# 2008 Year-End Accounting Update

December 2008

Ernst & Young
Quality In Everything We Do

# Agenda

- IFRS Update
- FASB Statement 141(R) - Business Combinations
- FASB Statement 160 - Noncontrolling Interests in Consolidated Financial Statements
- Other standard setter activity
  - FASB Statement 161 - Disclosure about Derivatives Instruments and Hedging Activities, an amendment of FASB Statement 133
  - 2008 EITF consensuses
  - FASB Staff positions issued during 2008
  - FASB exposure drafts
  - SEC update

# IFRS Update

# Agenda

- SEC Roadmap
- Timeline

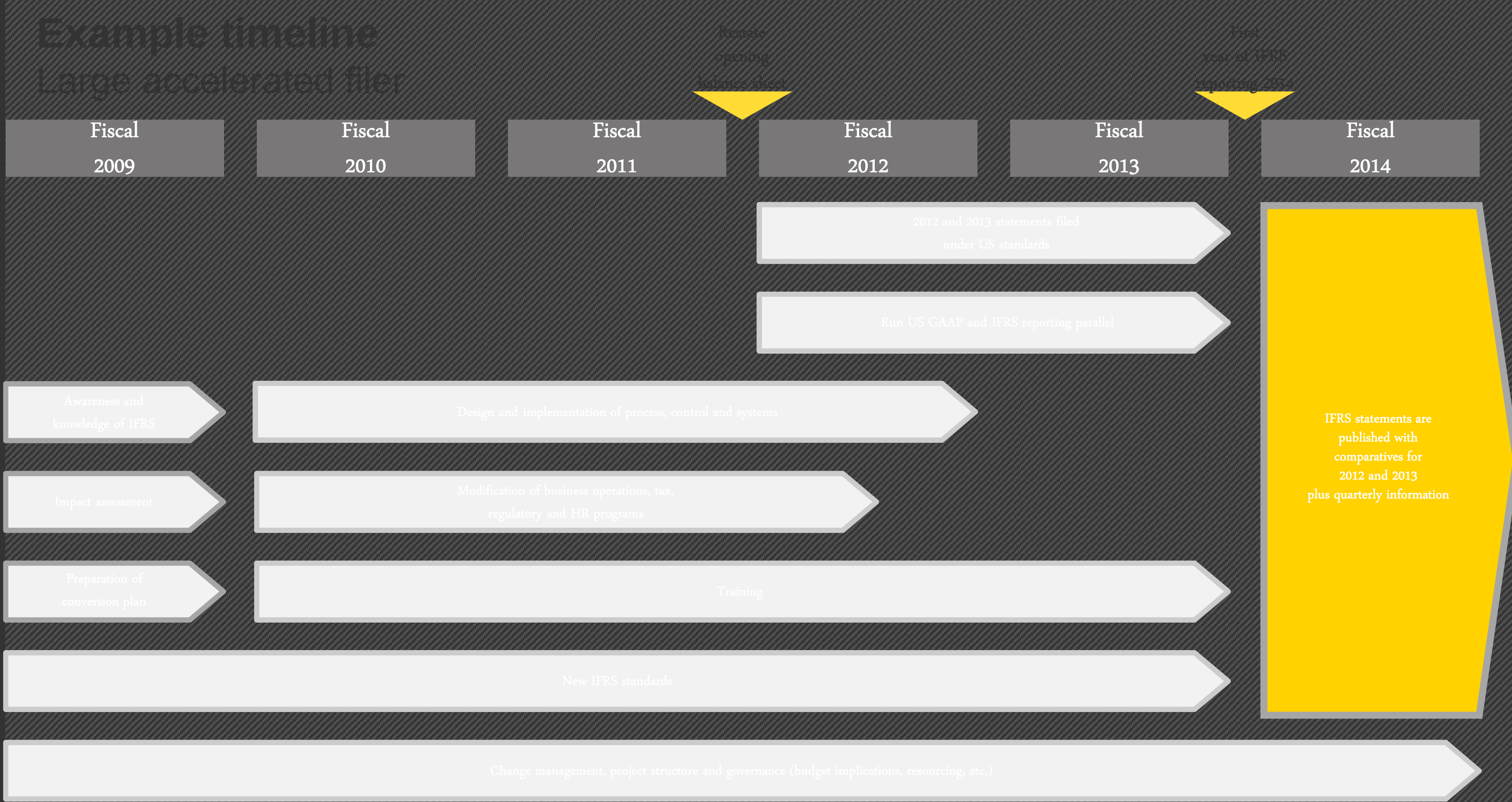
# SEC Roadmap

- In November 2008, the SEC issued the "Roadmap" on the potential use of IFRS for US companies
- IFRS reporting will be phased in as follows:
  - Large accelerated filers – 2014
  - Accelerated filers – 2015
  - Non-accelerated filers – 2016
- Certain companies will be allowed to early adopt IFRS after December 15, 2009
- Three years of audited financial statements will be required including an "opening balance sheet" as of the date of transition

# SEC Roadmap

- The Roadmap sets forth the following milestones that the SEC will consider before making a final decision:
  - Improvements in accounting standards
  - Accountability and funding of IASCF
  - Improvements in the use of XBRL
  - Improvements in IFRS education and training
- The SEC will  make the final decision in 2011 on whether to proceed with a final rule (could be earlier)
- The Roadmap has a 90 day comment period

# Timeline



Example timeline
Large accelerated filer
Restate opening balance sheet
First year of IFRS reporting 2014
Fiscal 2009
Fiscal 2010
Fiscal 2011
Fiscal 2012
Fiscal 2013
Fiscal 2014
2012 and 2013 statements filed under US standards
Run US GAAP and IFRS reporting parallel
IFRS statements are published with comparatives for 2012 and 2013 plus quarterly information
Awareness and knowledge of IFRS
Design and implementation of process, control and systems
Impact assessment
Modification of business operations, tax, regulatory and HR programs
Preparation of conversion plan
Training
New IFRS standards
Change management, project structure and governance (budget implications, resourcing, etc.)

# FASB Statement 141(R) - Business Combinations

# Overview

- New basis model
  - Requires new measurement (generally at fair value) of 100% of all assets, liabilities and noncontrolling interests
- Cost accumulation model no longer relevant
- Increased use of fair value
- Liabilities recognized in business combination only if liabilities of the acquired company

