

Insights

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Accounting

Toolkit for Private Equity Group Portfolio Company Accounting

The accounting treatment of acquisition-related transactions (particularly the formation transaction) entered into by a portfolio company of a private equity group can often be extremely complicated and involve many different sources of authoritative accounting guidance. McGladrey & Pullen, LLP has prepared a Private Equity Group Portfolio Company Accounting Toolkit to help guide readers through the appropriate accounting guidance, as well as provide examples to help with the related accounting and reporting. This toolkit includes flowcharts, and illustrations of their related application, for formation transactions often entered into by private equity group portfolio companies, together with certain technical accounting guidance utilized for transactions discussed throughout the toolkit. Furthermore, the toolkit includes two fact sheets that describe the changes to certain current authoritative guidance relating to business combinations and consolidations that will be effective for annual reporting periods beginning on or after December 15, 2008 (e.g., January 1, 2009 for calendar year-end companies).

Printed bound copies of the toolkit may be requested from your local McGladrey & Pullen audit specialist. In addition, this toolkit is available in PDF form at http://mcgladrey.com/PEG_Toolkit.pdf.

Accounting for Financial Guarantee Insurance Contracts

There has been diversity in the way financial guarantee insurance contracts were accounted for by insurance enterprises under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. That diversity resulted in differences in the recognition and measurement of claim liabilities and led to different financial statement information for similar transactions. The Financial Accounting Standards Board (FASB) therefore has issued FASB Statement No. 163, *Accounting for Financial Guarantee Insurance Contracts - an interpretation of FASB Statement No. 60*, to provide consistency in accounting for financial guarantee insurance contracts.

Statement No 163 clarifies how Statement No. 60 applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities. The Statement requires an insurance enterprise to recognize a liability for the unearned premium revenue at the inception of the financial guarantee insurance contract. The measure of the unearned premium revenue includes the present value of any premiums due in future periods. The unearned premium revenue is recognized as revenue in income over the period of the contract in proportion to the amount of insurance protection provided. The Statement requires recognition of a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. The claim liability is to be measured in an amount equal to the present value of the expected net cash outflows to be paid under the insurance contract discounted using a current risk-free rate.

Statement No. 163 also requires expanded disclosures about financial guarantee insurance contracts. The objective of the disclosures is to enable financial statement users to understand the factors affecting the present and future recognition and measurement of financial guarantee insurance contracts. Those disclosures generally include (a) information about premiums receivable and the related premium revenue, (b) information about claim liabilities, and (c) a description of the risk-management activities used to track and monitor deteriorating insured financial obligations.

Statement No. 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, except for disclosures about the insurance enterprise's risk-management activities. Disclosures about the insurance enterprise's risk-management activities are effective the first period (including interim periods) beginning after May 23, 2008. The decision by the FASB to require immediate disclosure about the insurance enterprise's risk-management activities is directly related to the current state of the credit markets.

The Statement is available in full at <http://www.fasb.org/pdf/fas163.pdf>.

Clarification of the Effective Date of FASB Statement No. 161

In March of 2008, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, to require enhanced disclosures about derivative instruments and hedging activities. Since that time, questions have been raised about the effective date stated in Statement No. 161:

"This Statement shall be effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged."

With respect to this effective date, financial statement preparers have wondered whether the disclosure requirements of Statement No. 161 are effective for financial statements issued for:

- Fiscal *years* that begin after November 15, 2008, and interim periods in those fiscal years; or
- The first fiscal *period* (i.e., interim period) that begins after November 15, 2008, regardless of whether that fiscal period is the first interim period in the entity's fiscal year.

We believe that the disclosure requirements of Statement No. 161 are effective for financial statements issued for a reporting period that begins after November 15, 2008, regardless of whether that reporting period is the first interim period in the entity's fiscal year. For example, if an entity's fiscal year end is June 30, 2008, the disclosures required by Statement No. 161 must be provided in its interim financial statements for the three months ending March 31, 2009 because the entity's third fiscal quarter beginning on January 1, 2009, will be its first reporting period that begins after November 15, 2008.

Changes to Consolidation and Equity Method Guidance for Not-for-Profits

The Financial Accounting Standards Board (FASB) has issued a FASB Staff Position (FSP), which makes several changes to the current guidance on consolidation and the equity method of accounting in AICPA Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, and the AICPA Audit and Accounting Guide, *Health Care Organizations* (the Guide). The purpose of the changes is to make the guidance more consistent between the two pronouncements and with other authoritative standards, where appropriate. FSP No. SOP 94-3-1 and AAG HCO-1, *Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations*.

