Assurance Group

Current Issues in Accounting/Auditing

May 6, 2009

Agenda

- Business Combinations
- Non-Controlling Interest
- Issues in current economic environment
- Fair Value

Business Combinations

- "Old Standard" – SFAS 141/142 issued in June 2001, effective for all business combinations after June 30, 1002
  - Required all business combinations to be accounted for under the purchase method
  - Required separate recognition of intangibles based on contractual-legal criterion or separability criterion
  - Did not apply to non-profit entities and common control mergers
  - Allowed indefinite-lived intangibles (i.e., goodwill)
  - Required annual impairment testing of indefinite-lived intangibles

SFAS 141(R)

- This statement establishes principles and requirements for how the acquirer should record the assets and liabilities, record goodwill or gain on bargain purchase, and properly disclose the information in the financial statements in a business combination.

- Issued in December 2007 and effective for acquisitions on/after first reporting period on/after December 15, 2008

- This was a joint project with the International Accounting Standards Board (IASB)

Main Concepts

- 100% of the assets and liabilities of the acquired entity will be recorded on the consolidated balance sheet, any minority interest will be considered equity.

- The Consolidated income statement will present the results of the entire enterprise followed by a schedule that allocates net income to controlling and non-controlling interests. EPS will be calculated based on the controlling interest stockholders' earnings.

Main Concepts

- Broadens scope – applies to all transactions and other events in which one entity obtains control over one or more other businesses (whether consideration is transferred or not), including “true mergers” and “mergers of equals”
- Still excludes non-profit entities and common control combinations

Key changes from SFAS 141

- Acquisition Date – Under SFAS 141 the acquisition date is a few days before or after the announcement date; under SFAS 141(R) the acquisition date is when the entity obtains control.

- Acquisition cost – Under SFAS 141 acquisition cost is added to the purchase price; under SFAS 141(R) acquisition cost is expensed.

Key changes from SFAS 141

- Bargain Purchase – Under SFAS 141 negative goodwill reduces certain assets carrying value until the aggregate total equals the purchase price. Under SFAS 141(R) assets and liabilities will be recorded at fair value under SFAS 157; the excess will be recorded as a gain net of deferred taxes

Key changes from SFAS 141

- In-Process R&D – Under SFAS 142 the company needs to assign a value to in-process R&D and record it during the acquisition, then expense the value immediately. Under SFAS 141(R) in-process R&D will be classified as intangible assets and will be amortized after the R&D phase is complete.

Key changes from SFAS 141

- Contingent Consideration – Under SFAS 141 contingent consideration is recorded when resolved as an adjustment to goodwill or paid in capital (if related to stock price changes). Under SFAS 141(R) buyers will be required to estimate the fair value of the contingent consideration and record it as an asset or a liability. At period end, the value is marked to market and any gains or losses are recorded in the income statement until the contingencies are resolved.

Key changes from SFAS 141

- Contingent Assets/Liabilities – Under SFAS 141 liabilities are recognized when probable and estimable (SFAS 5); contingent assets are rare. Under SFAS 141 (R) contractual contingent assets and liabilities (i.e. warranty) are recorded at fair value, and non-contractual contingent assets and liabilities (i.e. litigation) at fair value if more-likely than not.

FSP FAS 141(R)-1

- Issued April 1, 2009
- Modifies accounting for assets acquired and liabilities assumed in a business combination that arise from contingencies (other than contingent consideration)
- Requires acquirer to record at fair value, at the acquisition date, an asset or liability that can be determined during the measurement period
- If fair value can’t be determined, requires acquirer to recognize a liability or asset in accordance with SFAS 5 if it is probably and reasonably estimable.
- Removes “more likely than not” criterion

Key changes from SFAS 141

- Defensive Assets – Under SFAS 141 defensive assets are not recognized; under SFAS 141(R) defensive assets are recorded at fair value.

- Restructuring Cost - Under SFAS 141 restructuring liabilities are recognized if expected with an increase in goodwill, under SFAS 141(R) restructuring liabilities are recognized and expensed.

Key changes from SFAS 141

- Step Acquisition – Under SFAS 141 the acquirer records the cost of each incremental purchase until obtaining a controlling interest then the total cost incurred is considered the purchase price. Under SFAS 141(R) once control is achieved, the incremental investment will be adjusted to fair value; gains or losses will be included in current earnings.

Key changes from SFAS 141

- Disclosures – Under SFAS 141 disclosures are limited to describing the impact on earnings and the allocation of the purchase price. Under SFAS 141(R) the disclosure requirements are the same but management is also required to describe the economic facts that validate the recording of goodwill.

