

February 10, 2009

Accounting

Allocation of Unrealized Gains and Losses by Investment Partnerships

The governing documents of some nonregistered investment partnerships may contain provisions that do not allow allocations of unrealized gains or losses, or do not require the recognition of carried interest and clawback obligations until a specified date or time or until the occurrence of a specific event. Often, in these cases, the partnership's investments are either not marketable or are of such limited liquidity that interim valuations are highly subjective, and the intent of the provision is to delay the general partner's receipt of incentive allocations in cash until the gains can be measured objectively. In preparing financial statements of an investment partnership in accordance with U.S. generally accepted accounting principles, in which capital is reported by investor class, the question has been raised as to how cumulative unrealized gains (losses), carried interest, and clawback should be reflected in the equity balances of each class of shareholder or partner at the balance sheet date.

In response to this question, the American Institute of Certified Public Accountants has issued TIS 6910.29, *Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations*. This guidance concludes that if a nonregistered investment partnership reports capital by investor class, cumulative unrealized gains (losses), carried interest, and clawback provisions should be reflected in the equity balances of each class of shareholder or partner at the balance sheet date as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date consistent with the provisions of the partnership's governing documents. Specifically:

- Cumulative unrealized gains (losses) should be included in the ending balances of each class of shareholders' or partners' interest in the reporting entity at the reporting date, and the changes in such amounts would be reported in the changes in net asset value and partners' capital for the reporting period.
- In presenting each class of shareholders' or partners' interest in the net assets as of the reporting date, the financial statements should consider the carried-interest formula as if the investment company had realized all assets and settled all liabilities at their reported fair value, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date.
- The impact of a clawback should be calculated as of each reporting date under the methodology specified in the fund's governing documents. Such an obligation would not be recognized as an asset (receivable) in the entity's financial statements unless substantial evidence exists of the ability and intent to pay within a reasonably short period of time. Rather, in most instances, the obligation would be reflected as a deduction from the general partner's capital account. The specific circumstances require consideration and careful reading of the governing documents before determining whether a clawback, resulting in a negative general partner capital balance, is recognized or disclosed in the financial statements.

TIS 6910.29 is available in full at http://www.aicpa.org/download/acctstd/TPA_TIS_6910_29.pdf.

Insights is a biweekly publication of McGladrey & Pullen, LLP and should not be construed as accounting, auditing, consulting, or legal advice on any specific circumstances or facts. The contents are intended for general information purposes only. You are urged to consult your McGladrey & Pullen service provider concerning your situation and any specific questions you may have. You may call 1.888.214.1416 for a contact person in your area.

For further information about McGladrey & Pullen, LLP or to retrieve archived issues of *Insights*, visit our Web site: www.mcgladrey.com. If you do not wish to continue receiving *Insights*, or if you wish to place another person on the distribution list, please contact mpinsights@rsmi.com.

Proposed Interim Disclosures about Fair Value of Financial Instruments

So as to provide for increased frequency of financial statement disclosures about fair value of financial instruments, the Financial Accounting Standards Board (FASB) has proposed FASB Staff Position (FSP) No. FAS 107-b and APB 28-a, *Interim Disclosures about Fair Value of Financial Instruments*, which would amend FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments in interim financial statements as well as in annual financial statements. If finalized, this proposed FSP also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in all interim financial statements. The proposed FSP would apply to all financial instruments and entities within the scope of Statement No. 107.

The proposed FSP would require entities to disclose in the body or in the accompanying notes of interim financial statements and annual financial statements the fair value of all financial instruments, whether recognized or not recognized in the statement of financial position, as required by Statement No. 107. The fair value information disclosed in the notes would be presented together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amount relates to what is reported in the statement of financial position. Entities would also be required to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

If finalized, the proposed FSP would be effective for interim and annual reporting periods ending after March 15, 2009. The FSP would not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, the FSP would require comparative disclosures only for periods ending subsequent to initial adoption.

Proposed FSP No. FAS 107-b and APB 28-a is available for comment until March 2, 2009 at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas107-b&apb28-a.pdf.

