Recent market events

Accounting and reporting considerations

7 October 2008

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To our clients and other friends

Market events are having overarching effects on all industries and the economy as a whole. What started with concerns about subprime mortgage loans in the housing market has quickly led to further consolidation in the financial services industry. But Wall Street is not the only industry that has been significantly affected. Consumers and companies have also been significantly affected by recent market events. Companies of all types and sizes are increasingly finding it more difficult to address their liquidity and capital needs.

Recent market events have led to, among other things: declines in the fair values of investment securities; liquidity and funding concerns because of more restrictions placed on access to capital; a significant contraction in commercial paper and other short-term funding sources; debt covenant compliance concerns; bankruptcies; hedge funds and other investment vehicles indicating an inability to reliably value certain of their holdings, and halting redemption requests; and a concern that the net asset value of some money-market funds may decline to less than one dollar per share (that is, "break the buck"). At this publication's date, the Emergency Economic Stabilization Act of 2008 was signed into law, with its objective to promote the stability of the US financial system.

Heading into the end of 2008, the accounting and financial reporting implications of the credit crisis are at the forefront of many companies' minds. Accounting issues that likely will warrant increased focus by management and audit committees include: estimating fair value, especially for financial instruments that do not have readily observable market prices; determining whether revenue should be recognized; analyzing whether assets are impaired; evaluating liquidity and funding concerns; and assessing compliance with debt covenants.

This publication is designed to assist you in understanding and addressing certain accounting and financial reporting issues that may warrant increased focus because of the current market conditions. This publication first provides considerations for audit committees in discharging their responsibilities in the current environment. The publication then, by topic, summarizes key accounting and reporting issues that companies should be considering in preparing their quarterly and annual financial statements. The publication also provides references to additional literature prepared by Ernst & Young that more fully describes the issues.

We hope you find this publication helpful. As market events change, we will keep you updated. Ernst & Young professionals are available to assist you in understanding how the issues in this economic environment affect your company and are ready to discuss your particular concerns and questions.

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Overall economic conditions

The events in the financial markets over the past year have been unprecedented. Steep adjustments in real estate values, restricted criteria for obtaining capital, and the liquidity concerns of financial institutions have created unrest in the capital markets resulting in downward pressure on asset values.

Losses and write-downs at major financial institutions have intensified concerns about credit and liquidity risks and resulted in a further sharp reduction of market liquidity. Credit risk spreads — particularly for structured credit products — have widened dramatically, and securitization activity has all but shut down in a number of markets. Many securities dealers and other institutions that have relied heavily on short-term financing in repurchase agreement markets are facing much more stringent borrowing conditions. Asset prices continue to be volatile and many financial markets and institutions remain under considerable stress.

The sluggish pace of economic activity has been accompanied by a further deterioration in the labor market. Unemployment continues to rise and lower equity and home values continue to weigh on consumer sentiment and spending. In addition, amid falling house prices and rising foreclosures, activity in the housing sector continues to decline. The resulting softness in business sales and profits also makes the environment for capital spending less hospitable.

These conditions create challenges for many companies and their management, some of whom anticipate further challenges before stabilization in the capital markets occurs. It is with this backdrop that we have prepared this publication, which highlights important accounting and reporting considerations in the current economic environment.

Audit committee considerations

The evaluation and management of risks and their related effect on the financial statements are topping audit committee agendas in 2008. Financial statements of all companies are being affected by the current economic environment as they recognize impairments, restructure their operations, and determine fair values, particularly for illiquid or complex instruments.

Audit committees are focused on the oversight of company risk assessment and management activities and are inquiring as to whether recent credit and liquidity difficulties were detected timely by company risk programs. Audit committees are continuing to evaluate whether financial and operating risks around borrowing and lending activities are sufficiently identified and evaluated. Audit committees are also evaluating whether sufficient attention is being given to the amount of risk assumed across various operating, investing, and financing activities.

Difficult market conditions coupled with the implementation of Statement 157 have increased the spotlight on fair value accounting. For many companies and audit committees, the implementation of Statement 157 has created unexpected challenges, particularly the considerations regarding fair value when financial instruments have illiquid markets and related follow-on issues tied to the evaluation of whether identified impairments of financial instruments are other than temporary.

The following table provides considerations for audit committees in their discussions with management and auditors:

Risk management	► Review the company's risk management strategy in light of current market events. Understand any changes undertaken to the strategy and whether appropriate internal controls are in place to support those changes. ► Review management's assessment of the performance of internal controls during recent market events. ► Assist in developing and overseeing, as needed, the company's plan to address the identified financial, operational, or strategic exposures. ► Understand to what extent the company is susceptible to the financial, operational, or strategic exposures related to the growing set of credit, liquidity and valuation issues.
Fair value measurements	► Review management's methodology for determining fair value, particularly for complex or illiquid securities. ► Understand whether there have been any changes to that methodology. Understand whether the changes were appropriate, and if no changes have been made, whether that methodology is appropriate in light of the current environment. ► Understand key assumptions and how changes in those assumptions have affected and could affect the company in the future. ► Understand whether more items have been valued using internal-only models and how assumptions and results were corroborated.
Liquidity and capital resources	► Review management's analysis of liquidity and capital resources, including compliance with debt covenants or other contractual commitments or provisions. ► Understand what debt is expected to be refinanced and how. ► Understand if the current conditions could affect the company's ability to continue as a going concern.
Disclosures	► Understand how the company's disclosures have been enhanced to reflect current market conditions through filings, press releases, company websites, conference calls and other media. ► Understand how management has appropriately disclosed the company's critical accounting policies, market risk, liquidity and capital resources. ► Understand how management has included the SEC staff's recommended fair value disclosures.
Other	► Understand any new or unusual transactions such as sales of assets, new financing structures, or transactions with related parties. ► Consult with management, internal audit and the external auditor on the accounting and financial reporting implications of identified exposures. ► Review changes to key assumptions or estimates in light of current market events and business operations (for example, forecasted results, sales returns, cash flows, cost of capital, asset impairment, allowance for doubtful accounts and inventory obsolescence).

Internal control

Issue

Management is responsible for maintaining effective internal control. In addition, for public companies, management is required to evaluate the effectiveness of disclosure controls and procedures as of the end of each quarterly period and perform an assessment of the effectiveness of internal control over financial reporting as of the end of the fiscal year, pursuant to Sections 302 and 404, respectively, of the Sarbanes-Oxley Act of 2002.

Background

Dynamic and difficult market conditions can increase risk or create new risks that did not previously exist, resulting in a need for additional emphasis on the importance of maintaining effective internal control. In addition, challenges being faced in the current environment may have the unintended effect of diverting resources away from activities that are normally part of the internal control function.

Internal control considerations

Management should consider the effects of current conditions on risks and the related internal controls necessary to address them. Such considerations include whether:

- New material risks to operations, financial reporting, or compliance have arisen, including fraud risks
- The significance of previously identified risks has changed
- Existing controls are sufficient to address identified risks

Further, for management of public companies, consider whether new or increased risks:

- Affect the quarterly process of evaluating the effectiveness of disclosure controls and procedures
- Change the scope of management's annual assessment of internal control over financial reporting, including the nature and extent of evidence needed to support a conclusion that controls are operating effectively

Further discussion

The Committee of Sponsoring Organizations of the Treadway Commission (COSO), in *Internal Control — Integrated Framework*, defines internal control broadly "as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Additionally, COSO states that internal control consists of five interrelated components: Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring. Each of these five components is relevant to each of the objectives.

No matter the particular objective or component, all entities strive to maintain effective internal control. As a result, management should consider the effects of difficult current conditions on the achievement of the organization's objectives and the role that internal control plays in helping to achieve those objectives.

Internal control over financial reporting

The difficult market conditions have caused many companies to reconsider their processes for identifying and evaluating risks facing the company, including risks related to financial reporting. In particular, the current uncertainties in the market may create additional questions or concerns about the valuation, impairment, or recoverability of certain assets, and the processes affecting the determination of significant judgments and estimates. As a result, internal control over financial reporting, including controls over the process of preparing the financial statements and related disclosures, will be particularly important this year. Specific areas of internal control that management may need to pay particular attention to in the current environment include processes and controls relating to the development of inputs and assumptions for the valuation of significant assets or liabilities; the review of assets for recoverability or impairment; determining the need for management to engage an external specialist (for example, valuation or actuarial expert) to assist in the determination of the recorded amounts of certain assets or liabilities, as well as processes and controls over the review of the work of such an expert; and the misappropriation of assets or fraudulent financial reporting.

For companies with an internal audit department, management and audit committees may wish to consider whether the internal auditors should reconsider their current audit plan in light of any new or increased risks facing the company and adjust their audit plans accordingly.

Public company requirements

SEC rules and regulations require management, under the direction of the principal executive and financial officers, to evaluate on a quarterly basis the effectiveness of disclosure controls and procedures and to perform an assessment of the effectiveness of internal control over financial reporting as of the company's fiscal year end. The SEC requirements are pursuant to Sections 302 and 404 of the Sarbanes-Oxley Act of 2002.

When reconsidering their risks, operating processes and procedures, and internal controls in response to current market conditions, companies required to assess the effectiveness of internal control over financial reporting also should be aware of the potential effects on the scope and conduct of management's assessment process. This reconsideration could include determining whether all material risks to reliable financial reporting have been identified, whether identified controls are sufficient to address such risks, and whether the procedures to gather evidence to support the operating effectiveness of internal control over financial reporting continue to be sufficient when applying a top-down, risk-based approach. For example, if conditions in the current environment have increased the risk profile of certain operating processes and procedures, and controls related to such risks were already tested as of an interim date, management should consider the changing risk profile when determining the nature, timing, and extent of update procedures that are necessary during the intervening period between the interim and year - end assessment date.

Disclosure controls and procedures are designed to address that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC. Accordingly, in addition to considering how current market conditions affect the company's ability to maintain effective internal control over financial reporting that results in the preparation of timely, reliable, and accurate financial statements and related notes, companies also should consider how current market conditions affect disclosure controls and procedures that exist related to other required elements of periodic SEC filings. Specific elements of periodic filings that could be affected by current market conditions include:

- Description of business, properties, and legal proceedings, including a discussion of risk factors
- Management's discussion and analysis of financial condition and results of operations
- Quantitative and qualitative disclosures about market risk
- Executive compensation
- Certain relationships and related transactions
- Material events

Literature references

- Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework*
- SEC Final Rule Release No. 33-8238 – Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports – June 5, 2003
- SEC Interpretive Release No. 33-8810 – Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 – June 20, 2007
- EY publication, *2007 SEC Annual Reports* (Score No. CC0244)
- EY publication, *2008 Quarterly Financial Reporting* (Score No. CC0245)
- EY publication, *SEC Issues Final Rule: Management Reporting on Internal Control* (Score No. CC0173)

Valuation of investments

Issue

Measuring the fair values of certain asset classes has been challenging in the current environment.

Background

Changing levels of investor aversion to risk, combined with liquidity constraints and decreased trading volumes for certain asset classes, have required management to exercise significant judgment in determining fair value.

Accounting & reporting considerations

- At the time of this publication, the FASB had exposed for comment a proposed FSP that is intended to clarify the application of Statement 157 in markets that are not active. The FASB may issue final guidance as early as 10 October 2008. Accordingly, readers should closely monitor developments in this area.
- Fair value is intended to convey the current value of an asset or liability, not the potential value of the asset or liability at some future date (that is, the amount expected to be realized upon settlement or at maturity). As such, fair value should reflect current market conditions.
- The number of factors affecting an investment's fair value can be extensive and can vary both by type of instrument or within instrument types.
- For many instruments, evidence supporting the fair value determination may not come from trading in active primary or secondary markets.
- Estimates of fair value should appropriately consider credit, interest rate and liquidity risk. The fair value estimate should be based on reasonable and supportable assumptions that a third-party market participant would use in determining the current fair value of the instrument.
- Fair value estimates based on a valuation model should also include an appropriate risk premium reflecting the uncertainty surrounding the cash flows of the underlying assets (collateral).

Further discussion

Determining the fair value of investments such as US Treasury securities, basic corporate debt obligations, and exchange-traded equity securities is generally not complex. However, other investment types such as auction rate securities, money market funds, commercial paper, mortgage-backed or other asset-backed securities, alternative investments (such as hedge funds, private equity investments, funds of funds, etc.), collateralized debt obligations, municipal securities and other investments all present potential complexities in valuation because of the current conditions in the capital markets.

Due to current market conditions, trading of many of these instruments has declined significantly or may not be occurring at all. As such, it has become more difficult to obtain observable evidence to support the valuation of these instruments. As a result, particular attention should be given to the models and related assumptions used in valuing illiquid and/or complex instruments.

In order to clarify the application of Statement 157 in markets that are not active, the FASB has exposed for comment proposed FSP FAS 157-d, *Determining Fair Value in a Market That Is Not Active* (the proposed FSP). The proposed FSP would amend Statement 157 by providing an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is not active. The proposed FSP was exposed three days after the Office of the Chief Accountant of the Securities and Exchange Commission and the FASB staff jointly issued a press release (the Release) that addresses similar Statement 157 application issues.

The definition of fair value in Statement 157 indicates that a fair value measurement should not be based on a distressed sale or forced liquidation, but instead contemplates an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market.