- Eliminates the temporary control exception to consolidation that currently exists for certain relationships between not-for-profit organizations, and makes two related changes:
 - Amends SOP 94-3 and the Guide such that an organization is deemed to have a *majority voting interest in the board of another entity* whenever it has the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board.
 - Conforms the categorization of sole corporate membership in SOP 94-3 to that in the Guide, i.e., sole corporate membership of one not-for-profit organization in another generally is considered a controlling financial interest unless the sole corporate member's economic interest in the controlled entity is limited by state law or contractual agreement.
- With rare exception, confirms the continued applicability to not-for-profit lessees of the guidance on consolidation of special-purpose-entity lessors in the following Emerging Issues Task Force (EITF) Issues:
 - Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions"
 - Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities"
 - Issue No. 97-1, "Implementation Issues in Accounting for Leasing Transactions, including Those Involving Special-Purpose Entities"
- Requires not-for-profit organizations to apply the guidance on the equity method of accounting in the following pronouncements to their investments in for-profit partnerships, limited liability companies, and similar entities unless those investments are reported at fair value:
 - SOP 78-9, *Accounting for Investments in Real Estate Ventures*
 - EITF Issue No. 03-16, "Accounting for Investments in Limited Liability Companies"
 - FSP SOP 78-9-1, *Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5.*

The guidance in this FSP should be applied to fiscal years beginning after June 15, 2008, and to interim periods therein. The FSP is available in full at http://www.fasb.org/pdf/fsp_sop94-3-1&aag_hco-1.pdf.

TPAs Released for Financial Reporting by Investment Companies

The Accounting Standards Team of the American Institute of Certified Public Accountants has released four Technical Practice Aids (TPAs) relating to certain financial reporting issues of investment companies, which are summarized as follows:

- TPA 6910.25, *Considerations in Evaluating Whether Certain Liabilities Constitute "Debt" for Purposes of Assessing Whether an Investment Company Must Present a Statement of Cash Flows*. Per FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an Amendment of FASB Statement No. 95*, both registered and unregistered investment companies are exempt from the requirement to provide a statement of cash flows, if all of the following conditions are met:
 - During the period, substantially all of the enterprise's investments were highly liquid

- Substantially all of the enterprise's investments are carried at market value.
- The enterprise had little or no debt, based on the average debt outstanding during the period, in relation to average total assets.
- The enterprise provides a statement of changes in net assets.

This TPA addresses whether uncovered options and short sales of securities and reverse repos must be treated as debt under the third criteria above since those transactions/securities are not mentioned in the description of "average debt outstanding" in footnote 2 to paragraph 7 of Statement No. 102.

- TPA 6910.26, *Additional Guidance on Determinants of Net vs. Gross Presentation of Security Purchases and Sales/Maturities in the Statement of Cash Flows of a Nonregistered Investment Company*. This TPA concludes that if a nonregistered investment company presents a statement of cash flows, the investment company's trading style, investment objectives stated in its offering memorandum, and portfolio turnover should be the primary determinants of net vs. gross reporting. Regardless of whether net or gross reporting is appropriate based on the stated criteria, the TPA states that an entity should separately report its activity related to long positions from activity related to short positions.
- TPA 6910.27, *Treatment of Deferred Fees*. This TPA discusses the financial reporting implications for situations in which an investment advisor is allowed to elect to defer payment of its management fee, incentive fee, or both.
- TPA 6910.28, *Reporting Financial Highlights, Net Asset Value (NAV) Per Share, Shares Outstanding, and Share Transactions When Investors in Unitized Nonregistered Funds Are Issued Individual Classes or Series of Shares*. This TPA provides guidance regarding the presentation of certain financial highlights and disclosures for unitized nonregistered funds that issue a separate series of shares to each individual investor in the fund.

These TPAs are available in full at http://www.aicpa.org/download/acctstd/TIS6910_25_28.pdf.

Proposed Disclosures about Credit Derivatives and Certain Guarantees

Because of the turmoil in credit markets during 2007 and 2008, some sellers of credit derivatives (such as, credit default swaps, credit spread options, and credit index products) have faced severe adverse conditions because a large number of referenced obligations that their credit default swaps are guaranteeing are facing actual or potential defaults. Some financial statement users have expressed concerns that the disclosure requirements in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, do not adequately address the potential adverse effects of changes in credit risk on the financial position and performance of the sellers of credit derivatives. To improve disclosures about credit derivatives and guarantees, the Financial Accounting Standards Board has issued proposed FASB Staff Position (FSP) No. FAS 133-b and FIN 45-c, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45*.