Examples

- Example #1
  - Facts:
    - Purchase price $1,000,000
    - FV of current assets $300,000
    - FV of tangible assets $1,000,000
    - FV of liabilities $800,000
    - Acquisition cost $100,000
    - In process R&D $100,000
  - Propose an AJE to record the purchase under SFAS 141 and SFAS 141(R)

Examples

- Example #2
  - Facts:
    - Purchase price $300,000
    - FV of current assets $300,000
    - FV of tangible assets $1,000,000
    - FV of liabilities $800,000
    - Acquisition cost $100,000
  - Propose an AJE to record the purchase under SFAS 141 and SFAS 141 (R)

Non-Controlling Interest

- Old GAAP – ARB 51, issued 1959 (2 years before I was born)
  - Terminology was “minority interest”
  - Limited guidance existed
  - Recorded at cost
  - Cannot be reduced below zero for subsequent losses incurred
  - Classified on balance sheet as mezzanine level between liabilities and equity

SFAS 160

- This statement changes the terminology of minority interest to non-controlling interest to better address situation when majority ownership does not lead to consolidation (e.g. subsidiary in bankruptcy) or when a company has a minority interest but exercise control (e.g., under FIN 46 (R), *Consolidation of Variable Interest Entities*)
- Issued in December 2007 and effective for fiscal years beginning on/after December 15, 2008, and interim periods within those fiscal years.
- This was a joint project with the International Accounting Standards Board (IASB)

Key Changes

- Balance Sheet – The caption minority interest (a liability account) will be eliminated, and will be displayed as "Non-Controlling Interest," a separate item in the equity section

- Income and Comprehensive Income – Net income will include the portion related to the non-controlling interest parties with an attached statement allocating the income. EPS will be based on the controlling parties net income . Comprehensive income will be allocated.

Key Changes

- No gain or loss recognition when the parent retains control after ownership changes – such adjustments will flow through consolidated equity only

- Disclose reconciliation of beginning and ending balances of equity attributable to the parent and non-controlling interest

- Requires that a parent recognize a gain or loss in net income upon deconsolidation.

Key Changes

- Requires that a parent recognize a gain or loss in net income upon deconsolidation, equal to the difference between the proportional adjustment to the non-controlling interest and the fair value of the consideration paid or received

- Losses can reduce non-controlling below $0

Issues in Current Economic Environment

- Greater fraud risk
- How do you audit fair value measurements?
  - “Marketable” instruments
  - Non-marketable instruments
- Auditing accounting estimates
  - Inventory net realizable value
  - Accounts receivable collectibility
  - Deferred tax assets
  - Impairment triggers/value estimates

Issues in Current Economic Environment

- Option pricing variables – volatility, expected term, forfeiture rates, etc.
- Disclosures of significant risks and uncertainties (SOP 94-6)
- Going concern
- Loan covenants testing/compliance
- Restructuring reserves – SFAS 146

Issues in Current Economic Environment

- Revenue Recognition
  - “Bill and hold” arrangements
  - Sell-through requirements
  - Rights of return
  - Consignments
  - Channel stuffing
  - Side agreements
  - Change in payment terms

- Warranty reserves

Issues in Current Economic Environment

- Repricing of stock options
- Reduced internal controls due to cut back of staff
- Be more skeptical
- Pricing pressures may cause auditors to try to reduce work; circumstances dictate more audit work

Fair Value

- Most hotly discussed accounting topic in the last 10 years

- Political pressures are mounting in the US and abroad to have accounting rules that help in the current environment, not hurt

Fair Value

- “The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”
- Difficult to assess in this market with illiquidity and distressed sales

Fair Value

- Excerpts from SFAS 157:
  - "An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction"
  - "Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are …[w]illing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so"
  - "For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if … [t]he transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty."

Fair Value Pronouncements/Guidance

- FSP FAS 157-3 (discussed in New York)
- SEC study – December 2008
- *Valuation Considerations for Investments in Alternative Investments* – AICPA draft issues paper – January 2009
- FSP FAS 157-4, FSP FAS 107-1 and APB 81-1, FSP FAS 115-2 and FAS 124-2 – all issued April 9, 2009
- Innumerable articles, opinions, studies and analyses

SEC Study

- FV accounting was not a primary underlying cause of bank failures or other distressed financial institutions studied
- Investors agree that FV information is useful and increases quality of information
- Recommend to improve application of and guidance related to FV accounting under SFAS 157

FSP FAS 157-4

- Provides additional guidance for estimating fair value when volume and level of activity for an asset or liability has significantly decreased
- Provides guidance on identifying circumstances that indicate a transaction is not orderly
- Effective for reporting periods ending after June 15, 2009

FSP FAS 107-1 and APB 28-1

- Disclose more fair value information (methods and assumptions) in interim filings
- For public companies only
- Effective for reporting periods ending after June 15, 2009

FSP FAS 115-2 and FAS 124-2

- Amends guidance for other than temporary impairment (“OTTI”) for debt securities
- Intend to sell – OTTI has occurred
- Assess whether it is more likely than not that the entity will be required to sell before maturity
- OTTI related to credit loss recognized in earnings
- OTTI related to other factors recognized in equity (other comprehensive income)

Fair Value

- Still evolving – stay tuned
- Become more adept at understanding generally accepted valuation methodologies and when to apply them
- Use experts (or become one yourself through training and certification)

Conclusion

- FV is here to stay, whether you like it or not
- We all need to adapt (or retire!!)
- FV requires considerable judgment
- Be aware of litigation risk in particularly tricky situations
- It's not "business as usual," so don't audit like it is
- Seek help from experts as needed
- Smile!!