

Insights

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Accounting

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 FASB Staff Position (FSP) No. 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161*.

This FSP amends 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 triggering 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 FSP amends FIN 45 to require an additional disclosure about the current status of the payment/performance risk of a guarantee.

The provisions of the FSP that amend Statement No. 133 and FIN 45 are effective for reporting periods (annual or interim) ending after November 15, 2008. The FSP is available in full at http://www.fasb.org/pdf/fsp_fas133-1&fin45-4.pdf.

The FSP also clarifies the effective date of FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. See related article below.

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.

To clarify the effective date of Statement No. 161, the FASB has issued FASB Staff Position (FSP) No. 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161*. This FSP states that the disclosure requirements of Statement No. 161 are effective for any reporting period (annual or quarterly interim) beginning after November 15, 2008. For example, an entity with a March 31 fiscal year-end should provide the disclosures for its fourth quarter interim period ending March 31, 2009, in its 2009 annual financial statements. This clarification of the effective date of Statement No. 161 was effective upon issuance of the FSP on September 12, 2008.

The FSP is available in full at http://www.fasb.org/pdf/fsp_fas133-1&fin45-4.pdf. The FSP also addresses certain disclosures about credit derivatives and guarantees. See related article above.

SEC

MD&A Disclosure Regarding the Application of Statement No. 157

In March 2008, the SEC’s Division of Corporation Finance identified a number of disclosure issues related to FASB Statement No. 157, *Fair Value Measurements*, that public entities may wish to consider in preparing Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) for their Form 10-Qs. In September 2008, the Division of Corporation Finance urged public companies to continue evaluating whether they could “provide clearer and more transparent disclosure regarding fair value measurements, particularly with regard to financial instruments that are not currently actively traded and whose effects have had, or are reasonably likely to have, a material effect on financial condition or results of operations.” Specifically, the SEC believes that information about the judgments and assumptions underlying fair value measurements, the sensitivity of measurements to those assumptions, and details about the methodology and inputs used can help investors better understand fair value measurements.

To the extent material, public companies are encouraged to consider the following additional fair value measurement disclosure items in MD&A, among others:

- The significant judgments made in classifying a particular financial instrument in the fair value hierarchy.
- An explanation of how credit risk is incorporated and considered in the valuation of assets or liabilities.
- Gains or losses on financial instruments that are required to be carried at fair value, together with an explanation of:
 - How credit risk affected the valuation of derivative liabilities and the resulting gain or loss included in earnings relating to the changes in that credit risk; and
 - How counterparty credit risk affected the valuation of derivative assets and the resulting gain or loss included in earnings relating to the changes in that credit risk. Also, consider discussing how deterioration in the counterparty's credit and the company's ability to collect on a derivative asset will impact the company's financial statements.
- The criteria used to determine whether the market for a financial instrument is active or inactive.
- Which financial instruments are affected by the lack of market liquidity, how the lack of liquidity impacted the valuation technique used, and how illiquidity factored into fair value determination of those financial instruments.
- If brokers or pricing services are used to assist in determining fair values, consider explaining the extent to which, and how, the information is obtained and used in developing the fair value measurements in the financial statements.

The SEC's September guidance is available at

<http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm> and the March guidance is available at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm>.

Evaluating Consistency of Financial Statements

On September 16, 2008, the SEC approved Public Company Accounting Oversight Board (PCAOB) Auditing Standard (AS) No. 6, *Evaluating Consistency of Financial Statements*. AS 6 will supersede the PCAOB's interim auditing standard on the auditor's responsibilities to evaluate the consistency of a company's financial statements, AU Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, and conforming amendments to AU Section 508, *Reports on Audited Financial Statements*. AU Section 420 generally reflected the provisions of APB Opinion No. 20, *Accounting Changes*, which was superseded by FASB Statement No. 154, *Accounting Changes and Error Corrections*. AS 6 more closely aligns the auditor's responsibilities with the provisions of Statement No. 154. Further, AS 6 clarifies that the auditor's report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principle or the correction of a misstatement.

