

April 21, 2009

Accounting

Guidance Regarding Fair Value Measurements

FASB Statement No. 157, *Fair Value Measurements*, provides a framework for measuring fair value and a definition of fair value that contemplates an orderly transaction between market participants, not a forced or distressed sale. In the current economic crisis, many constituents have requested additional authoritative application guidance to assist them in determining fair values when the volume and level of activity for the asset or liability have significantly decreased. On April 9, 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, to provide this application guidance. This FSP emphasizes that even if there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation techniques used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Specifically, it reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive.

More information about this FSP is available in a fact sheet on our Web site at http://www.mcgladrey.com/determining_fairvalue_factsheet.pdf.

The FSP is effective for interim and annual periods ending after June 15, 2009, but entities may early adopt the FSP for the interim and annual periods ending after March 15, 2009. The FSP is available in full at http://www.fasb.org/pdf/fsp_fas157-4.pdf.

Guidance for Recognition and Presentation of Other-Than-Temporary Impairments

On April 9, 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, to provide additional guidance in accounting for and presenting impairment losses on securities. The FSP amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and FSP No. FAS 115-1/124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The recognition guidance in the FSP applies only to debt securities classified as available for sale and held to maturity (*i.e.*, not to equity securities as originally proposed). The presentation and disclosure guidance in the FSP applies to debt and equity securities that are subject to the disclosure requirements of Statement No. 115 and FSP No. FAS 115-1/124-1.

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More information about FSP No. FAS 115-2 and FAS 124-2 is available in a fact sheet on our Web site at http://www.mcgladrey.com/recognition_otherthantemporary_debt.pdf.

The FSP is effective for interim and annual periods ending after June 15, 2009, but entities may early adopt the FSP for the interim and annual periods ending after March 15, 2009. Entities will be required to record a cumulative effect adjustment as of the beginning of the period of adoption to reclassify the noncredit-related component of a previously recognized other-than-temporary impairment from retained earnings to other comprehensive income if the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery.

The FSP is available in full at http://www.fasb.org/pdf/fsp_fas115-2andfas124-2.pdf.

Interim Disclosures about Fair Value of Financial Instruments

The Financial Accounting Standards Board (FASB) has issued FASB Staff Position (FSP) No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, which amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments in interim financial statements of publicly traded companies as well as in annual financial statements. This FSP also amends APB Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in all interim financial statements. The FSP applies to all financial instruments within the scope of Statement No. 107 held by publicly traded companies.

The FSP requires 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 for which it is practicable to estimate that fair value, whether recognized or not recognized in the balance sheet, as required by Statement No. 107. The fair value information disclosed in the notes should 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 balance sheet. Entities also are required to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments and should describe changes in those methods or significant assumptions, if any, that occurred during the period.

The FSP is effective for interim reporting periods ending after June 15, 2009, but entities may early adopt the FSP for periods ending after March 15, 2009. An entity may early adopt the FSP only if it also elects to early adopt FSP No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, and FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. The FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, the FSP requires comparative disclosures only for periods ending subsequent to initial adoption.

FSP No. FAS 107-1 and APB 28-1 is available in full at http://www.fasb.org/pdf/fsp_fas107-1andapb28-1.pdf.

Accounting for Assets and Liabilities Arising from Contingencies

Preparers, auditors, and members of the legal profession have expressed concerns about the application of FASB Statement No. 141 (revised 2007), *Business Combinations*, to assets and liabilities arising from contingencies in a business combination. The Financial Accounting Standards Board (FASB) therefore has issued FASB Staff Position (FSP) No. FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*, to amend Statement No. 141(R) related to the accounting for assets and liabilities arising from contingencies in a business combination.

Before being amended by this FSP, Statement No. 141(R) generally required that all contractual contingencies and all noncontractual contingencies that are more likely than not to give rise to an asset or liability be recognized at their acquisition-date fair value (noncontractual contingencies not meeting the more-likely-than-not criterion at the acquisition date would be accounted for in accordance with other U. S. generally accepted accounting principles). The FSP requires assets acquired and liabilities assumed in a business combination that arise from contingencies to be recognized at fair value at the acquisition date if the acquisition-date fair value can be determined during the measurement period. If the acquisition-date fair value of such an asset or liability cannot be determined during the measurement period, the asset or liability should be recognized as of the acquisition date if (1) information available before the end of the measurement period indicates that it is probable that an asset existed or a liability had been incurred at the acquisition date and (2) the amount of the asset or liability can be reasonably estimated. These criteria should be applied using the guidance in FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination must be recognized initially at fair value in accordance with the guidance for contingent consideration arrangements in Statement No. 141(R).

The FSP also amends the subsequent measurement and accounting guidance and the disclosure requirements for assets and liabilities arising from contingencies in a business combination. An acquirer must develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature. Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination must be measured subsequently in accordance with the guidance for contingent consideration arrangements in Statement No. 141(R). An acquirer must disclose information that enables users of its financial statements to evaluate the nature and financial effects of a business combination that occurs either during the current reporting period or after the reporting period but before the financial statements are issued.

The FSP is effective for assets or liabilities arising from contingencies in 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 FSP is available in full at http://www.fasb.org/pdf/fsp_fas141r-1.pdf.