Some investors in less liquid assets might consider the current pricing of their instruments, especially those with mortgage loans as an underlying, to be reflective of distressed sales and/or forced liquidations and, therefore, not indicative of fair value. Determining whether a current observable transaction represents a distressed sale or forced liquidation requires judgment. However – while not authoritative – as discussed in the white paper issued by The Center for Audit Quality in October 2007, *Measurements of Fair Value in Illiquid (or Less Liquid) Markets*, judgments should be supported with persuasive evidence when an instrument's current observable market price is ignored based on a view that this price represents liquidation or distressed sale values. The issue as to whether a transaction is distressed affects companies' measurement of fair value under both US GAAP and IFRS. As such, although not authoritative, we believe the draft white paper issued by an IASB expert advisory panel in September 2008, *Measuring and Disclosing Fair Value of Financial Instruments in Markets That Are No Longer Active*, provides useful considerations for all entities in evaluating whether transactions are forced or distressed.

The inputs used in determining fair value measures may be observable or unobservable, but they should reflect the assumptions that market participants would use in pricing an asset or a liability in a current transaction. Valuation techniques should maximize the use of observable inputs and minimize the use of unobservable inputs. As such, even in situations in which the market for a particular asset is deemed to be inactive, prices or inputs from this market cannot be ignored and should still be considered in the measurement of fair value. However, in weighing the reliance that should be given to observable inputs from inactive markets, entities should consider various factors including the timing of the transaction in relation to the measurement date, as well as whether the instrument in the observed transaction(s) was similar or identical to the item being measured.

Adjustments (sometimes significant) to prices or other observable data in inactive markets may be required for a number of reasons including (i) timing differences between the date of the transaction and the measurement date, (ii) differences between the instrument being measured and a similar instrument that was the subject of the transaction, or (iii) the volume and level of activity in the market. The proposed FSP notes that when significant adjustments to observable data are determined using unobservable data, the resulting measurement would be considered a level 3 measurement.

Statement 157 discusses a range of information and valuation techniques an entity might use to estimate fair value. As such, the guidance does not preclude the use of an income approach in determining a fair value estimate for financial instruments in inactive markets. In fact, Statement 157 states that valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value.

While not specifically prioritizing the use of one valuation technique over another (in the absence of quoted prices in active markets), Statement 157 does prioritize the use of observable inputs over unobservable inputs when applying those valuation techniques. As such, when models are used in determining fair value, the inputs to the models should maximize observable market data to the extent available and relevant. In situations where it is deemed appropriate to utilize both the income approach and market approach in estimating the fair value of financial instruments in markets that are not active, the extent to which unobservable inputs were utilized in either approach should be a consideration in weighing the level of evidence provided by each approach. Additionally, in situations where multiple techniques are used, significant differences in results should be assessed and understood.

Quoted prices in active markets

Quoted prices in an active market provide the best evidence of fair value. Recent market conditions may have caused a sharp decline in normal trading volumes of various financial instruments. The fact that transaction volume in a market may be significantly lower than in previous periods does not necessarily mean that there is not an active market.

Similarly, as discussed above, the existence of a relatively thin market as compared to previous periods does not necessarily constitute evidence that the transactions in the market are forced or distressed transactions.

Quotes from broker-dealers or other third-party sources

If quoted market prices are not available for an instrument, investors may obtain estimates of fair value from broker-dealers or other third-party sources that are based on proprietary valuation models or other valuation techniques. For instruments that are measured based on estimates of fair value obtained from third-party sources, management should understand the method and inputs used by the broker-dealer or other third-party source in developing the estimate, including whether a pricing model, a cash flow projection, or some other valuation technique was used.

Understanding the source of information received from broker-dealers or other third party sources is critical in assessing the reliance to be given to these inputs. For example, certain broker quotes may represent level 3 inputs as they are not based on observable inputs or transactions (for similar or identical instruments), but rather determined using the broker's own assumptions about market participant assumptions and a proprietary model. In this instance, the broker quote represents a piece of evidence that should not be ignored, but would not necessarily be determinative in measuring fair value. Instead, it may be weighed against the fair value estimate based on a company's own assumptions about market participant assumptions and its model. In these situations, companies should work to understand the reasons behind any significant differences between the two models, or assumptions/inputs used in those models, and attempt to develop their best estimate of fair value.

Gaining an appropriate understanding of how broker quotes or other third party prices are determined will be necessary in assessing what level the estimate falls in under the Statement 157 hierarchy and will determine the disclosures to be made.

Valuation models

Many of the illiquid and/or complex instruments noted above are valued using an internally or externally developed valuation model. Examples of valuation models include the present value of expected future cash flows, option-pricing models, and option-adjusted spread models. Both observable and unobservable inputs may be used in models to estimate fair value.

When models are used to derive estimates of fair value, the fair value measurement objective remains the same, which is to obtain an exit price from the perspective of a transaction between market participants as of the measurement date. Therefore, valuation models should attempt to take into account all the factors that market participants would consider in determining a current price for this asset. For many of the instruments discussed above, this consideration may require adjustments to model values to address factors such as liquidity, credit risk, or any other factors market participants would consider, but that are not captured in the model. This may require companies to make their own assumptions about the assumptions market participants would use in pricing the instrument. The proposed FSP notes that the use of an entity's own internal assumptions about future cash flows and appropriately risk-adjusted discounts rates is acceptable when relevant observable market data does not exist. However, if there is relevant observable data indicating that marketplace participants would use different assumptions, the entity should adjust its assumptions to incorporate that market information.

Relevant market information may not be limited to transactions for the identical instrument being measured. Instead, general market information may provide an indication of market participants' current assumptions regarding the pricing of risk (for example, credit or liquidity risk). While this information may not be determinative for the particular instrument being measured, it can serve to either support or contest an entity's internal assumptions about market participant assumptions.

When a model is used in valuing a financial instrument, the model's ability to adequately reflect the current market conditions and related risks must be considered. When pricing information is available, an important control is to calibrate a model to market transactions for identical or similar instruments to help determine that the model reflects current market conditions and not an intrinsic or fundamental value.

Alternative investments

Alternative investments may take the form of common or preferred stock or other in-substance equity interests such as unitized interests in a trust (for example, commingled or common trust funds), or an investment in a limited liability partnership or limited liability corporation (for example, hedge funds, real estate funds, or private equity funds).

Determining the appropriate accounting and measurement attributes for alternative investments requires an understanding of the type of entity that issued the investment (for example, partnership, limited liability partnership (LLP), or limited liability company (LLC)), as well as the terms and nature of the investment.

The volatility of the underlying assets in many funds likely has increased as a result of the current market conditions. Management is responsible for the valuation of alternative investments in its financial statements, and this responsibility cannot be outsourced or assigned to a third party. Management can look to a fund manager for the mechanics of the valuation, but management must have sufficient information to evaluate and independently challenge the valuation of these assets. This information should include, to the fullest extent possible, the nature of the underlying investments, the portfolio strategy of the fund, and the method and significant assumptions used by the fund manager to value the underlying investments.

The fair value of the underlying assets in a fund serves as a good starting point in determining, and may in some cases be equal to, the fair value of an entity's interest in the fund. However, management needs to consider all relevant factors and attributes of its interest in assessing whether adjustments to the underlying net asset value are necessary in determining the fair value of its alternative investment.

Literature references

- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*
- FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
- FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*
- FASB Statement No. 157, *Fair Value Measurements*
- Center for Audit Quality, *Measurements of Fair Value in Illiquid (or Less Liquid) Markets, October 3, 2007* http://www.aicpa.org/caq/download/WP_Measurements_of_FV_in_Illiquid_Markets.pdf
- EY Financial Reporting Developments, *Fair Value Measurements – FASB Statement 157* (Score No. BB1462)
- EY Hot Topic, *Application of FASB Statement No. 157 to Investments in Hedge Funds* (Score No. BB1539)
- EY publication, *SEC Comments and Trends, an analysis of current reporting issues* (Score No. BB1589)
- September 2008 SEC Staff Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements), http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm
- SEC Press Release 2008-234, *SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting* (30 September 2008), http://www.sec.gov/news/press/2008/2008-234.htm
- Proposed FASB Staff Position (FSP) FAS 157-d, *Determining the Fair Value of a Financial Asset in a Market That Is Not Active*

Other-than-temporary impairment of debt and equity securities

Issue

Many debt and equity securities have experienced significant and extended declines in fair value due to the current market conditions, raising questions about whether these declines represent an other-than-temporary impairment (OTTI).

Background

The significant disruptions in the global capital markets have led to declines in the fair values of many investment securities. Continued negative trends in the market, which have persisted for an extended period of time in many cases, have brought about an increased emphasis on the accounting for, and disclosure of, other-than-temporary impairments of debt and equity securities.

Accounting & reporting considerations

- Investors should assess whether an impaired investment is other-than-temporarily impaired at every reporting period.
- An OTTI assessment is inherently judgmental and dependent on several factors. There is no "bright line" or "safe-harbor" in either the duration or severity of an impairment to indicate if it is other than temporary.
- As declines in fair value become more severe and take longer to resolve, there must be a greater degree of analysis and objective evidence to support an assertion regarding the anticipated recovery in fair value and the intent and ability to hold until such recovery.
- Generally, an investment is other-than-temporarily impaired if it is *probable* that the company will be unable to collect all amounts due under the contractual terms of the security.
- Even if the inability to collect is not probable, a company may be required to recognize an OTTI loss if, for example, the company does not have the intent and ability to hold the security until its fair value has recovered.
- EITF 99-20 requires companies to determine whether there has been an adverse change in a *market participant's view* of either the timing or amount of estimated cash flows for certain classes of debt securities that represent beneficial interests in trusts backed by other assets (for example, mortgage loans). If an adverse change has occurred, the impairment is considered other than temporary.

Further discussion

The nature of an OTTI assessment depends on the type of the investment security (that is, debt or equity) and whether the investment is an interest in securitized financial assets.

Debt securities

In assessing debt securities for impairment, investors must first determine which guidance is applicable to their particular investments. All investments in debt securities are included in the scope of Statement 115. However, many interests in securitized financial assets (for example, mortgage-backed and other asset-backed securities) are included in the scope of the impairment guidance of EITF 99-20.

Statement 115 indicates that a debt security should be considered impaired when a company determines that it is *probable,* as defined in Statement 5, that all amounts due (both principal and interest) will not be collected according to the security's contractual terms. A company may elect to hold a debt security to maturity as a strategy to preserve its value and avoid a loss. If a company follows such a strategy, the probability of repayment by the issuer of the security becomes the primary indicator of whether the decline is other than temporary. However, a company's OTTI assessment should evaluate all objective and subjective factors that relate to the credit risk of the debt security, including whether the severity and duration of the impairment provides relevant information regarding collectibility.

There is no "bright-line" or "safe-harbor" in either the period of time a debt security is impaired (duration) or the amount by which its fair value is below its cost basis (severity) when evaluating whether such impairment is other than temporary. However, the greater the duration or severity of the impairment, the more robust management's evidence needs to be to support the anticipated recovery in fair value and the more difficult it will be for management to assert that the impairment is temporary. As noted in SAB 59, the duration and severity of the impairment are not the only factors that should be considered in making the impairment assessment. The assessment should also consider the financial condition and near-term prospects of the issuer, the investor's intent and ability to hold the investment for a period of time sufficient to permit the anticipated recovery in market value, and other relevant factors. The SEC staff believes that to conclude an impairment is temporary, management must assert its intent to hold the security until recovery. The SEC staff has noted that SAB 59 does not provide an exemption from the assessment of impairment on the basis of the severity and duration of the market decline. In assessing these factors, SAB 59 notes that the investor should be "acting upon the premise that a write-down may be required."

The nature of the impairment should be considered in determining the relevance of each of the impairment factors noted in SAB 59. For example, while an investor may be able to assert the intent and ability to hold an interest rate-related impaired security to anticipated recovery, a similar representation generally would not be relevant for a credit-related impairment.

EITF 99-20, which provides incremental impairment guidance for a subset of the securities within the scope of Statement 115, generally applies to interests in securitized financial assets that have contractual cash flows and are either debt securities under Statement 115 or are required to be accounted for in a manner similar to debt securities under Statement 115. EITF 99-20 is not applicable to beneficial interests in securitized financial assets that (1) are of high credit quality[1] and (2) cannot be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

[1] The SEC staff has indicated that securities rated "AA" or higher would generally meet this condition.

Generally, the determination of whether a security is within the scope of EITF 99-20 has historically been made only at the acquisition date. However, we understand that entities have interpreted the issue of when to evaluate whether an instrument falls within the scope of EITF 99-20 differently and have developed accounting policies on the application of EITF 99-20 subsequent to acquisition. We believe the following accounting policies would be acceptable:

- One-time assessment at acquisition only – the entity determines if a beneficial interest is within the scope of EITF 99-20 at the date of acquisition and does not reassess due to future events
- Assessment at acquisition and in connection with other-than-temporary impairments – the entity determines if an interest is in the scope of EITF 99-20 at the date of acquisition and reassesses on a date it is determined to be other-than-temporarily impaired
- Continual assessment – the entity determines if an interest is in the scope of EITF 99-20 at the date of acquisition and on a continuous basis thereafter (that is, at each reporting period)

An entity should consistently apply its elected accounting policy and include this policy in its accounting policy disclosures.

Under EITF 99-20, a holder of an interest in securitized financial assets should periodically update (at least quarterly) its estimate of cash flows to be collected over the life of the interest. This estimate of cash flows should be based on current information and events that a third-party market participant would use in determining the current fair value of the interest. If there has been an adverse change in such estimated cash flows either in timing or amount, an other-than-temporary impairment should be considered to have occurred, and the beneficial interest should be written down to fair value with the change in fair value included in income.