It should be noted that at its January 23, 2009 meeting, the FASB decided not to finalize proposed FSP No. FAS 107-a, *Disclosures about Certain Financial Assets: An Amendment of FASB Statement No. 107*, which had proposed certain additional required disclosures related to debt securities classified as held-to-maturity and available-for-sale, and loans and long-term receivables that are not measured at fair value with changes in the fair value recognized through earnings.

SEC

SEC Requires Use of Interactive Data for Reporting of Financial Information

The SEC has issued Final Rule No. 33-9002, *Interactive Data to Improve Financial Reporting*, which will require public companies to use interactive data for the reporting of financial information. With interactive data, all of the facts in a financial statement are labeled with unique computer-readable extensible business reporting language (XBRL) reporting software "tags," which function like bar codes to make financial information more searchable on the internet and more readable by spreadsheets and other software. Investors will be able to instantly find specific facts disclosed by companies and mutual funds, and compare that information with details about other companies.

For public companies, interactive data financial reporting will occur on a phased-in schedule beginning next year. The largest companies (with a public float above \$5 billion) that file using U.S. generally accepted accounting principles (GAAP) will be required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2009. The remaining companies that file using U.S. GAAP will be required to file with interactive data on a phased-in schedule over the next two years. Companies that file using International Financial Reporting Standards will be required to provide their interactive data reports starting with fiscal years

ending on or after June 15, 2011. Companies will be able to adopt interactive data earlier than their required start date.

Last year the SEC unveiled its new financial reporting system, Interactive Data Electronic Applications (IDEA), a database to collate the XBRL tags attached to electronic filings. IDEA users will be able to instantly gather information from thousands of companies and forms, giving investors faster and easier access to key financial information about public companies and mutual funds. The new IDEA system is supplementing and eventually replacing the agency's EDGAR database, marking the SEC's transition from collecting forms and documents in EDGAR to making financial data itself freely available to investors in IDEA.

Investors can begin seeing this new information at <http://idea.sec.gov>. For participants in the SEC's Voluntary Filer Program, investors can find clearly labeled buttons taking them to a company's or mutual fund's voluntary interactive data submissions. As soon as companies and funds make their mandatory interactive data submissions to the SEC, their financial information will be immediately available to investors through the SEC's IDEA system as well as on the Web sites of companies and funds disclosing the data.

Rule 33-9002 is available in full at <http://www.sec.gov/rules/final/2009/33-9002.pdf>.

International

Going Concern Audit Considerations in the Current Economic Environment

The International Auditing and Assurance Standards Board has recently issued a Practice Alert, *Audit Considerations in Respect of Going Concern in the Current Economic Environment*, to assist auditors and management in addressing the effect of the credit crisis and economic downturn on an entity's ability to continue as a going concern and whether these effects should be described in financial statements. The Alert highlights areas within International Standard on Auditing (ISA) 570, *Going Concern*, as well as other ISAs, that are particularly relevant in the current economic environment, and provides additional guidance for auditors in evaluating management's use of the going concern assumption. It also raises awareness of issues surrounding liquidity and credit risk that may create new uncertainties for entities or exacerbate existing ones.

Bob Dohrer, a partner in McGladrey & Pullen's International Assurance Services Group, observed, "Auditors and management are currently faced with evaluating the effect of the credit crisis and economic downturn on an entity's ability to continue as a going concern, and the resulting effects on financial statement disclosures and audit opinions. While recognizing that ISA 570 and IFRS differ in some respects when compared with U.S. GAAS and U.S. GAAP, this Practice Alert raises our awareness about relevant going-concern considerations in today's economy, even for companies with a long history of profits and credit availability."

The Practice Alert is available in full at http://web.ifac.org/download/IAASB_Staff_Audit_Practice_Alerts_2009_01.pdf.

IASB Proposes Amendments to IFRIC Interpretations

The International Accounting Standards Board (IASB) has published proposals to amend IFRIC 9, *Reassessment of Embedded Derivatives*, and IFRIC 16, *Hedges of a Net Investment in a Foreign Operation*.

The proposed amendment to IFRIC 9 is a consequential amendment that became necessary as a result of the changed definition of a business combination in International Financial Reporting Standard 3, *Business Combinations*, issued in January 2008. If finalized, the amendment would exclude from the scope of IFRIC 9 embedded derivatives in contracts acquired in combinations of entities or business entities under common control and in the formation of joint ventures. The amendment would be effective prospectively for annual periods beginning on or after July 1, 2009.