This FSP would amend Statement No. 133 to require additional disclosures about credit derivatives. Specifically, for each statement of financial position presented, the seller of a credit derivative would be required to disclose the following for each credit derivative (which may include groups of similar credit derivatives), even if the likelihood of the seller having to make any payments under the credit derivative is remote:

- The nature of the credit derivative, reason(s) for entering into the credit derivative, events or circumstances that would require the seller to perform, and current status of the payment/performance risk of the credit derivative.
- The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative, exclusive of any amounts that might be recovered under recourse or collateralization provisions.
- The fair value of the credit derivative.
- The nature of any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and any assets held either as collateral or by third parties that, upon the occurrence of any specified pre-agreed event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative.

Although credit derivatives are similar to guarantees, the disclosure requirements in FASB Interpretation (FIN) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, apply to only some, but not all, credit derivatives. The FASB believes that instruments with similar risks and rewards should have similar disclosures and, therefore, the disclosures in FIN 45 should apply to all credit derivatives. The proposed FSP would amend FIN 45 to require an additional disclosure about the current status of the payment/performance risk of a guarantee. The current status of the payment/performance risk of the guarantee could be indicated by either current external credit ratings, when available, or current internal categories/groupings based on the manner in which the guarantor manages its risk.

The FASB believes that because of the large size of the credit derivatives market (estimated to be \$62.2 trillion in December 2007 by the International Swaps and Derivatives Association) and the importance of having similar disclosures for similar instruments, the effective date for the proposed disclosures should be as soon as practicable. Therefore, the effective date for this proposed FSP is for fiscal years and interim periods ending after November 15, 2008 with earlier application encouraged. The FSP encourages but does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In years after initial adoption, the FSP would require comparative disclosures only for periods subsequent to initial adoption.

The proposed FSP is available for comment until June 30, 2008 at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas133-b&fin45-c.pdf.

Two Consultative Documents on the Conceptual Framework

In 2004, the Financial Accounting Standards Board and the International Accounting Standards Board (collectively referred to as "the Boards") added to their agendas a joint project to develop an improved conceptual framework that provides a foundation for developing future accounting standards. The project is being undertaken in eight phases:

- A. Objectives and qualitative characteristics
- B. Definitions of elements, recognition, and derecognition
- C. Measurement
- D. Reporting entity concept

- E. Boundaries of financial reporting, and presentation and disclosure
- F. Purpose and status of the framework
- G. Application of the framework to not-for-profit entities
- H. Remaining issues, if any

On May 29, 2008, the Boards released consultative documents that seek comment on two of the eight phases of the joint project. First, they published an Exposure Draft related to Phase A, *An improved Conceptual Framework for Financial Reporting: Chapter 1: The Objective of Financial Reporting and Chapter 2: Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*. The Exposure Draft seeks views on an improved objective of financial reporting, the qualitative characteristics of information provided by financial reporting, and constraints on the provision of that information. The document reflects the Boards' updated proposals in light of comments received on an initial consultation document published in July 2006. The revised Exposure Draft now proposes that the objective of financial reporting is to provide financial information that is useful to current and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. It also presents an improved description of "faithful representation," one of the qualitative characteristics that financial information should possess if it is to provide a useful basis for economic decisions.

The second document published by the Boards, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity*, sets out the Boards' preliminary views on Phase D of the project - the reporting entity concept and related issues. Although the reporting entity concept determines some important aspects of financial reporting, the Boards' existing frameworks do not address it specifically. The Boards' preliminary views are:

- A reporting entity is a circumscribed area of business activity of interest to current and potential equity investors, lenders, and other capital providers.
- Control is the basis for determining the composition of a group reporting entity.
- Consolidated financial statements should be prepared from the perspective of the group reporting entity.

These documents are available for comment until September 29, 2008 at <http://www.fasb.org/draft/index.shtml>.

International

Amended Accounting for Cost of an Investment in Separate Financial Statements

Concerns had been raised that retrospectively determining cost in accordance with International Accounting Standard (IAS) 27, *Consolidated and Separate Financial Statements*, on first-time adoption of IFRS could not, in some circumstances, be achieved without undue cost or effort. In response to these concerns, the International Accounting Standards Board has amended International Financial Reporting Standard (IFRS) 1, *First-time Adoption of International Financial Reporting Standards*, and IAS 27 to revise certain aspects of determining the cost of an investment in separate financial statements. Among other provisions, these amendments:

- Allow first-time adopters to use a deemed cost of either fair value or the carrying amount under previous accounting practice to measure the initial cost of investments in subsidiaries, jointly controlled entities and associates in the separate financial statements;
- Require that when a new parent is formed in a reorganization, the new parent must measure the cost of its investment in the previous parent at the carrying amount of its share of the equity items of the previous parent at the date of the reorganization; and
- Remove the definition of the cost method from IAS 27 and replace it with a requirement to present dividends as income in the separate financial statements of the investor.

The amendments are effective for annual periods beginning on or after January 1, 2009, with earlier application permitted.

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