In applying EITF 99-20, questions often arise as to whether a change in market interest rates is an indicator of other-than-temporary impairment. While a decline in fair value due solely to a change in the risk-free rate may be considered temporary under EITF 99-20, investors should be particularly careful when assessing changes in market interest rates. Market interest rates have several components, including a risk-free component and a spread for credit risk beyond that of a risk-free issuer. A widening of the credit spread (including instrument-specific, sector, and general market credit spreads) indicates that market participant expectations of *probability-weighted* cash flows have adversely changed and is a strong indicator that there has been a change in a market participant's *best estimate* of cash flows, which may require the impairment to be recognized as an other-than-temporary impairment.

Given the current volatility in the credit markets, management should update its cash flow estimates to reflect current information and events that a third-party market participant would use in determining the current fair value of the interest. Management is required to update its estimates to reflect declines in recent performance and not wait until the performance is experienced over a longer time frame.

Equity securities

The SEC staff has expressed a view that a decline in fair value of an equity security for a period of six to nine months is a strong indicator that the impairment is other than temporary. However, there is no "bright-line" in terms of the duration or severity of impairment that automatically leads to the conclusion that an equity security impairment is either temporary or other than temporary. For example, current market conditions may indicate that a shorter period of impairment, particularly for investments in mortgage industry participants, may be more indicative of an other-than-temporary impairment when considered with the other factors noted in SAB 59.

Perpetual preferred securities have variable or fixed dividend rates, but lack a contractual maturity or redemption date. These securities are often perceived in the marketplace to be similar to debt securities due to their stated dividend rates. However, perpetual preferred securities are more akin to equity securities in that they lack a contractual maturity or redemption date. As equity securities, perpetual preferred securities may be classified either as available-for-sale or trading securities. If classified as available-for-sale, a decline in fair value must be evaluated to determine if the decline is temporary or other than temporary. A key consideration in this evaluation is whether the fair value of the security is expected to recover sufficiently to allow a full recovery of the investor's cost basis over the near term. As the circumstances causing the impairment of a perpetual preferred security will vary between investors and securities, we do not believe a bright-line test exists when determining whether a perpetual preferred security impairment is temporary or other than temporary. Accordingly, all of the factors in SAB 59 should be considered and judgment must be applied.

Changes in liquidity and/or sales of impaired securities

Due to the current conditions in the credit markets, management may consider selling investment securities to address various liquidity needs. Management should evaluate the effect of the current market conditions on a company's liquidity and capital resources regarding the intent and ability to hold impaired securities until anticipated recovery. Further, actual sales of impaired securities should be carefully considered to determine whether such sales are consistent with management's prior assertion to hold impaired securities to anticipated full recovery.

When securities that were previously accounted for as temporarily impaired are sold prior to recovery, management should document the facts and circumstances that prompted the sale. Sales in response to significant, unanticipated changes in market conditions, asset/liability management positions, or business plans may justify a change in the investor's intent. However, sales that are not based on significant, unanticipated changes in circumstances may indicate that the investor's past and current assertions (intent and ability to hold to recovery) are insufficient to conclude that impairments related to other investments being held are temporary.

While the turbulence in the markets in recent months may lead to the conclusion that a significant, unanticipated change has occurred, a company's individual facts and circumstances must be assessed to determine if its intent assertion remains valid for the remaining impaired securities. To support previous conclusions that impairments were temporary when changes to management's intent with respect to an impaired security occur, management should prepare contemporaneous documentation describing the significant, unanticipated changes in the circumstances that gave rise to the change in intent.

In addition, management should evaluate the facts and circumstances associated with security sale activity between the most recent balance sheet date and key subsequent financial reporting dates (for example, press release and SEC filing dates) to determine whether any losses on the sale of impaired securities should have been recorded in a prior period. The closer a subsequent sale is to the end of the prior reporting period, the more difficult it will be for management to support that the sale was due to a significant, unanticipated change in circumstances since the balance sheet date, and that the loss is not a prior-period event.

Outsourced portfolio management arrangements

Many outsourced portfolio management arrangements are designed to provide the external investment manager with the discretion to buy and sell securities based on investment criteria to maximize yield within certain risk tolerances. Unless such an arrangement includes restrictions on the sale of specific impaired securities, management will not be able to assert an intent and ability to hold impaired securities to anticipated recovery or maturity.

The SEC staff has stressed the need for management to consider all relevant factors that may impair its ability to hold its securities until recovery. These factors may include contractual constraints as well as liquidity and capital needs. For example, the SEC staff has indicated that if the investment decision-making authority has been unconditionally delegated to a third party, management has relinquished the ability to hold a security until recovery.

Literature references

- FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
- FASB Statement No. 124, *Accounting for Certain Investments in Held by Not-for-Profit Organizations*
- FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*
- EITF 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"
- SEC Staff Accounting Bulletin No. 59, *Noncurrent Marketable Equity Securities*

Derivatives

Issue

Recent events have prompted numerous questions about the effect of a derivative counterparty's creditworthiness on the fair value of a derivative contract as well as its possible effect on continued qualification for hedge accounting.

Background

Recent events have prompted numerous questions from companies who have derivative relationships with counterparties in various degrees of financial distress. That distress may range from widening credit spreads to the actual bankruptcy filing of that counterparty or an affiliated entity. Companies are evaluating whether they should be terminating such derivative relationships either through negotiations with distressed counterparties or because credit or other events that allow them to extend notice of termination have already occurred.

Accounting & reporting considerations

- A fair value measurement of a derivative must include the effect of nonperformance risk (including credit risk) of both parties.
- The deterioration of a derivative counterparty's creditworthiness or a company's own creditworthiness likely causes hedge ineffectiveness. Severe deterioration in the counterparty's creditworthiness may potentially prevent a hedging relationship from being "highly effective" on an ongoing basis and cause hedge accounting to cease at that point.
- When assessing counterparty credit risk, companies should consider the effect of master netting agreements – including whether overall positions are in a net asset or liability position – and the existence of collateral or other credit support.
- In cash flow hedging relationships, a company with derivative assets that finds its derivatives unexpectedly terminated may need to recognize a current loss in earnings for the decline in fair value and/or impairment of its asset, even though all the previous gains continue to be recognized in other comprehensive income awaiting future reclassification to earnings when the transaction the derivative was hedging eventually affects earnings.
- A derivative may contractually terminate upon credit deterioration or bankruptcy filing and consequently should be reflected on the balance sheet as either a receivable from or a payable to the counterparty. Receivables need to be assessed for collectibility with any resulting loss reflected in earnings in accordance with Statement 5.

Further discussion

Companies that have hedging derivatives or hedged forecasted transactions with counterparties experiencing credit deterioration should carefully consider the implications on the fair value accounting requirement for derivatives and the stringent criteria for qualifying for hedge accounting.

In assessing the appropriate accounting of derivative relationships, it is critically important for companies to identify the specific entity counterparty and monitor its status. Additionally, companies should seek the advice of legal counsel for a complete understanding of the terms of its arrangements and any required actions under the arrangements.

Considering credit risk in measuring fair value

Derivative contracts accounted for under Statement 133 are measured at fair value and are therefore within the scope of Statement 157. Statement 157 requires the consideration of credit risk in measuring the fair value of financial instruments, such as derivatives.

The fair value measurement of a derivative must include the effect of nonperformance risk (that is, credit risk) of counterparties experiencing credit deterioration. Additionally, the derivative's fair value must reflect the hedger's own creditworthiness.

Credit risk associated with a derivative contract is similar to other forms of credit risk in that the cause of economic loss is the obligor's default before the maturity of the contract. However, for many derivative products, two features set credit risk apart from more traditional forms of credit risk in instruments like debt: (i) the uncertainty of the credit exposure upon default (due to the uncertainty of the future mark-to-market change in the derivative instrument) and (ii) the bilateral nature of credit risk in many derivative instruments such as swaps and forwards. In these instruments, both parties to the transaction are exposed to credit risk given the potential for the instrument to "flip" from an asset to a liability (or vice versa).

Collateral arrangements, master netting agreements, credit support annex (CSAs), and other credit enhancement or risk mitigation tools serve to reduce the credit exposure associated with derivative instruments and should be considered in determining their fair value. However, while these agreements often serve to reduce credit exposure, they typically do not eliminate the exposure completely. For example, most CSAs do not require collateral to be posted until a certain threshold has been reached, and, once reached, collateral is only required for the exposure in excess of the threshold.

Implications for hedge accounting and hedge effectiveness

DIG Issue G10 states that companies must consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative with an ongoing assessment of hedge effectiveness and measurement of ineffectiveness. If the chances of the counterparty not defaulting ceases to be probable, the company will be unable to conclude that a cash flow hedging relationship is expected to be highly effective in offsetting cash flows and, consequently, may need to cease hedge accounting. This concept applies equally to derivative contracts that are assets or liabilities.

A derivative counterparty does not typically enter into financial distress overnight. Fair value concepts should contemplate changes in market participant concerns regarding non-performance risk as they occur. Eventually, those changes may become so great as to introduce hedge ineffectiveness into the relationship, and as market perceptions of nonperformance risk continue to increase, such deterioration could call into question the continued application of hedge accounting for those affected derivatives in formal hedging relationships.

Severe deterioration in the counterparty's creditworthiness may potentially prevent the hedging relationship from being "highly effective" on an ongoing basis and cause hedge accounting to cease at that point.

Under the cash flow hedge accounting model, the effective portion of the changes in the fair value of the hedging derivative is deferred in other comprehensive income (OCI) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings. Once these amounts are reflected in OCI, they are permanently linked to the underlying forecasted transaction identified by the hedge designation documentation and cannot otherwise be removed from OCI unless the forecasted transaction to which it has been linked becomes probable of not occurring. The determination that a derivative is no longer highly effective as a hedge due to counterparty credit degradation does not invalidate hedge accounting until the point of such determination, and accordingly, previous balances deferred in OCI when hedge accounting was in effect would be reclassified to earnings as the hedged item affects earnings (that is, not immediately).

Terminating the derivative contract

Once an entity decides to terminate its derivative contract, whether it be an election or mandated because of a credit event outlined in the contract, the contract's fair value no longer changes with movements in its underlying. The contract is no longer accounted for at fair value under Statement 133 and should be evaluated as a receivable or payable at "termination value" (that is, the amount expected to be received or paid). Hedge accounting, of course, ceases at that point, assuming it did not already cease in an earlier period.

In scenarios such as bankruptcy in which the derivative is an asset and cannot be terminated at an amount that preserves the economic equivalent associated with the full remaining net contractual cash flows of the derivative, companies need to assess recoverability of this receivable in the same way it would assess any other receivable. A company's assessment will be affected by which particular entity the receivable is from (whether bankrupt or not). Companies may need additional information from their counterparty about its financial condition that may not otherwise be publicly available in order to report this receivable appropriately.

Continuing or replacing the derivative

Some hedgers will not want to terminate their derivatives and will pursue some sort of continuation or replacement strategy. Nevertheless, many will need to evaluate whether such a strategy triggers the termination of the original hedge relationship (that is, an "automatic" de-designation) and necessitates the need to re-designate the hedge relationship anew, with all the attendant issues of beginning a new hedge relationship with new hedge documentation and new hedge effectiveness assessments. When possible, hedgers may try to have their derivative contract novated from a distressed counterparty to a new counterparty, with all three parties providing consent. The presence of a new counterparty will likely cause the fair value of the derivative contract to change due to a reassessment of the nonperformance risk associated with the new counterparty, which would also contemplate other derivative positions in master netting arrangements with that counterparty.

Literature references

- FASB Statement No. 5, *Accounting for Contingencies*
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- FASB Statement No. 157, *Fair Value Measurements*
- DIG Implementation Issue G10, *Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative*
- EY Financial Reporting Developments, *FAS 133 – Derivatives and Hedging* (Score No. BB0977, Revised December 2006)
- EY Technical Line, *Considerations for Derivatives with Counterparties in Financial Distress* (Score No. BB1594)

Auction rate securities

Issue

Several banks and broker-dealers (collectively, BDs) that sold auction rate securities (ARSs) announced settlements under which the BDs agreed to repurchase ARSs from certain investors at par at some future date(s), raising accounting issues for the proposed settlements (from the perspective of both the investor and the BD).

Background

In February 2008, the market for ARSs effectively ceased when the vast majority of auctions failed, preventing investors from selling their ARSs. Until then, investors had considered ARSs short-term, liquid investments. As a result of the failed auctions, holders of the ARSs find themselves holding illiquid securities whose actual duration is significantly longer than expected, in some cases as long as 20 years. Certain investors and regulatory agencies have alleged that certain BDs that sold ARSs may have violated laws relating to proper sales and marketing practices when advising their clients to invest in ARSs.

Accounting & reporting considerations

- The failure of the Dutch auction process for ARSs and the related settlements raises certain accounting issues regarding the proposed settlements from the perspective of both the investor and the BD. It also raises questions about possible other-than-temporary impairment (OTTI).
- Several factors affect when and how the settlement agreements may be recognized and measured.
- The settlements should not affect the fair value of the ARSs because the settlements are separate contractual agreements.
- If a company intends to exercise the right to require the BD to repurchase the ARS at par (this right is akin to a put option), management generally may not assert the intent to hold the ARS to recovery for OTTI purposes.
- Companies may elect a one-time transfer of ARSs from available-for-sale to trading and elect the fair value option under Statement 159 for the put option.