Per IFRIC 16, a derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the group (except the foreign operation that itself is being hedged), as long as the designation, documentation and effectiveness requirements of International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*, that relate to a net investment hedge are satisfied. While the total amounts of foreign exchange differences are actually the same with and without hedge accounting, the split between the amounts included in profit or loss and foreign currency translation reserve would be different. Without hedge accounting, the foreign exchange difference created from the hedging instrument would be included in profit or loss while the difference created from the net investment would be included in the foreign currency translation reserve. The IASB proposes to amend IFRIC 16 paragraph 14 to remove the parenthetical comment: "(except the foreign operation that itself is being hedged)." The amendment would be effective for annual periods beginning on or after October 1, 2008.

These proposals are set out in an Exposure Draft, *Post-implementation Revisions to IFRIC Interpretations*, which is available for comment until March 2, 2009 at http://www.iasb.org/NR/rdonlyres/F8BCF415-0ED2-4227-B68F-B791F45837CE/0/ED_AmendmentsIFRIC9andIFRIC16_website.pdf.

Business Combinations: IFRS vs. U.S. GAAP

This article is the twelfth 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 business combinations. Actual differences in the accounting treatment between the two frameworks depend on specific circumstances.

IFRS 3, *Business Combinations*, (as revised in 2008) and FASB Statement No. 141, *Business Combinations*, (as revised in 2007) were issued as part of a joint effort by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to improve financial reporting while promoting the international convergence of accounting standards. Despite the goal to develop a common and comprehensive standard, the boards reached different conclusions on a few matters, including the effective dates of the standards. IFRS 3(R) is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after July 1, 2009, while Statement No. 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

The IASB and FASB have identified approximately 20 other potential differences between the two standards. Undoubtedly, the most significant difference is the way in which noncontrolling interests (minority interests) in an acquiree are measured. Under IFRS, preparers have the choice of measuring noncontrolling interests either at fair value (full goodwill approach) or at the proportionate share of the acquiree's identifiable net assets (purchased goodwill approach). Statement No. 141(R) requires the non-controlling interest to be measured at fair value.

As far as contingent consideration is concerned, both IFRS 3(R) and Statement No. 141(R) require an acquirer to classify contingent consideration as an asset, a liability, or equity on the basis of other IFRS or U.S. GAAP. As a result, differences between the applicable IFRS and U.S. GAAP might cause differences in the initial classification and, in turn, differences in the subsequent accounting treatment. In terms of subsequent measurement under IFRS, it is likely that International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, and IAS 37, *Provision, Contingent Liabilities and Contingent Assets*, will be applicable. Under Statement No. 141(R), contingent consideration is subsequently measured at fair value with changes in fair value recognized in earnings, unless the contingent consideration is a hedging instrument.

IFRS 3(R) states that contingent liabilities must be recognized provided fair value can be measured reliably, regardless of the degree of probability of an inflow or outflow of economic benefits. Subsequently, contingent liabilities are remeasured at the higher of the amount that would be recognized in accordance with IAS 37 or the amount initially recognized less, if appropriate, cumulative amortization recognized in accordance with IAS 18, *Revenue*. On the other hand, Statement No. 141(R) distinguishes between contractual and noncontractual contingencies. Contractual contingencies are recognized at their acquisition-date fair value. Noncontractual contingencies are recognized provided that the “more likely than not” recognition threshold is met. Subsequently, Statement No. 141(R) requires an acquirer to continue to report recognized assets or liabilities at their acquisition-date fair value until the acquirer obtains new information about the possible outcome of the contingency. (On December 15, 2008 the FASB issued proposed FSP No. FAS 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*, which would eliminate certain, but not all, differences between IFRS 3(R) and Statement No. 141(R). For example, the FSP would eliminate the distinction between a contractual and noncontractual contingency and in some cases differences between U.S. GAAP and IFRS in the subsequent accounting for contingent assets and liabilities.)

As previously mentioned, we have illustrated only a few of the differences between IFRS 3(R) and Statement No. 141(R). Accounting for business combinations involves accounting for many types of assets and liabilities, and therefore the interaction with other standards is particularly pervasive. Clearly this can lead to a series of other differences that are indirectly triggered by those standards.

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