# Summary of significant changes

- Broadened definition of a business
  - Likely will result in more transactions accounted for as business combinations
- "Purchase price allocation period" is now "measurement period"
  - Applies to measurement and allocation of purchase price
  - Revised measurements must be applied <u>retroactively</u>
- Expense acquisition-related transaction costs
  - Debt and equity issuance costs continue to be capitalized

# Summary of significant changes (continued)

- Recognize pre-acquisition contingencies at the acquisition date fair value for:
    - (1) all contractual pre-acquisition contingencies and
    - (2) non-contractual pre-acquisition contingencies that are determined to be "more-likely-than-not" of materializing
  - Subsequent adjustments made only when "new information" about the possible outcome is obtained
- Recognize contingent consideration arrangements at their acquisition-date fair values
  - Subsequent accounting is dependent upon classification of contingent consideration (equity versus liability)

# Summary of significant changes (continued)

- Capitalize acquired IPR&D assets
  - Subject to periodic impairment reviews pursuant to Statement 142
  - Upon completion – assign a useful life and amortize
- Assets the acquirer does not intend to use or use to the extent of highest and best use (defensive assets)
  - Measured and recognized at fair value based on the highest and best use by a market participant
  - Subsequent accounting being addressed by EITF Issue No. 08-7

# Summary of significant changes (continued)

- Share-based payment awards
  - More expense (as compared to FAS 141) could result if service period of replacement awards is shorter than original award
- Restructuring liabilities recognized in purchase accounting only if the criteria of Statement 146 are met as of the acquisition date
  - Limits restructuring obligations to those assumed from the target
  - Liabilities resulting from actions taken by the acquirer are NOT included in purchase accounting

# Summary of significant changes (continued)

- Income Taxes
  - Reduction in target's valuation allowance after the acquisition date is recognized as a reduction of income tax expense
  - All adjustments to liabilities for income tax uncertainties that pre-date or result from the acquisition are recognized as an element of the income tax provision
  - A deferred tax asset is recognized for the excess of tax deductible goodwill over financial reporting goodwill
- Determination of purchase price when issuing equity securities
  - Final purchase price to be determined when control is obtained