AS 6 also removes from the PCAOB's interim auditing standards the hierarchy of generally accepted accounting principles that identifies the sources of accounting principles and the framework for selecting principles to be used in preparing financial statements. Because the Financial Accounting Standards Board has incorporated the hierarchy into the accounting standards by issuing FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, the hierarchy no longer will be needed in the auditing standards.

AS 6 and related amendments will be effective November 15, 2008. The PCAOB Release related to AS 6 is available in full at http://www.pcaobus.org/Rules/Docket_023/PCAOB_Release_No._2008-001_--_Evaluating_Consistency.pdf.

Financial Institutions

Accounting for Declines in the Fair Value of Debt Securities

In accordance with generally accepted accounting principles, management of an enterprise 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. When evaluating whether a decline in the fair value of a security is temporary or other-than temporary, management must select the appropriate impairment model. McGladrey & Pullen's National Office of Audit and Accounting recently issued a white paper, *Accounting for Declines in the Fair Value of Debt Securities*, which discusses, among other matters, the two models used to determine whether impairment of a debt security is other than temporary. These models are based on the pertinent guidance in Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and Emerging Issues Task Force 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*.

The [white paper](#) is available in full at www.mcgladrey.com.

International

How Judgment Is Applied in Practice

This article is the fifth 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 explain how the exercise of judgment is not the result of obscure decisions but rather is intended to be the result of a thoughtful process that combines two major ingredients: knowledge of principles-based IFRS, and sound and professional business and accounting knowledge.

Perhaps the first thing that crosses one's mind when comparing the word "principle" with the word "rule" is that a rule offers a higher degree of certainty, provided it is well formulated and detailed. A principle might initially be perceived as less prescriptive and subject to a higher degree of interpretation. In other words, when we move from an environment characterized by rules to an environment characterized by principles, we could say that we enter a sort of unknown territory dominated by a not-well-defined process called "exercising judgment."

The Oxford English Dictionary defines "judgment" as: "The ability to make sensible decisions after carefully considering the best thing to do." Interestingly, that dictionary gives the following exemplification, among others, for how the word "judgment" can be used: "It is not something I can give you rules for; you'll have to use your judgment." This example describes very well the idea behind a set of principles: principles extend where rules, by definition, cannot arrive.

Contrary to popular belief, the exercise of judgment is not the result of an uncontrollable obscure process. In fact, using the words of the Oxford English Dictionary, the exercise of judgment is more like a "sensible" and "careful" journey that can be undertaken only after carefully considering "the best thing to do" – *i.e.*, by having a good knowledge and understanding of the core principles underpinning IFRS. The following steps might constitute some milestones along the journey of exercising judgment.

Preliminary Considerations

- Focus on the substance of the transaction from a business standpoint. Understanding the economic rationale of the transaction is a fundamental prerequisite.
- Forget about IFRS and U.S. generally accepted accounting principles. As an experienced accountant basing your analysis on the principle of substance over form, what would you consider to be the proper accounting treatment to be applied?

Analysis of IFRS

- Identify the possible accounting alternatives that can be used under IFRS.
- Consider all relevant IFRS literature, including IASB staff discussion papers that resulted in the issuance of the IFRS.
- Analyze what peers and competitors did in similar situations. What is the industry practice?
- Verify whether there are applicable regulatory enforcement decisions.

Build a Case

- Document the process that led to a final decision, explaining the reasons for the decision. That is, reply to the following questions: Why is alternative A preferable to alternative B? According to what IFRS literature does this make sense?
- Consult other views and share your opinion.

It is likely that at the end of this journey the exercise of judgment is not as obscure as we thought. However, this process takes time and effort, and there are no miraculous shortcuts that can be taken. Ultimately there is no better recipe than explaining why alternative A is preferred over alternative B and what the consequences are.

Readers of financial statements will have all the information they need to make informed decisions. Sometimes artificially reducing inherent uncertainty to a black and white situation does not add very much to transparency. In certain cases it is not a question of right vs. wrong, but rather a question of transparent information vs. lack of information. Possibly in such cases, what is meaningful is explaining why a certain decision has been made, rather than simply saying what the decision was.

For further information, please contact Bob Dohrer (robert.dohrer@rsmi.com) or Marco Marcellan (marco.marcellan@rsmi.com) in our International Assurance Services Group.

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