Further discussion

Most of the settlements targeted retail clients (that is, individuals, charities, and small-to-medium sized businesses) with a few including institutional investors. Although the scope and nature of the settlements vary by BD, the buy-back programs generally include the following:

- The BD offers to repurchase at par ARSs that were purchased through the BD prior to a specified date (Effective Date). The offer is generally open for a specified timeframe.
- The BD will make whole any losses sustained by its clients who purchased ARSs before the Effective Date and sold such securities at a loss between the Effective Date and the date of the settlement announcement.
- Until the BD actually provides for the repurchase of the securities, some BDs are providing no-cost loans that will remain outstanding until the ARSs are repurchased.
- Settlements with various regulators generally require the payment of monetary penalties.

Investors — Accounting for the right to put ARS to BDs

Each settlement arrangement should be evaluated based on its specific facts and circumstances. Once a settlement is announced, an investor in an ARS needs to determine whether the specific ARSs it holds are included in the proposed settlement. Until the investor has an enforceable legal right to accept the offer, the proposed settlement represents a gain contingency. Statement 5 provides that gain contingencies are not recognized in the financial statements until realized, but may be disclosed.

Determining whether an investor has a legally enforceable right to the settlement will be based upon the specific facts and circumstances and will vary based on the settlement terms. Unless obvious (for example, the investor has obtained written evidence from the BD outlining the terms of the settlement and it is clear the investor is included in the settlement), management should consider the need to consult with legal advisors in making this determination.

While the determination of the appropriate accounting for the settlement agreement will depend upon its specific terms and conditions, generally the settlement agreements will result in the investor obtaining an asset akin to a put option (that is, the right to "put" the ARSs back to the BD at some specified date for a payment equal to the par value of the ARS). To the extent these put options are non-transferable and cannot be attached to the ARS instrument if the ARSs are sold to another entity, the put option would be a freestanding instrument between the BD and the investor. Once a legally enforceable right exists, the investor should recognize the put option as an asset, measured at its fair value, with the resulting gain recognized in earnings.

Because the price a market participant would be willing to pay for the ARS would not include anything for the value of the put option, the put option cannot be considered in the determination of the fair value of the ARS. Accordingly, the investor would continue to determine the fair value of the ARS without consideration of any settlement. Likewise, no consideration of the put option should be given in any analysis of whether a decline in the fair value of ARS below its cost is other-than-temporary.

Because the investor must tender the ARSs to receive the settlement, and the ARSs themselves are not readily convertible to cash, the put option would not meet the definition of a derivative under Statement 133 and would not be subsequently adjusted to fair value each reporting period. However, recognizing that the put option (which effectively has a strike price equal to par) acts as an economic hedge for the investor against any further price movement in the ARS, investors may want to recognize future changes in the fair value of the put option as those changes occur to offset the fair value movements in the

ARS. In order to subsequently measure the put option at fair value, the investor may elect the fair value option under Statement 159 and adjust the put option to fair value with corresponding changes in fair value reported in earnings. The fair value option under Statement 159 is only permitted at the initial recognition of the put option and the investor must document its election concurrently.

Recognizing the unprecedented events in the ARS market and the broad-reaching legal settlements that have been agreed upon by BDs and securities regulators, investors may elect a one-time transfer of the ARS that can be put to the BD from available-for-sale to trading, on the basis that the conditions outlined above meet the conditions for such a rare transfer.

The transfer of the ARSs from available-for-sale to trading would allow future movements in the fair value of the ARSs to be reported in earnings, which would create accounting symmetry with the put option when the fair value option of Statement 159 has been elected, both at inception and until the settlement is realized.

OTTI considerations

Up to this point, an investor in ARS may not have already recognized OTTI on its ARS holdings. By agreeing to a settlement with the BD, the investor is essentially stating that it no longer has the intent of holding the ARSs until recovery, as it will now recover any unrealized loss through the settlement offer. Accordingly, upon recognition of the put option, investors should recognize an OTTI on the ARSs.

To the extent that no OTTI loss had been previously recognized, the amount of the OTTI recognized at this time should be offset, to a great extent, by the gain recognized upon initial recognition of the put option. To the extent any additional OTTI losses were previously recognized, the gain on the put option should exceed the amount of OTTI required at this time.

BDs — Accounting for the offer to repurchase securities at par at future dates

Prior to reaching any legal settlements, BDs that sponsored or sold ARSs should follow the accounting and disclosure guidance for loss contingencies in Statement 5. Under that guidance, a BD recognizes a liability when it is probable a loss has been incurred and such loss is reasonably estimable. Until both of those conditions are met, no loss may be recognized. Unlike the investor's accounting discussed above, the BD could be required to recognize a liability earlier than when it has legally obligated itself. When a loss should be accrued will depend on the facts and circumstances of each particular situation.

When the BD obligates itself to legally enforceable settlement terms to repurchase ARSs from investors, the settlement would be subject to the scope of FIN 45. The obligation under the settlement (that is, the put option) should be recorded as the greater of: a) the fair value of the guarantee or b) the contingent liability amount required to be recognized at inception of the guarantee by Statement 5. FIN 45 does not provide guidance on how the guarantor's liability for its obligation under the guarantee would be measured subsequent to initial recognition. However, as the BD has written a put option that is deeply in the money at issuance, the fair value of the put option is going to move very closely with the fair value of the underlying ARSs. As a result, we believe the put option should be subsequently adjusted to fair value each period with changes in fair value reported in earnings in accordance with the SEC staff's longstanding view on reporting written options at fair value.

Other considerations

Management should consider whether any settlements agreed to by BDs and securities regulators include other provisions beyond the offer to repurchase ARSs at par, including "no-cost" loans, reimbursements for losses on sales of ARSs prior to the Effective Date, and arbitration offers for consequential damages incurred by the investors.

A "no-cost" loan should be evaluated for both the investor and BD based on the specific terms of the loan. The offer to reimburse losses incurred in a certain period and to pay consequential damages should be evaluated and accounted for in accordance with Statement 5, with the criteria for loss contingencies being followed by the BDs and the criteria for gain contingencies being evaluated by the investors. Similarly, the settlement by a BD with the regulators for penalties should also be evaluated and accounted for in accordance with Statement 5.

Literature references

- FASB Statement No. 5, *Accounting for Contingencies*
- FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- FASB Statement No. 157, *Fair Value Measurements*
- FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*
- FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statement No. 5, 57, and 107 and rescission of FASB Interpretation No. 34*
- Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*
- EY Technical Line, *Auction rate securities and settlement agreements* (Score No. BB1593)

Consolidation

Issue

Current market events have raised questions about the consolidation of commercial paper (CP) conduits, money market funds (MMFs), and other investment vehicles.

Background

With the disruptions in the credit markets, the CP and other short-term funding markets have experienced significant contraction. This contraction has already affected or has the potential to affect an entity's liquidity. Many of the potential "solutions" to the liquidity issues that entities are considering raise significant accounting and reporting implications.

As a result of recent market events, some MMFs have become exposed to declines in the credit quality of certain of their underlying assets. As a result, some of the sponsoring institutions of these money market funds have stepped in to provide various forms of financial support to avoid "breaking the buck" (that is, a decline in the normally constant $1 net asset value of a MMF). This financial support raises consolidation accounting issues.

Accounting & reporting considerations

Commercial paper conduits

- CP conduits are likely to be variable interest entities (VIEs) pursuant to FIN 46(R).
- Models used to determine the primary beneficiary (PB) of a CP conduit should include assumptions that reflect recent observable market data.
- The Center for Audit Quality white paper, *Consolidation of Commercial Paper Conduits*, provides additional non-authoritative guidance on consolidation considerations.
- Any support provided by sponsors to CP conduits that was not contractually required raises questions about whether the CP conduit should be consolidated.

Money market funds

- The act of providing support by a MMF sponsor is a reconsideration event in accordance with FIN 46(R).
- Because the sponsor protects the MMF shareholders from expected losses, the shareholders' equity is no longer completely at risk. Consequently, MMFs previously considered voting interest entities may be VIEs.
- The SEC staff has indicated that consolidation of supported MMFs is not required if the sponsoring institution does not absorb the majority of the expected future risk associated with the MMF's assets, including interest rate, liquidity, credit and other relevant risks.

Further discussion

Commercial paper conduits

The disruptions in the credit markets are having significant effects on structures used by many entities to finance their operations. As investors have fled to lower risk investments, such as U.S. Treasury bills, the CP and other short-term funding markets have experienced significant contraction. This contraction has already affected or has the potential to affect an entity's liquidity and financing costs due to limited investor appetite to roll over or purchase additional CP. The inability to roll over or issue new CP has resulted in a lack of immediately available funds to repay maturing CP.

CP structures are typically evaluated under FIN 46(R) to determine if they are VIEs, and if so, who is the PB. CP conduits are likely to be VIEs pursuant to FIN 46(R) because their equity investment at risk is generally non-substantive (that is, nominal) and the holders of the equity investment at risk usually lack substantive decision making authority over conduit activities. Management should determine that models developed by sponsors to determine the PB are consistent with the various legal agreements that established the conduit and any first loss notes designed to absorb the majority of the conduit's variability. The Center for Audit Quality (CAQ) white paper, *Consolidation of Commercial Paper Conduits*, addresses the application of FIN 46(R) by sponsors of conduits, particularly in circumstances where conduits are affected by market conditions. In circumstances where entities must reconsider the status of a VIE and/or the determination of the PB, recent market events should be appropriately reflected in the probability-based scenarios.

Money market funds

A fund adviser may take certain actions to prevent an MMF from "breaking the buck" including:

- Purchasing assets from the fund at prices in excess of the assets' current fair values (for example, at par)
- Making a direct contribution to the fund to offset the effect of a realized or unrealized loss on an asset held by the fund
- Entering into letters of credit or liquidity puts with the fund to offset the decreases in fair value of assets held by the fund
- Eliminating daily dividends and/or waiving fees for a period of time

Generally, such support is not contractually required and is provided at the sole discretion of the sponsor. An adviser's actions may result in an explicit or implicit variable interest in the fund that could affect the determination of which entity is the PB of the fund. We believe that the act of providing support by an MMF sponsor is a reconsideration event in accordance with FIN 46(R). By providing the non-contractual support, the sponsor protects the MMF shareholders from the MMF's expected losses; therefore, the shareholders' equity investment is no longer completely at risk. Consequently, those MMFs supported by the sponsor that had been previously considered voting interest entities become VIEs subject to the consolidation provisions of FIN 46(R).

In a press release dated 17 September 2008, the staff of the SEC's Office of the Chief Accountant clarified its view that consolidation of supported MMFs is not required if the sponsoring financial institution does not absorb the majority of the expected future risk associated with the MMFs' assets, including interest rate, liquidity, credit and other relevant risks that are expected to affect the value of the MMF assets. The published views expressed by the staff in the release are consistent with our understanding of the staff's informal views in analyzing consolidation in these circumstances. In these circumstances, the SEC staff expects adequate disclosure of the nature of the support provided.

There are non-regulated funds that operate similarly to MMFs. We understand that the SEC staff's views apply *only* to MMFs that are regulated (primarily under the Investment Company Act of 1940 and the rules adopted under the Act), without analogy to other structures, even those that operate similarly to MMFs. A careful analysis of the facts and circumstances must be performed in applying FIN 46(R)'s provisions to these situations.

Other

The discussion above highlights the need to challenge the consideration of implicit variable interests as that term is defined in FSP FIN 46(R)-5. Actions to provide support to third parties that are not contractual may raise questions about whether such actions may be undertaken again, and if so, how that potential is considered in the company's consolidation analysis.

Literature references

- FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51*
- FASB Staff Position FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*
- The Center for Audit Quality, *Consolidation of Commercial Paper Conduits, October 3, 2007* http://www.aicpa.org/caq/download/WP_Consolidation_of_Commercial_Paper_Conduits.pdf
- EY Financial Reporting Developments, *FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities* (Score No. BB1112, Revised August 2008)
- EY Hot Topic No. 2008-27, *SEC staff issues clarification on consolidation issues relating to bank support for money market funds* (Score No. BB1583)

Qualifying special-purpose entities

Issue

Servicers of mortgage loans who proactively work with borrowers to avoid foreclosure raise questions about whether these actions are inconsistent with the qualifying special-purpose entity (QSPE) criteria.

Background

The pace of mortgage modifications to address the financial crisis was slower than anticipated, for a host of reasons, including not only continuing questions about accounting, but also legal and economic issues. Certain parties have sought initiatives to develop a broader based solution to help stem the tide of mortgage defaults and foreclosures. These defaults and foreclosures have accelerated in the subprime mortgage market, due to steep interest rate resets and other factors.

Accounting & reporting considerations

- Questions have arisen as to the level of discretion permitted by QSPEs to modify loans prior to default, specifically whether the ability to modify a loan when default is "reasonably foreseeable" would be inconsistent with the QSPE criteria and off-balance sheet treatment in Statement 140.
- The SEC's Office of the Chief Accountant has noted that activities by servicers entering into loan restructuring or modification activities (consistent with the nature of activities permitted when a default has occurred) and when default is "reasonably foreseeable" do not preclude continued off-balance sheet treatment under Statement 140.
- The SEC staff has indicated it expects registrants to provide sufficient disclosures in both MD&A and the notes to the financial statements regarding the servicer's borrower evaluation procedures and standardized approach to facilitate the effective use of a variety of foreclosure and loss prevention efforts (that is, the nature of the permitted loan modification actions of off-balance sheet QSPEs).