# Effective date and transition

- The standard is effective for fiscal years beginning after 15 December 2008
  - Early adoption prohibited for US GAAP
- No effect on prior transactions
  - Except, changes to deferred tax asset valuation allowances and income tax uncertainties after effective date of FAS 141(R) will affect acquirer's earnings
  - Restructuring liabilities recognized pursuant to EITF 95-3 continue to follow that guidance (adjustments to goodwill)
  - Contingent consideration continues under Statement 141
  - Purchase price adjustments continue to be based on Statement 141 (even if purchase price allocation period is after effective date)

# Effective date and transition (continued)

- Transaction costs capitalized under Statement 141 for deals closing after effective date of FAS 141(R)
  - 3 alternatives
    - Costs would be expensed when probable that acquisition will not close until after the effective date
    - Costs would be expensed on the effective date
    - Costs would be expensed retrospectively on the effective date (e.g. restate prior period financial statements to reflect costs)
- Identification of reporting units and assessment of goodwill impairment
  - Expanded definition of a business could increase the number of reporting units

# FASB Statement 160 - Noncontrolling Interests in Consolidated Financial Statements

# Fundamentals of Statement 160

- Significantly affects consolidation accounting for all entities, except for NFPs
- Addresses how to account for noncontrolling interests in a consolidation and changes:
  - Classification and presentation of noncontrolling interests
  - Allocation of earnings between controlling and noncontrolling interests
  - Recognition of purchases and sales of shares of subsidiary
- No net EPS impact to parent (except for loss allocation) under Statement 160

# Reporting noncontrolling interests

**Current rules**

- Typically "minority interest" reported as a mezzanine item between liabilities and equity
- Consolidated net earnings exclude minority interest component
- Rule 5-04 of Reg S-X requires presentation of minority interest after income tax as a component of income from continuing operations

**New rules**

- Mezzanine accounting is not permitted and "noncontrolling" interest is reported as a separate component of shareholders' equity
- Consolidated net earnings include noncontrolling interest component
  - Income attributable to noncontrolling interests shown separate as an allocation of consolidated net earnings

# Reporting noncontrolling interests—allocation of losses

## Current rules

- Losses attributed to both the controlling and minority on the basis of their ownership interests and contractual rights and obligations, but generally only to minority interest to the extent of the minority interest investment (minority interest can't go negative)

## New rules

- Allocated losses can exceed the noncontrolling interest investment (i.e., it can go negative)
  - Could have beneficial impact to income attributable to controlling (i.e. Parent) interest and EPS
  - Pro forma disclosure required in year of adoption
  - Prospective adoption precludes recouping losses previously absorbed by parent

# Loss of control of subsidiary

## Current rules

- Loss of control results in deconsolidation and gain or loss recognition
- Gain or loss is the difference between the FV of any consideration received and the carrying value of the interest sold
- Any remaining noncontrolling interest is recorded based on historical carrying value

## New rules

- Similar to current, except that any retained shares are revalued to FV and a gain/loss recorded (new basis recognition event)
- “Full” gain or loss recognition, including revaluation of the retained interest

# Effective date and transition

- Statement 160 is effective for fiscal years beginning after 15 December 2008
- Early adoption prohibited
- Prospective, except for presentation and display

# Other standard setter activity

# FASB Statement 161 - Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133

# Overview of Statement 161

- Enhances disclosures
- New discussion of objectives and strategies for using derivatives for risk management purposes
- Volume of derivative activity disclosed
- Tabular disclosure of gross fair value amounts, gains and losses on derivatives, and related hedged items
- Limited exemption for derivatives included in trading activities
- Credit-risk disclosures
- Effective for calendar-year companies in their first quarter 2009 financial statements