EITF Consensuses-for-Exposure

At its March 19, 2009 meeting, the Emerging Issues Task Force (EITF) reached consensuses-for-exposure on the following Issues:

- *Issue No. 08-9, "Milestone Method of Revenue Recognition"*
Revenue recognition for a single unit of accounting depends on the nature of the deliverables composing that unit of accounting, the corresponding revenue recognition criteria, and whether those criteria have been met. Because the delivery may span multiple accounting periods, various accounting methods have been adopted to address when delivery has occurred and when revenue should be recognized. The proportional performance method is generally accepted as one way of recognizing revenue in a pattern that reflects a vendor's performance of its obligation under the contractual arrangement. In the application of the proportional performance method, the fixed or determinable fees associated with an arrangement generally do not include consideration tied to the achievement of milestones. One method developed to address the revenue recognition for the additional consideration is the milestone method. Under the milestone method an entity recognizes contingent arrangement consideration earned from the achievement of a milestone in its entirety in the period in which the milestone is achieved. In this Issue, the EITF reached consensuses-for-exposure on numerous matters related to the milestone method of revenue recognition, including the definition of a milestone and the determination of whether a milestone is substantive.

The EITF reached a consensus-for-exposure that the application of the milestone method of revenue recognition pursuant to the guidance in this Issue would be an accounting policy election. Therefore, adoption of the milestone method by an entity that has previously made an alternate accounting policy election would be considered a change in accounting principle and recognized in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*.

- *Issue No. 09-1, "Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance."*

Corporate entities may enter into share-lending arrangements that are executed in connection with a convertible debt offering. This is done for a reduction in the interest rate or an increase in proceeds received from the issuance of a convertible debt instrument, and due to a lack of liquidity or extensive open short positions in their shares. The EITF reached a consensus-for-exposure that at the date of issuance, a share-lending arrangement entered into on an entity's own shares in contemplation of a convertible debt offering or other financing is required to be measured at fair value and recognized as debt issuance cost in the financial statements of the entity. If finalized, this Issue would be effective for fiscal years beginning on or after December 15, 2009, and interim periods within those fiscal years. Early adoption would not be permitted.

The minutes of the March 19, 2009 EITF meeting are available in full at http://www.fasb.org/eitf/03-19-09_mtg_minutes.pdf.

Public Sector

Hierarchy of Generally Accepted Accounting Principles for State and Local Governments

On April 2, 2009, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. This Statement incorporates the hierarchy of generally accepted accounting principles (GAAP) for state and local governments into the GASB's authoritative literature. Prior to the Statement, the GAAP hierarchy was set forth in the American Institute of Certified Public Accountants' Statements on Auditing Standards (SAS). GASB Statement No. 55 moved relevant portions of the SASs to the GASB literature without substantive changes. Statement No. 55 was effective immediately upon issuance.

GASB Issues Invitation to Comment on Pension Accounting and Financial Reporting

The Governmental Accounting Standards Board (GASB) recently published an Invitation to Comment, seeking feedback on possible improvements to the existing standards of accounting and financial reporting for pension benefits by state and local governmental employers and by the trustees, administrators, or sponsors of pension plans. The Invitation to Comment is intended to elicit comments at an early stage of the GASB's re-examination of pension accounting and financial reporting standards. It addresses several key issues related to pension accounting and financial reporting that were raised during the research phase of this re-examination, such as:

- Which defined benefit pension processes, transactions, or other events should be the focus of financial reporting (*e.g.*, whether pension financial reporting should focus on the process by which an employer incurs an obligation to employees, the process by which an employer finances its projected future cash outflows, or both processes);

- The recognition of employers' pension liabilities and expenses (*e.g.*, whether an employer should recognize the effects of pension-related transactions or other events immediately upon occurrence or amortize them over future periods for expense recognition);
- Alternative approaches to the measurement of pension obligations for accounting and financial reporting purposes;
- The use of actuarial methods in accounting measurement approaches that involve the amortization of pension costs;
- Issues specific to employers' participation in cost-sharing multiple-employer pension plans; and
- Questions relating to accounting and reporting by defined benefit pension plans.

Invitation to Comment – Pension Accounting and Financial Reporting is available for comment until July 31, 2009 at http://www.gasb.org/exp/itc_pension_accounting_and_financial_reporting.pdf.

International

Inventories: IFRS vs. U.S. GAAP

This article is the seventeenth 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 inventories. Actual differences in the accounting treatment between the two frameworks depend on specific circumstances.

The IFRS standard dealing with inventories is International Accounting Standard 2, *Inventories*. Under this Standard, inventories are measured at the lower of cost and net realizable value. Net realizable value is defined as the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Under U.S. GAAP, the primary standards dealing with inventories are Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, FASB Statement No. 151, *Inventory Costs - An Amendment of ARB No. 43, Chapter 4*, and FASB Interpretation No. 1, *Accounting Changes Related to the Cost of Inventory - an Interpretation of APB Opinion No. 20*. Under these standards, inventories are measured at the lower of cost or market (current replacement cost). The upper limit on market value is net realizable value (estimated selling price minus cost of completion and disposal), and the lower limit is net realizable value minus normal profit margin.

Inventories have to be written down to net realizable value for IFRS and to market value for U.S. GAAP, preferably on an item-by-item basis. Because of the different mechanics discussed above, impairment charges might result in different amounts. However, in general, both frameworks foresee that in certain circumstances it may be appropriate to group similar or related items to calculate impairment and therefore, in such cases, differences may be virtually eliminated. Under IFRS when the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realizable value because of changed economic circumstances, the amount of the write-down is reversed so that the new carrying amount is the lower of the cost and the revised net realizable value. However, the reversal is limited to the amount of the original write-down. Under U.S. GAAP, reversals are always banned.

The following table illustrates cost formulas used under the two frameworks:

	IFRS	U.S. GAAP
Last-in, first-out (LIFO)	Prohibited	Allowed
First-in, first-out (FIFO)	Allowed	Allowed
Average cost method	Allowed	Allowed
Standard cost method	May be used for convenience if the results approximate cost	May be used if the results reasonably approximate cost computed under one of the recognized bases
Retail method	May be used for convenience if the results approximate cost	In some situations may be both practical and appropriate

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