Further discussion

In June 2007, the FASB hosted a forum to discuss the accounting issues associated with the potential activities that servicers may take in response to anticipated residential mortgage loan defaults. A central question that was discussed was whether the ability to modify a loan when default is "reasonably foreseeable" would be inconsistent with the QSPE criteria in Statement 140.

At the FASB's forum, the following activities of servicers were contemplated:

- Determining which loans held by a QSPE were due to have an interest rate reset
- Contacting the borrower to determine the borrower's understanding of the interest rate reset and whether the borrower would be able to afford the new loan payment
- Performing an analysis of the borrower's condition and the current loan terms if the borrower indicated an inability to afford the new payment
- If the analysis indicates that default on the loan is reasonably foreseeable, granting a concession to the borrower (modifying the terms of the loan) in order for the servicer to maximize the cash flows to QSPE

While the FASB did not issue any guidance as a result of the forum, the SEC's Office of the Chief Accountant (OCA) expressed a view in a July 2007 letter to the U.S. House of Representatives Committee on Financial Services (the Committee). In that letter, it was noted that "…entering into loan restructuring or modification activities (consistent with the nature of activities permitted when a default has occurred) when default is reasonably foreseeable does not preclude continued off-balance sheet treatment under FAS 140." In responding to the Committee, the SEC staff also indicated its general agreement with the servicer activities contemplated at the forum and noted above.

In January 2008, the staff of the OCA issued a letter to The Center for Audit Quality (CAQ) and Financial Executives International (FEI) on the application of Statement 140 to the loan modification guidance included in the American Securitization Forum's "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans" (the ASF Framework).

The ASF Framework, which was issued in December 2007, provides recommended guidance for servicers of securitized mortgage loans to streamline borrower evaluation procedures and a standardized approach to facilitate the effective use of a variety of foreclosure and loss prevention efforts. The ASF Framework focuses on subprime adjustable-rate mortgage (ARM) loans and categorizes the population of subprime ARM loans into three segments, generally by origination and interest rate reset dates.

The OCA letter expressed a view that modifications of certain subprime ARM loans (as referred to in the letter) that occur pursuant to the ASF Framework would not result in a change in the status of a transferee as a QSPE under Statement 140. The letter also indicates that OCA expects registrants to provide sufficient disclosures in filings with the Commission regarding the effect that the ASF Framework has had on QSPEs that hold subprime ARM loans and provides additional information regarding the disclosures the SEC staff would generally expect in both Management's Discussion and Analysis and the notes to the financial statements. The guidance in the OCA letter should not be extended by analogy or relied upon for any mortgage modification other than one occurring pursuant to the specific screening criteria identified in the letter.

Literature references

- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- American Securitization Forum, Letter dated 6 December 2007, *Statement of Principles, Recommendations and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans*
- U.S. Securities and Exchange Commission, Letter dated 8 January 2008 from the Office of the Chief Accountant issued jointly to Financial Executives International and the Center for Audit Quality

Long-lived assets to be held and used

Issue

Impairment indicators are more likely to be prevalent requiring assets to be evaluated for impairment.

Background

The current economic and market conditions and/or a company's response to the current conditions may indicate that long-lived assets to be held and used (including intangible assets subject to amortization) are impaired.

Accounting & reporting considerations

- Long-lived assets to be held and used are reviewed for impairment in accordance with Statement 144 and tested for impairment whenever impairment indicators are present.
- Companies are required to evaluate their operations for the presence of impairment indicators on a regular basis. Due to the current economic environment, it may be more likely that impairment indicators exist.
- If impairment indicators exist, the test for recoverability for long-lived assets to be held for use is made using an estimate of undiscounted cash flows expected to be generated from the use of the long-lived asset (or asset group) and its eventual disposal.
- If the estimated undiscounted cash flows exceed the carrying amount of a long-lived asset (or asset group), the long-lived asset (or asset group) is recoverable and no further analysis is required.
- If the estimated undiscounted cash flows are less than the carrying amount of the long-lived asset (or asset group), the long-lived asset (asset group) is not recoverable and must be evaluated for impairment by comparing the fair value and carrying amount of the long-lived asset (asset group).
- When a long-lived asset (or asset group) is tested for recoverability, it may also be necessary to review depreciation and amortization estimates and methods.
- Management should document its key judgments and estimates in evaluating long-lived assets for impairment.

Further discussion

Examples of events or changes in circumstances that indicate that the carrying amount of a long-lived asset may not be recoverable include:

- A significant decrease in the market price of a long-lived asset (or asset group)
- A significant adverse change in the extent or manner in which a long-lived asset (or asset group) is being used or in its physical condition
- A significant adverse change in legal factors or business climate that could affect the value of a long-lived asset (or asset group), including an adverse action or assessment by a regulator
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (or asset group)
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (or asset group)
- A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life

Current market conditions may lead to a conclusion that one or more of these events have occurred. However, these events are merely examples of circumstances that would require a recoverability test and should not be considered all-inclusive. Management should identify the indicators that it believes are relevant in determining whether it should perform an impairment analysis based on their industry and operations.

In evaluating capitalized internal use software for impairment in accordance with Statement 144, companies should consider the following examples of impairment indicators specific to internal use software included in SOP 98-1, in addition to the impairment indicators noted in Statement 144:

- The software is not expected to provide substantial service potential.
- A change occurs in the extent or manner in which the software is used or is expected to be used.

The SEC staff has asked registrants to provide detail on the process undertaken by a company in determining that impairment indicators existed, how the recoverability test was performed, and how fair value was determined. Additionally, the SEC staff has asked registrants to provide more robust disclosures about the impairment of long-lived assets as required by Statement 144. The SEC staff has specifically requested additional disclosure regarding the facts and circumstances leading to the impairment and the segment in which the impaired asset is reported.

Statement 144 does not require early warning disclosures in circumstances in which an impairment loss has not been recorded in the current period, but might be triggered in the near future (for example, where impairment indicators are present, but undiscounted cash flows slightly exceed the carrying amount of the assets). However, SOP 94-6 might require disclosure. SOP 94-6 points out that if indicators of impairment are present, but a loss is not required to be recognized, the estimate associated with the recoverability of the carrying amount of a long-lived asset may be particularly sensitive to change. Disclosure is required if: (1) it is at least reasonably possible that management's estimate resulting in an impairment not being recorded will change in the near term (that is, one year) due to one or more future confirming events, and (2) the effects of the change would be material to the financial statements. Additionally, early warning disclosures may be required in MD&A.

It is important for companies to maintain contemporaneous documentation of management's impairment analysis (both the qualitative analysis of impairment indicators and the quantitative calculations), including the documentation of analyses performed when an impairment loss is not recognized. Such documentation should include the indicators that management believes are or are not relevant in determining whether it should perform an impairment analysis, as well as a requirement to document the results of the analysis.

Literature references

- FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
- Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*
- Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
- EY Financial Reporting Developments, *Accounting for the Impairment or Disposal of Long-Lived Assets-FASB Statement 144*
- EY Hot Topic, *Asset Impairment Considerations in the Current Economic Environment* (Score No. BB1522)
- EY publication, *SEC Comments and Trends, an analysis of current reporting issues* (Score No. BB1589)

Goodwill and indefinite-lived intangible assets

Issue

Impairment tests for goodwill or indefinite-lived intangible assets may be required to be performed on more than an annual basis.

Background

Current economic and market conditions and/or a company's response to the current conditions may indicate that goodwill and indefinite-lived intangible assets are impaired.

Accounting & reporting considerations

Goodwill

- Goodwill is tested for impairment on an annual basis and in between annual tests if events or circumstances indicate it is more likely than not that the fair value of the reporting unit is less than its carrying value.
- Two-step impairment test: (1) Compare fair value of reporting unit to carrying amount (including goodwill). If the fair value exceeds the carrying amount, than there is no impairment. If carrying amount exceeds fair value, complete step two to measure impairment loss, if any. (2) Allocate fair value of reporting unit (as determined in step one) to reporting unit's assets and liabilities consistent with Statement 141. This is referred to as a "hypothetical purchase price allocation." The portion of fair value remaining after assigning amounts to reporting unit's assets and liabilities based on their fair values represents the implied fair value of goodwill. If the implied fair value of goodwill is less than the carrying amount of goodwill, an impairment loss is recognized for the difference.

Indefinite-lived intangible assets

- Indefinite-lived intangible assets are tested for impairment on an annual basis and in between annual tests if events or circumstances indicate the asset might be impaired. Statement 144 provides examples of relevant impairment indicators.
- Impairment is tested by comparing the fair value of the intangible asset to its carrying amount.
- If the carrying amount exceeds fair value, an impairment loss is recognized for any difference between the carrying amount and fair value.

Further discussion

Goodwill

Statement 142 includes the following examples of events that might require an interim impairment test for goodwill:

- A significant adverse change in legal factors or in the business climate
- An adverse action or assessment by a regulator
- Unanticipated competition
- A loss of key personnel
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of
- The testing for recoverability under Statement 144 of a significant asset group within a reporting unit
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit

Current economic and market conditions may lead to a conclusion that one or more of these events have occurred. However, these events are merely examples of circumstances that might require an interim impairment test and they should not be considered all inclusive. Some other examples might include the following:

- Have there been recent news articles or analysts' reports about the decline or expected decline in performance in the company's market or industry?
- Has the company or its competitors reported production slow-downs or shut-downs?
- Have market multiples for competitors in the industry sector declined?
- Have any of the company's competitors recognized an impairment loss?
- Does the company's stock price and market capitalization suggest that the fair value of a reporting unit is less than its carrying amount?
- Has a forecast of business outlook or capital costs affected the potential recoverability of goodwill?
- Have earnings remained at a level below forecasted levels such that they indicate long-lived assets, indefinite-lived assets, and goodwill may not be recoverable?
- Has the company experienced lower-than-expected earnings or does it expect lower earnings in the next fiscal quarter/year?
- Has the company signaled to the market that earnings expectations for the quarter have been revised downward?
- Has the company experienced a current-period operating or cash flow loss?
- Does the company project continuing earnings or cash flow losses associated with the use of a long-lived asset or group of assets?

While a decline in stock price and market capitalization is not specifically cited as a circumstance requiring an interim goodwill impairment test, a company's stock price and market capitalization should be considered in determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. A significant decline in a company's stock price may suggest that the fair value of one or more reporting units has fallen below their carrying amounts. Similarly, declines in the stock prices of other companies in a reporting unit's industry may suggest that an interim test for goodwill impairment is required. To assess whether the decline in market capitalization is an indicator requiring an interim goodwill impairment test, companies should consider the underlying reasons for the decline in the value of the securities (for example, adverse change in the business climate, an adverse action taken by a regulator), as well as the significance of the decline and the length of time the securities were trading at a depressed value. It should not be assumed that a decline in the market price is temporary and that the stock price will recover.

When performing step one of the goodwill impairment test, the estimated fair value of the company is sometimes greater than the market capitalization of the company. This excess is generally due to a control premium being factored into the fair value of the company. The SEC staff often asks companies to reconcile the company's estimate of its fair value with the company's market capitalization. Companies should perform a careful analysis to determine whether the amount of the assumed control premium is reasonable. Factors to consider include industry, market, economic, and other factors that market participants would consider in assessing fair value (for example, thinly traded securities).

In performing step two of the goodwill impairment test, the hypothetical purchase price allocation is performed only for the purpose of measuring goodwill impairment and should not result in a change in basis of the recognized net assets (other than a reduction in goodwill) or in the recognition of any unrecognized assets of the reporting unit.

The hypothetical purchase price allocation can be complex and time consuming. If a company has not yet completed its goodwill impairment testing as of a filing date, the company should record its best estimate of impairment, if any, and disclose the fact that the impairment is an estimate, the reasons therefore, and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.

The SEC staff frequently asks for supplemental information about:

- Details of the goodwill impairment analysis for each reporting unit, including how reporting units are identified, how assets, liabilities, and goodwill are allocated to reporting units, and how the value of each reporting unit was estimated
- Details of the company's analysis of events that occurred since the latest annual goodwill impairment assessment and whether those events suggest that the fair value of goodwill is less than its carrying amount

The SEC staff often asks registrants to provide more robust disclosures of accounting policies for goodwill impairments and the details of any recognized goodwill impairments. These comments have asked for more discussion of the following:

- The accounting policies relating to the goodwill impairment tests, including when the two-step impairment test is performed, identification of reporting units, and how the fair value of goodwill is derived in the second step
- The facts and circumstances leading to an impairment
- The significant assumptions and estimates used in determining the fair value of reporting units with a goodwill impairment

Registrants should provide expansive disclosures to satisfy the requirements of paragraph 47 of Statement 142. Even if no impairment is identified in a particular period, registrants should disclose their accounting policy related to goodwill impairment testing. At a minimum, the disclosures should include the annual assessment date and a description of when an interim test is required, as well as a description of how the estimated fair value of a reporting unit is determined and significant assumptions used in that analysis.

Indefinite-lived intangible assets

EITF 02-7 provides guidance for determining the unit of accounting in testing indefinite-lived intangible assets for impairment.

Recognition of an impairment charge for an intangible asset that was previously considered indefinite-lived may be an indication that the asset no longer meets the indefinite-lived criteria, and thus should be amortized over its remaining useful life.

