS 19, with a view to issuing a revised standard by 2011.

Preliminary Views on Amendments to IAS 19, "Employee Benefits" will be available for comment until September 26, 2008 at www.iasb.org.

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