# EITF – 2008 Consensuses

- Issue 07-4—Application of the Two-Class Method under FASB Statement No. 128, Earnings per Share, to Master Limited Partnerships
- Issue 07-5—Determining Whether an Instrument (or an Embedded Feature) is Indexed to an Entity's Own Stock
- Issue 08-1—Revenue Recognition for a Single Unit of Accounting (Tentative)
- Issue 08-3—Accounting by Lessees for Maintenance Deposits under Lease Agreements
- Issue 08-4—Transition Guidance for Conforming Changes to Issue No. 98-5
- Issue 08-5—Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement
- Issue 08-6 – Accounting for Equity Method Investments
- Issue 08-7 – Accounting for Defensive Intangible Assets
- Issue 08-8 – Accounting for an Instrument (or Embedded Feature) with a Settlement Amount that is based n the Stock of an Entity's Consolidated Subsidiary

# FASB Staff Positions (FSPs) Issued in 2008

- FSP No. FIN 48-2—Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises (FSP FIN 48-2)
- FSP No. SOP 07-1-1—Effective Date of AICPA Statement of Position 07-1
- FASB Staff Position No. FAS 157-1—Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13
- FSP No. FAS 157-2—Effective Date of FASB Statement No. 157 (FSP FAS 157-2)
- FSP No. FAS 140-3—Accounting for Transfers of Financial Assets and Repurchase Financing Transactions

# FSPs Issued in 2008 (continued)

- FSP SOP 90-7-1—An Amendment of AICPA Statement of Position 90-7, Financial Reporting by Entities in Reorganization under the Bankruptcy Code
- FSP FAS 142-3—Determination of the Useful Life of Intangible Assets FAS 142-3)
- FSP APB 14-1—Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) (FSP APB 14-1)
- FSP SOP 94-3-1 and AAG HCO-1—Omnibus changes to consolidation and Equity Method Guidance for Not-for-Profit Organizations
- FSP EITF 03-6-1-Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities

# FSPs Issued in 2008 (continued)

- FSP FAS 117-1—Endowments of Not-for-Profit Organizations
- FSB 133-1 and FIN 45-4—Disclosures about Credit Derivatives and Certain Guarantees
- FSP FAS 157-3—Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active)

# FSP FAS 133-1 and FIN 45-4 effective for this year-end for sellers of credit derivatives

- Effective for 30 November 2008 year-ends and interim periods thereafter
- Seller of a credit derivative must disclose, even if the likelihood of the seller having to make any payments is remote:
  - The nature of the credit derivative, including the approximate term, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform, and the 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, regardless of potential recoveries.
  - The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral or by third parties that the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative.
- Investors in credit-linked notes (insurers) can be sellers of credit derivatives under this FSP.  This FSP applies to embedded derivatives.

# FASB Exposure Drafts

- Loss Contingency Disclosures
- Hedging Activities
- Amendment to FIN 46(R)
- Amendment to Statement 140
- Earnings Per Share
- FSP 132(R)-a, Employers' Disclosures about Postretirement Benefit Plan Assets
- Preliminary Views on Liability vs. Equity
- Conceptual Framework Project

# SEC Key personnel changes

- Three new commissioners sworn in at the SEC
  - Elisse Walter, former FINRA Senior EVP
  - Luis Aguilar, former law partner at McKenna Long & Aldridge
  - Troy Paredes, former Washington University law professor
  - They joined Chairman Christopher Cox and Commissioner Kathleen Casey to complete the 5-member commission
- New SEC Deputy Chief Accountant for Professional Practice
  - Paul Beswick, former EY partner in AABS Professional Practice
- Steven Harris appointed to PCAOB

# SEC hot buttons – recent developments

- Fair value disclosures
- Off-balance sheet arrangements and VIEs
- Impairment recognition
  - Other-than-temporary impairment of investments
  - Impairment of goodwill
  - Deferred tax asset valuation allowances
- Auction rate securities

# SEC hot buttons – recurring themes

- Executive compensation
- Share-based payments
- Item 4.02 Form 8-Ks
- Disclosure controls and procedures
- Financial statement classification
- Revenue recognition
- Segments
- Hedging
- Warrants and embedded conversion features
- Non-GAAP measures
- MD&A
- Legal contingencies
- Pensions and other postretirement benefit plan disclosures
- Consolidation
- Inventory
- Intangible assets
- Impairment and disposal of long-lived assets
- Earnings per share
- Uncertain tax positions