Literature references

- FASB Statement No. 142, *Goodwill and Other Intangible Assets*
- EITF Issue No. 02-7, "Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets"
- EY Financial Reporting Developments, *Goodwill and Other Intangible Assets — FASB Statement 142*(Score No. BB1499)
- EY Hot Topic, *Asset Impairment Considerations in the Current Economic Environment* (Score No. BB1522)
- EY publication, *SEC Comments and Trends, an analysis of current reporting issues* (Score No. BB1589)

Income taxes

Issue

Losses in recent years must be considered in evaluating deferred tax assets for realizability.

Background

Current market conditions have caused many companies to record losses. As a result, the realizability of some or all deferred tax assets may not be more likely than not (that is, a probability of greater than 50%) because taxable income may not be sufficient.

Accounting & reporting considerations

- Sufficient taxable income of the appropriate character must exist to support the realizability of deferred tax assets.
- Cumulative losses or expectations of cumulative losses generally indicate the need for a valuation allowance on deferred tax assets. It is rare to support the lack of a valuation allowance based solely on tax planning strategies when a company has cumulative losses.
- Appropriate disclosures should be made to support either the absence or existence of a valuation allowance.
- Liquidity concerns may cause companies to consider repatriation of earnings from foreign operations. Such cash transfers could have tax implications.

Further discussion

Statement 109 requires a valuation allowance to be recognized if, based on the weight of available evidence (both positive and negative), it is more likely than not (likelihood of more than 50 percent) that some portion, or all, of the deferred tax asset will not be realized. Four sources of taxable income should be considered in determining whether a valuation allowance is required as follows:

a) Future reversals of existing taxable temporary differences

b) Taxable income in carryback years, if carryback is permitted under the tax law

c) Tax planning strategies

d) Future taxable income exclusive of reversing temporary differences and carryforwards

Ultimately, the realizability of deferred tax assets depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period under the tax law. The character of taxable income addresses the nature of the taxable income, such as tax jurisdiction, ordinary income, capital gains or losses, or operations of an entity that is not included in a company's consolidated income tax return. This consideration is particularly important when evaluating the realizability of deferred tax assets subject to limitations under current tax law. For example, if a company has substantial capital loss carryforwards, those losses may only be available to offset capital gains rather than ordinary taxable income. As such, careful consideration of the magnitude, timing and character of taxable income is required when assessing the realizability of deferred tax assets related to items such as capital losses.

In addition, when assessing the available evidence to support the realizability of a company's deferred tax assets, it is important to remember that recent cumulative losses (or the expectation that a company will have cumulative losses) constitute significant negative evidence. Although interpretations might vary, we believe a company is in a cumulative loss position for financial reporting purposes when it has a cumulative loss (or is expecting to have a cumulative loss) for the latest three years (the current year and two previous years), even if the cumulative loss is only the result of losses recorded in the current reporting period. We believe a cumulative loss should be measured as the aggregate of pretax book income (loss) and pretax results from all other sources (for example, discontinued operations and extraordinary items), excluding the cumulative effect of changes in accounting principle. Also, companies that currently are not in a cumulative loss position, but expect to be in such a position based upon forecasts of expected future losses, should consider the negative evidence of the expected cumulative loss in the same manner as an existing cumulative loss. That is, we do not believe significant difference exists between currently being in a cumulative loss position and expecting to be in one.

As a result of the significance of a company being in or expecting to be in a cumulative loss position, positive evidence of equal or greater significance is needed to overcome that negative evidence before a tax benefit is recognized for deductible temporary differences and loss carryforwards. In evaluating the positive evidence available, expectations as to future taxable income, exclusive of other allowable sources of taxable income, rarely would be sufficient to overcome the negative evidence of recent cumulative losses, even if supported by detailed forecasts and projections. Expectations about future taxable income generally are overshadowed by a company's historical loss experience in recent years and estimating future taxable income in such cases often necessitates the prediction of a turnaround or other change in circumstances, which typically is not susceptible to the objective verification requirement of Statement 109.

Management also should consider the appropriateness of the disclosures made in both the notes to the financial statements and in Management's Discussion and Analysis (MD&A) regarding the realizability of deferred tax assets.

Statement 109 and SOP 94-6 contain the disclosure requirements for income tax valuation allowances. The disclosures in SOP 94-6 focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term.

The SEC staff routinely requests disclosures to be included in MD&A about uncertainties that might exist with respect to the realization of deferred tax assets that are not offset by deferred tax liabilities. For deferred tax assets that can be realized through carrybacks and reversals of existing taxable temporary differences (essentially those deferred tax assets that are not dependent upon future events), disclosure generally could be limited to discussion of the basis by which management determined that it was more likely than not the deferred tax asset would be realized. In instances where the implementation of tax planning strategies is the basis for not recognizing a valuation allowance for all or some portion of the deferred tax asset, the SEC staff requires that disclosures include a discussion of the uncertainties that might affect the realization of deferred tax assets, as well as the factors that led management to conclude that it was more likely than not the deferred tax asset would be realized.

The SEC staff has requested that registrants include the following types of disclosure in their MD&A:

- Disclosure of the basis for management's determination that it is more likely than not that the net deferred tax asset will be realized
- Disclosure of the types of uncertainties that may affect the ultimate realization of deferred tax assets
- Disclosure of the registrant's intention to evaluate the realizability of the deferred tax asset quarterly by assessing the need for a valuation allowance

Examples of uncertainties relating to future taxable income may include:

- Possible declines in sales, margins and revenues stemming from a variety of sources, such as loss of market share, technological obsolescence or increased competition
- The amount of expected future taxable income that would have to be generated to realize the deferred tax assets, and whether the existing levels of pre-tax earnings for financial reporting purposes are sufficient to generate that minimum amount of future taxable income
- The period in which future taxable income would have to be earned to realize the deferred tax asset
- Whether the source of the expected future taxable income will stem from ordinary and recurring operations or whether sales of operating assets will be necessary to achieve the required levels of income. If the source of the expected future taxable income is from other than ordinary and recurring operations, the amount of taxable income that could be generated from those transactions should be disclosed along with a discussion of how management plans to consummate those transactions and material uncertainties, if any, that could affect those transactions.

Additionally, liquidity concerns may lead companies to consider repatriation of foreign earnings/cash. Such actions would likely have tax consequences.

Literature references

- FASB Statement No. 109, *Accounting for Income Taxes*
- Statement of Position 94-6, *Disclosure of Certain Risks and Uncertainties*
- Ernst & Young's Financial Reporting Developments, *Accounting for Income Taxes* (Score No. BB1150, Revised June 2007)
- EY Hot Topic, *Valuation Allowance Considerations* (Score No. BB1473)
- EY publication, *SEC Comments and Trends, an analysis of current reporting issues* (Score No. BB1589)

Inventory

Issue

Excess or obsolete inventories and lower of cost or market adjustments may be necessary.

Background

Current market conditions and corresponding effects on consumer spending may result in excess and obsolete inventories or inventories with carrying amounts above market.

Accounting & reporting considerations

- Obsolete, damaged, slow-moving, excess, and other inventory items may indicate that the inventory cost is not recoverable.
- To determine the appropriate inventory valuation, management should include a review of the recoverability of inventory and consider potential unrealized losses on sales and purchase commitments.
- Management should be alert for potential obsolescence issues while taking physical inventories, reviewing detailed inventory records for usage, and comparing inventory detail with prior periods.
- A review of sales contracts, sales backlog, and new catalogs may identify inventory valuation issues.
- For manufacturers and distributors, management should consider whether the financial condition of major customers could impair the recoverability of inventory on hand.
- There may be valuation issues associated with returns from merchants and leftover merchandise from the retail season.

Further discussion

In the current environment, management should consider the need for, and sufficiency of, allowances to reduce inventory from cost to market by evaluating the ultimate recoverability of the cost of the inventory items in question. The following are some factors to consider when evaluating the carrying amount and/or realizable value of inventory:

- Scrap or salvage value
- Possible alternative uses for inventory items (for example, raw materials or components may be used in manufacturing items other than the items in which they are normally used)
- Realizable value if inventory is sold by methods or in markets other than the usual ones (for example, for export rather than directly to domestic retailers)
- Expected changes in customers' preferences that may or may not result in the items being or becoming obsolete
- The possibilities of selling the items by reducing their prices
- The possibilities that raw materials may be returned to vendors for credit
- Projected or budgeted sales of apparently excess quantities

Retailers should be sensitive to situations in which holiday sales fall short of expectations. Often, leftover merchandise will have to be permanently marked down, frequently to clearance-level prices. Management should consider its plans for moving leftover merchandise and determine that an adequate valuation allowance is established, regardless of whether selling prices are reduced at year end.

The SEC staff has recently issued comments asking registrants how they have determined that inventories are stated at the lower of cost or market. The SEC staff has questioned the registrants' determinations of market values, net realizable values, and replacement costs when valuing inventories at the lower of cost or market. A registrant should disclose the manner in which lower of cost or market is determined. If write-downs of inventory are significant, a registrant should disclose the loss amounts and consider separately displaying the amount of loss in the statement of income as a separate component of cost of goods sold.

Literature references

- Accounting Research Bulletin No. 43, Chapter 4, Inventory Pricing
- EY publication, *SEC Comments and Trends, an analysis of current reporting issues* (Score No. BB1589)

Postretirement benefits

Issue

The plan assets of a postretirement benefit plan may include asset classes that have experienced severe price volatility as a result of the increased credit risk and the reduced liquidity in the marketplace.

Background

This volatility has given rise to questions about how to measure the fair value of asset classes affected by the illiquidity in today's market. Employers who sponsor postretirement benefit plans are required to recognize the funded status of their postretirement benefit plans in the statement of financial position. The funded status is measured as the difference between the fair value of plan assets and the benefit obligation at the measurement date for each plan.

Accounting & reporting considerations

- Increased credit risk and reduced liquidity in the marketplace could affect the fair value of plan assets used in determining the funded status of postretirement benefit plans.
- Assumed returns on plan assets included in the next fiscal year's periodic benefit costs should reflect current expectations of asset returns.
- The assumed discount rate used to measure the benefit obligation at the measurement date should not be based on bonds that have been downgraded as a result of the credit crisis below the "high-quality" (for example, Moody's Aa) rating level.
- Bonds that are on "watch" should be monitored for a possible downgrade at the measurement date.
- Recognition of an underfunded plan may have implications for debt covenant compliance.

Further discussion

Statement 158 requires employers that sponsor postretirement benefit plans to recognize the funded status of postretirement benefit plans in the statement of financial position. The funded status is measured as the difference between the fair value of plan assets and the benefit obligation at the measurement date for each plan.

The plan assets of a postretirement benefit plan may include asset classes that have experienced severe price volatility as a result of the increased credit risk and the reduced liquidity in the marketplace. This volatility has given rise to questions about how to measure the fair value of asset classes affected by the illiquidity in today's market. Accordingly, management should document how the fair values of plan assets were measured in recognizing the funded status of the postretirement benefit plans. In addition, assumed returns on plan assets included in the next fiscal year's periodic benefit costs should reflect current expectations of asset returns in this current economic environment.

The benefit obligation at the measurement date for each plan reflects the actuarial present value of estimated future cash outflows required to satisfy an employer's postretirement benefit obligation. The rate used to discount those estimated future cash outflows should be determined using a method that is based on rates of return on high-quality fixed-income investments. "High-quality" fixed-income investments are viewed as fixed-income debt securities that receive one of the two highest ratings by a recognized ratings agency (for example, Moody's Aa rating or higher). As a result of the credit crisis, some bonds that were previously considered "high-quality" may have been or will soon be downgraded to a rating below the highest two ratings by a recognized ratings agency. Management should determine that the methods used to determine the discount rate excludes bonds that are no longer considered "high-quality" at the measurement date. The conclusions reached regarding bonds that are on "watch" for a possible downgrade at the measurement date should also be documented.

Literature references

- FASB Statement No. 87, *Employers' Accounting for Pensions*
- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*
- FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
- EITF Topic D-36, "Selection of Discount Rates Used for Measuring Defined Benefit Pension Obligations and Obligations of Postretirement Benefit Plans Other Than Pensions"

Debt

Issue

Companies are defaulting on their debt covenants while simultaneously facing challenges to both maintain current and obtain new financing and liquidity sources.

Background

Compliance with debt covenants that were easily met in the past may now be more challenging. A company that could quickly refinance maturing debt in the past may find it much more difficult to do so or discover that it takes longer to arrange financing.

Accounting & reporting considerations

- Debt arrangements should be reviewed for compliance with all provisions and covenants as well as for the existence of cross defaults. Any defaults should be identified early so that any required communications with lenders can commence promptly.
- The intent and demonstrated ability to refinance maturing debt on a long-term basis should be documented to support the debt classification.
- Debt waivers should indicate that the bank is waving repayment for at least one year and a day beyond the balance sheet date to support long-term classification.
- Concessions granted by lenders may be indicative of a troubled debt restructuring.
- The value of auction rate securities (ARS) must be carefully evaluated, especially if they are used as collateral for debt agreements. Furthermore, the classification of and accounting for outstanding ARS must also be considered when a debt arrangement has been modified or extinguished.
- Certain provisions of convertible debt agreements may require them to be classified as current or risk losing certain tax advantages.
- The old and new borrowing capacity of modified lines of credit should be compared to determine if the modification is an extinguishment.

Further discussion

Reviewing long-term debt agreements for debt compliance early in the financial statement close process can provide management with more time to negotiate with lenders and obtain appropriate waivers to support the classification of debt in the financial statements. The wording of the waivers should indicate that the lender has waived the right to demand repayment for at least one year and a day after the balance sheet date for the debt to be classified as long-term.

As debt obligations become due, companies may desire to classify maturing debt as noncurrent based on a plan to refinance that debt. There are specific criteria to be met in Statement 6 and related guidance to establish the issuer's intent and demonstrated ability to refinance maturing debt on a long-term basis in order to justify classification of an existing obligation as noncurrent.

Companies may seek to renegotiate the terms of their outstanding debt. Depending on the significance of any change in the terms, usually measured based on changes in discounted cash flows, the debt will be deemed to either have been modified or extinguished. The form of the transaction (same debt/new terms versus issuing new replacement debt) is not determinative in the analysis. EITF Nos. 96-19 and 98-14 provide guidance on accounting for modifications or exchanges of issued debt. Depending on the facts and circumstances, the transaction may require accounting as a troubled debt restructuring under Statement 15.

Due to disruptions in the credit markets, many ARS auctions have failed. Such events raise several accounting and financial reporting issues for issuers about the accounting for the resulting penalty interest expense, the continued use of hedge accounting, and the failed auction triggering a cross-default of other debt arrangements. In addition, issuers may consider extinguishing or modifying the debt arrangements, which also raise issues as to extinguishment accounting, accounting for debt issuance costs and balance sheet classification of the ARS.

For issuers of convertible securities, the market turmoil and recent temporary rules issued by the SEC restricting short-selling may affect the rights and behavior of investors in convertible debt. For example, many convertible debt issuances over the past several years have contained parity provisions that allow conversion of the instruments if the fair value of the debt is less than, by some predefined percentage, the conversion value of the debt (calculated as some variation of the number of shares into which the debt is convertible times the current share price). Given the market dynamics, anomalies in market prices may trigger this provision and, depending on the terms of the debt, affect its balance sheet classification. For example, if the debt could be converted with settlement of its principal amount in cash and the conversion spread in shares, triggering the parity provision would require the debt to be classified as current unless certain criteria were met to retain its non-current classification.

A popular financing structure in recent years has been to issue convertible debt with a freestanding call-spread option, wherein the issuer purchases a call option that aligns with and economically offsets the conversion option included in the convertible debt, and then writes a call option at a higher strike price to partially finance the purchased call option. If structured appropriately, the convertible debt and purchased option may be combined for tax purposes to produce an advantageous tax position. However, the effect of current market conditions on equity derivatives and their counterparties may trigger termination of those equity derivative instruments. Tax professionals should evaluate any tax implications of these structures including the potential loss of the advantageous deductions and the effects on current and deferred taxes.

Literature references

- FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced an amendment of ARB No. 43, Chapter 3A*
- FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*
- FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor (an amendment to ARB No. 43, Chapter 3A)*
- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- APB Opinion 26, *Early Extinguishment of Debt*
- EITF Issue No. 86-30, "Classification of Obligations When a Violation Is Waived by the Creditor"
- EITF Issue No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion"
- EITF Issue No. 95-13, "Classification of Debt Issue Costs in the Statement of Cash Flows"
- EITF Issue No. 96-19, "Debtor's Accounting for a Modification and Exchange of Debt Instruments"
- EITF Issue No. 98-14, "Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements"
- EITF Issue No. 02-4, "Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*"
- EITF Issue No. 06-6, "Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments"
- EY Financial Reporting Developments, *FAS 6 — Classification of Short-term Obligations Expected to Be Refinanced* (Score No. 38341)
- EY Financial Reporting Developments, *FAS 15 — Troubled Debt Restructurings* (Score No. 38699)

Share-based payments

Issue

What are the accounting considerations a company needs to keep in mind when (1) modifying a share-based payment award, (2) canceling and/or replacing a share-based payment award, and (3) entering into an equity restructuring and the share-based payment award either does or does not contain anti-dilution protection?

Background

The weakening economy has affected the operating results and share prices of many publicly-traded companies. In response to current market conditions, companies may be considering alternatives to maintain value in employee share-based payment awards. Changes to existing awards may involve modifying or removing vesting conditions tied to company results, including share price performance. Companies also may decide to reprice their options when the stock price falls and the desired motivational effect of the options is lost. In other cases, companies may modify awards to protect employees following an equity restructuring event.

Accounting & reporting considerations

- Modifications of share-based payment awards may result in the recognition of additional compensation cost calculated as the fair value of the modified award in excess of the fair value of the original award measured immediately before its terms are modified based on current circumstances.
- Total compensation cost for a modified award will never be less than the original grant-date fair value of the award unless, at the date of the modification, the original award's vesting conditions (other than those linked to a company's share price) were not probable of achievement.
- Changes to awards to provide cash settlement alternatives may result in classification of those awards as liabilities.
- Cancellations of awards with the concurrent granting of replacement awards and changes in awards as a result of an equity restructuring are accounted for as modifications.
- Cancellations of awards without the granting of replacement awards result in the immediate recognition of unrecognized compensation expense.
- Modifications of awards may have significant tax consequences.
- Even for awards that have not been modified, forfeiture estimates should be updated to reflect management's current expectations of awards expected to vest.
- Financial statement disclosures should include a description of significant modifications, including the terms of the modifications, the number of employees affected, and the total incremental compensation cost resulting from the modifications.

Further discussion

The modification of a share-based payment award may result in incremental compensation cost that will need to be recognized in addition to any remaining unrecognized compensation cost measured on the original grant date. The calculation of incremental value is based on the fair value of the modified award in excess of the fair value of the original award measured immediately before its terms are modified based on current circumstances. The value of the original (pre-modification) award will be estimated based on current assumptions, without regard to the assumptions made on the grant date.

The measured cost of a modified award generally cannot be less than the grant-date fair value of the original award. However, an exception to that requirement involves a modification to a vesting condition (other than a market condition that is linked to the company's share price) when the award was not expected to vest pursuant to the original terms. An example is a modification to accelerate service vesting in connection with the anticipation of, or concurrent with, the termination of an employee. In that case, because the employee will be terminated and, therefore, is not expected to vest in the original award, any of the originally measured compensation cost is reversed, and the fair value of the award on the modification date is recognized over the period the employee is required to provide service to earn the award (if any). Essentially, the accounting follows the logic that the employee was terminated and forfeited the original award, but was granted a new, fully vested award.

Changes in an award to provide cash settlement alternatives should be accounted for as either a cash settlement or a modification. If future service is required to vest in the cash payment or the obligation continues to be indexed to the employer's shares, the award should be accounted for as a modification. Cash settlements generally are accounted for as treasury-stock transactions, with the recognition of any previously measured but unrecognized compensation, as well as incremental compensation cost for any cash payment in excess of the fair value of the award at settlement. Modifications differ from the cash settlement accounting model in that the measure of compensation cost would include any increase in the fair value of the award between the grant date and the modification date.

The cancellation of an award accompanied by a concurrent grant of a replacement award would require modification accounting. Companies will need to assess whether any incremental compensation cost results from the fair value of the replacement award in excess of the fair value of the cancelled award at the cancellation date. In contrast, the cancellation of an award that is not accompanied by a concurrent grant of a replacement award results in the immediate recognition of any remaining unrecognized compensation cost.

A change to the terms of an award as a result of an equity restructuring is accounted for as a modification regardless of whether the terms of the award provide for an adjustment in the event of an equity restructuring. Some plan documents provide that the company must make an equitable adjustment in the event of an equity restructuring, but there is discretion in how that adjustment is determined. For example, in the event of a large nonrecurring cash dividend, the company could choose to adjust the strike price and number of shares underlying the options to keep the employee whole, or make a cash payment to the employee and not adjust the terms of the option. As long as an equitable adjustment is required (even if some discretion is permitted in how to make an equitable adjustment), in many cases no incremental compensation cost will result from the modification.

Conversely, if the company has the discretion to choose to not make the adjustment, the adjustment is not required, and significant incremental compensation cost generally will result if an adjustment occurs.

A modification to add an anti-dilution provision in contemplation of an equity restructuring would result in two modification measurements: one at the time the anti-dilution provision is added and another at the time of the equity restructuring. Plans may have an anti-dilution provision that may not be clear whether the company's discretion involves whether an adjustment must be made (which would result in incremental compensation cost) or how the adjustment must be made (which in most cases would not cause incremental compensation cost). If the language in the plan document is not clear, a legal determination must be made whether an adjustment is required with respect to the anticipated equity restructuring transaction. It generally will be appropriate to obtain the opinion of legal counsel as to whether or not an equitable adjustment is required in connection with the contemplated equity restructuring transaction. If legal counsel is unable to offer an opinion that the adjustment is required, then the company would conclude that an adjustment is not required and therefore the modification will result in incremental compensation cost.

The modification of an option can result in significant tax consequences. For example, a modification may cause the option to be viewed as a newly granted option for tax purposes. If that option is viewed for tax purposes as a newly granted option and is in the money on the modification date, the option may: (1) be viewed as deferred compensation under Section 409A of the Internal Revenue Code (which may result in significant negative tax implications for the employee), (2) if granted to executives, be subject to limitation on the employer's tax deduction under Section 162(m) of the Internal Revenue Code, or (3) no longer qualify as an incentive stock option.

Literature references

- FASB Statement No. 123 (revised 2004), *Share-Based Payment*, as amended and together with FASB Staff Positions No. 123(R)-1 through 123(R)-6
- EY Financial Reporting Developments, *Share-Based Payment – FASB Statement No. 123 (revised 2004)* (Score No. BB1172, Revised November 2006)

Revenue recognition

Issue

Current market conditions may require an increased focus on when revenue may be recognized.

Background

In the current economic environment, many companies will face increasing pressure to meet revenue targets and analysts' expectations. Accordingly, a heightened focus on revenue recognition may be warranted.

Accounting & reporting considerations

- In an economic downturn, vendors may offer expanded rights of return requiring more attention on estimating returns. As a result, higher return allowances may be required, or revenue may need to be deferred until returns can be estimated or return rights lapse.
- Resellers and distributors may request to delay payment for goods until they are sold through to the customer, or may lack the ability to pay until such sales occur. This may require revenue deferral whereas previously revenue may have been recognized upon delivery to the reseller.
- Sales people may have more incentive to enter into side arrangements to close a deal. The existence of side arrangements may result in improper revenue recognition if the terms and conditions in the side arrangement are not known to accounting and finance personnel.
- More consignment arrangements could exist as consignees generally do not pay for goods until they have been sold to the end customer.
- Customers may request extended payment terms that could change the timing of revenue recognition.

Further discussion

With the current market conditions, many companies will face increasing pressure to reach earnings goals and analysts' estimates. These pressures may lead companies to change business practices, which can affect the amount and timing of revenue recognition. Following is a description of some transactions that require focus in an economic downturn:

- A company's historical returns experience may not be predictive of future returns due to changing conditions or business practices. Statement 48 specifies criteria for revenue recognition by the seller when the buyer has the right, explicitly or implicitly, to return the product. Pursuant to Statement 48, revenue from such sales transactions shall be recognized at the time of sale only if a number of conditions are met, including the presence of historical evidence on which to base estimates of future returns. It is possible that, because of changes in facts and circumstances, or due to the terms of transactions, a company's ability to reasonably estimate future sales returns may fluctuate. If companies institute new business practices in response to changes in market conditions, or as arrangements include new or expanded rights of return, companies should reevaluate whether a higher allowance for returns should be recorded or whether future returns can be reasonably estimated. If a company is unable to make a reasonable estimate of returns due to changing conditions or business practices, revenue should be deferred until such estimates can be made or the return rights lapse.

- In an economic downturn, resellers and distributors may request a vendor to provide greater rights than those provided previously or those it would provide to end customers. A vendor may agree to maintain a mutually beneficial relationship and maximize future sales. For example, a vendor may agree not to require payment for products shipped to distributors (either explicitly or implicitly) until they are sold to the end customer. Additionally, even if greater rights are not requested it may be more difficult to determine a reseller's ability to pay or whether concessions will be provided (even if the vendor is not otherwise contractually obligated to provide a concession) if a reseller is unable to sell delivered products to end customers. Accordingly, evaluating whether fees from resellers are fixed or determinable may be more difficult and may result in changes to historic revenue recognition practices. Vendors that have previously recognized revenue on delivery to resellers should evaluate whether revenue recognition should be delayed until the delivered products are resold.

- Customers may request a vendor to provide extended payment terms. Arrangements that provide payment terms that extend beyond a vendor's normal or standard payment terms should be deemed to include extended payment terms. The inclusion of extended payment terms in any arrangement may indicate that the fees associated with that arrangement are not fixed or determinable. Extended payment terms may indicate the customer is relying on a future event as a trigger for the payment, such as installation, acceptance or financing, or that the risk that the vendor may grant future concessions has increased. Management should evaluate the effect, if any, on whether fees due pursuant to arrangements containing extended payment terms are fixed and determinable, and on the collectibility of such fees, to determine the effect on the timing and amount of revenue recognition.

- Side agreements are amendments to a contract that are either undocumented or documented in agreements separate from the main contract. In essence, a side agreement is an element of the arrangement that is documented outside the base contract. The potential for side agreements is greater for complex or material transactions or when complex arrangements or relationships exist between a vendor and its customers. It is important for side arrangements to be communicated to the appropriate accounting and finance personnel so that the effects, if any, of the terms and conditions in the side arrangement are appropriately accounted for.

- A consignment sale is one in which physical delivery of a product has occurred, but the buyer is not required to pay until the product is either resold to an end consumer or used by the buyer. Under such arrangements, the seller (consignor) retains the title to the merchandise, and the dealer (consignee) acts as a selling agent. Products delivered pursuant to a consignment arrangement do not meet the basic revenue recognition criterion of delivery because the risks and rewards of ownership have not transferred to the buyer. While some transactions are clearly identified as a consignment arrangement, there are other, less transparent transactions in which the seller has retained the risks and rewards of ownership, despite no longer having physical possession of the inventory. That is, title has been transferred, but the seller retains obligations related to the product indicating that not all of the risks and rewards of ownership have been transferred. Revenue for consignment arrangements should not be recognized until the consigned products are sold to end customers because the mere shipment of merchandise/products does not result in the recognition of revenue if the buyer (consignee) does not assume risk of ownership for the product.

Literature references

- FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
- Statement of Position No. 97-2, *Software Revenue Recognition*
- SEC Topic 13, *Revenue Recognition*
- EY publication, *Revenue Recognition, Lessons Learned from Restatements and Enforcement Actions* (SCORE No. BB1158)
- EY publication, *SEC Comments and Trends, an analysis of current reporting issues* (Score No. BB1589)

Restructurings and disposal or exit activities

Issue

Restructurings of operations and disposal or exit activities may occur more frequently.

Background

Market events have led not only financial institutions, but companies across a variety of industries to consider strategic alternatives. Companies have announced workforce reductions, consolidation of facilities, and other restructurings during 2008. In addition, entities may be considering eliminating certain operations (either through a sale or wind-down).

Accounting & reporting considerations

- Liabilities for costs associated with an exit or disposal activity are recognized and initially measured at fair value when incurred.
- For one-time termination benefits, the timing of liability recognition is dependent on whether (1) the arrangement requires employees to render service until terminated to receive termination benefits and (2) employees will render service beyond a minimum retention period.
- Liabilities for costs (a) to terminate a contract before the end of the term and (b) that will continue to be incurred under the contract for the remaining term without economic benefit are recognized and measured at fair value in the period in which the liability is incurred.
- Liabilities (expenses) for other costs associated with exit or disposal activities, such as costs to consolidate or close a facility, should be recognized and measured at fair value in the period in which the liability is incurred (as opposed to the date that the entity commits to a plan).
- Liabilities for costs associated with exit or disposal activities are not remeasured at fair value in subsequent periods. Instead, liabilities should be adjusted only for revisions in estimated timing and/or amount of future cash flows, using the credit-adjusted, risk-free rate that was used to measure the liability initially.
- Judgment is required to determine if the results of operations of a component of an entity to be disposed of should be classified as discontinued operations.

Further discussion

Statement 146 requires that a liability for costs associated with an exit or disposal activity be recognized and initially measured at fair value when incurred (that is, when the definition of a liability in CON 6 is met). Under Statement 146, an entity's commitment to a plan, by itself, does not result in the recognition of a liability.

For employees that are entitled to receive one-time termination benefits regardless of when their service terminates and for employees who will not be retained to render service beyond the minimum retention period, a liability for the termination benefits should be recognized and measured at its fair value at the communication date (that is, when all communication date requirements have been met in accordance with paragraph 8 of Statement 146). If employees are required to render service beyond a minimum retention period until they are terminated in order to receive the one-time termination benefits, a liability should be measured initially at the communication date based on its fair value as of the termination date and recognized ratably over the future service period.

The accounting for ongoing benefit arrangements is covered under other existing literature, including Statements No. 87, 88, 106, and 112.

Liabilities for contract termination costs are to be recognized and measured at fair value in the period in which the liability is incurred (generally when the entity terminates the contract pursuant to the contractual terms or ceases to use the rights conveyed under the contract).

Management should also determine if the results of operations of a component of an entity to be disposed of should be classified as discontinued operations in accordance with Statement 144. The results of operations of a component of an entity to be disposed of by sale may not be reported as discontinued until the "held-for-sale" criteria are met. For disposals other than by sale (for example, abandonment, distribution, or exchange for similar productive assets), the results of operations of a component of an entity cannot be reported as a discontinued operation until the period in which the long-lived asset or disposal group is either abandoned, distributed, or exchanged, depending on the manner of disposal.

Companies that have undertaken a restructuring or decided to exit parts or all of certain lines of a business should evaluate the long-lived assets associated with the line of business for impairment in accordance with Statement 144, as the factors contributing to the decision to restructure are likely consistent with some of the impairment indicators in Statement 144, paragraph 8.

Entities should consider the SEC staff's view on the income statement classification of inventory markdowns associated with a restructuring. The SEC staff recognizes that circumstances may exist in which an entity can assert that inventory markdowns are costs directly attributable to a restructuring. However, the staff believes that it is difficult to distinguish inventory markdowns attributable to a restructuring from inventory markdowns attributable to external factors that are independent of a restructuring. Further, the staff believes that decisions about the timing, method, and pricing of dispositions of inventory generally are considered to be normal, recurring activities integral to the management of the ongoing business. Accordingly, the SEC staff believes that inventory markdowns should be classified in the income statement as a component of cost of goods sold.

Literature references

- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits, an amendment of FASB Statements No. 5 and 43*
- FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
- FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*
- SEC Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges, as amended (Staff Topic 5P)*
- EY Financial Reporting Developments, *Accounting for the Impairment or Disposal of Long-Lived Assets — FASB Statement 144* (Score No. BB0997)
- EY Financial Reporting Developments, *Accounting for Costs Associated with Exit or Disposal Activities — Statement 146* (Score No. BB1072)
- EY publication, *SEC Comments and Trends, an analysis of current reporting issues* (Score No. BB1589)

Certain topics for financial services entities

Issue

The recent market events have prompted numerous questions about the accounting for certain types of transactions common with companies in the financial services industry.

Background

Credit quality deterioration in the financial services sector, including rising loan delinquency and defaults and decreasing secondary market liquidity, has significantly affected lending institutions, mortgage banking companies, investment banks, insurers, asset managers, and other financial service companies.

Accounting & reporting considerations

- Management's process for determining the allowance for credit losses should be based on a comprehensive, well-documented, and consistently applied approach.
- The accounting for foreclosed assets has become more material for many entities.
- The terms and forms of credit enhancements must be carefully evaluated as the accounting may depend on the structure of the arrangements.
- Acquired loans or debt securities may be required to be accounted for in accordance with SOP 03-3, which prohibits the carryover of the seller's allowance for credit losses.
- Management should review its fair value estimates and disclosures for loans held for sale.
- Management should carefully evaluate risks related to counterparty exposure.

Further discussion

Loans and allowance for credit losses

The process for determining an appropriate allowance should be based on a comprehensive, well-documented and consistently applied analysis of the loan portfolio. The analysis should take into account management's current judgments about portfolio credit quality, including all significant qualitative factors that affect collectibility. The documentation should support management's conclusion that the recorded allowance for credit losses is appropriate and that changes in the allowance are directionally consistent with trends in the factors considered. Management should also consider the results of recent regulatory examinations and testing performed by internal audit and the loan review function in the allowance estimation process. Management's documentation of the overall appropriateness of the allowance for credit losses should also reflect consideration of the results of recent examinations and this testing.

Lenders that are modifying the terms of on-balance sheet loans need to determine whether the modifications are troubled debt restructurings, whether the modifications or exchanges should be accounted for as the extension of new loans or the continuation of the original loans and the appropriate accounting for both unamortized and any new loan origination fees and costs. In the event that the modification or restructuring of a loan is considered to be a troubled debt restructuring, all of the provisions of Statement 114 apply, including the impairment recognition and measurement guidance.

Foreclosed real estate

The current market conditions are also leading to increases in many lenders' other real estate owned portfolios. Statements No. 15, 66, 114 and 144 provide the primary accounting guidance for foreclosed assets.

At the time of foreclosure, the property's fair value (less the cost to sell) becomes the cost basis of the foreclosed real estate. The amount, if any, by which the recorded investment in the loan (plus any senior debt) exceeds the fair value (less costs to sell) of the property is a credit loss that should be charged to the allowance for credit losses. At each subsequent balance sheet date, foreclosed property should be reported at the lower of the current fair value less cost to sell the asset or the asset's cost basis. If the fair value less cost to sell is less than the property's cost basis, the deficiency is recognized as a valuation allowance against the asset with a corresponding charge to expense.

The guidance in Statement 66 should be considered in determining the appropriate accounting for the disposal of foreclosed real estate.

Credit enhancement

Because the accounting for various forms of credit enhancement may vary depending on how the specific arrangement is structured, management should carefully document its accounting analysis. Contracts viewed as financial guarantees or credit enhancement agreements may not be exempt from Statement 133 because they may be credit derivatives. Arrangements referred to as "financial guarantees" and "insurance contracts" that relate to an underlying borrower's credit event should be carefully examined to determine whether the arrangements qualify for the financial guarantee scope exception in Statement 133, or are derivative contracts that must be accounted for under Statement 133.

Loans or debt securities acquired in a transfer

Investors purchasing loans or debt securities may determine that some of the loans or securities acquired will follow the accounting guidance in SOP 03-3. This guidance addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans and debt securities acquired in a transfer if those differences are attributable, at least in part, to credit quality. SOP 03-3 prohibits "carrying over" or the establishment of a valuation allowance in the initial accounting of loans acquired in a transfer that are within the scope of the SOP.

Loans held for sale

Statement 65 and SOP 01-6 establish the accounting for loans held for sale for which the fair value option in Statement 159 has not been elected. If the fair value option has not been elected, loans held for sale should be reported at the lower of cost or fair value. Given the deteriorating credit environment and changes in secondary market liquidity, management should review its estimates of the fair values of loans held for sale and the related disclosures.

In challenging management's estimates of the fair value of loans held for sale, it should consider liquidity risk and/or the widening of credit spreads. Specifically, internal models used to project cash flows should consider current credit spreads, which have been very volatile in the current year, as the fair value estimate should be based on reasonable and supportable assumptions that a third-party market participant would use in determining the current fair value of the instrument at the balance sheet date.

Understanding counterparty exposure

Those entities with cash, collateral, securities and other balances with troubled financial institutions need to assess the collectibility of such balances. Particular attention should be paid to the legal entities and rules applicable to each corresponding jurisdiction. Legal claim to such assets are dramatically affected by the type of agreements executed with these institutions. For example, a swap receivable balance with a corresponding offsetting swap payable balance may benefit from an ISDA netting arrangement, whereas a cash balance not held within a separate customer account is potentially subordinate to senior debtholders of the troubled institution.

Literature references

- FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*
- FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*
- FASB Statement No. 66, *Accounting for Sales of Real Estate*
- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
- Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*
- Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*
- The Center for Audit Quality, *Accounting For Underwriting And Loan Commitments, October 3, 2007* http://www.aicpa.org/caq/download/WP_Accounting_for_Underwriting_and_Loan_Commitments.pdf
- EY Financial Reporting Developments, *Accounting for Derivative Instruments and Hedging Activities* (Revised, December 2006, Score No. BB0977)
- EY Financial Reporting Developments, *Accounting for the Impairment or Disposal of Long-Lived Assets-FASB Statement 144* (Score No. BB0997)
- EY Financial Reporting Developments, *FASB Statement No. 66, Accounting for Sales of Real Estate, and Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects* (Score No. BB1465)
- EY publication, *SEC Comments and Trends, an analysis of current reporting issues* (Score No. BB1589)

Disclosures

Issue

The significant disruptions in the capital markets and the overall economic downturn have heightened the need for clearer, more transparent disclosures.

Background

Due to the volatile business and economic environment, financial statement users and regulators have sought more transparency in companies' disclosures regarding risks, liquidity, capital resources, critical accounting policies, fair value accounting and off-balance sheet arrangements.

Accounting & reporting considerations

- Management should take a fresh look at its financial statement disclosures addressing risks, uncertainties and concentration of risks.
- Management should evaluate the sufficiency of its MD&A, including its liquidity plans and how a rating change and/or increased funding costs might affect future earnings, the ability to enter into new business, ability to fund collateral calls or repurchase requests, etc.
- Management should challenge whether its previously disclosed market risks should be updated to reflect current conditions.
- Management should understand that the SEC believes that MD&A should make investors aware of the sensitivity of financial statements to methods, assumptions, and estimates underlying the financial statements.
- Management should be aware that the SEC staff has issued two illustrative letters to registrants identifying a number of fair value disclosures that companies should consider in preparing their MD&A.
- Management should be aware that the SEC staff has recommended additional disclosures for off-balance sheet arrangements and arrangements with variable interest entities (VIEs).

Further discussion

Risks and uncertainties

SOP 94-6 requires disclosures about the risks and uncertainties existing as of the balance sheet date in the following areas: (1) nature of operations, (2) use of estimates in the preparation of the financial statements, (3) certain significant estimates, and (4) current vulnerability due to certain concentrations.

Disclosure of certain significant estimates should be made when information that is known to management prior to the issuance of financial statements meets both of the following criteria: (1) it is at least reasonably possible (as defined in Statement 5) that management's estimate of the effect on the financial statements of a condition, situation, or set of circumstances existing at the date of the financial statements will change in the near-term as a result of one or more future confirming events, and (2) the effect of the change would be material to the financial statements. The disclosure should indicate the nature of the uncertainty and an indication that it is at least reasonably possible that a change in the estimate will occur in the near-term. Disclosure of the factors that cause the estimate to be sensitive to change also is encouraged.

Disclosures about vulnerability from concentrations should be made when all three of the following conditions are met:

- The concentration of risk exists at the date of the financial statements.
- The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near-term.

Companies should consider whether they have concentrations in volume of business transacted with a particular customer, supplier, or lender; revenue from particular products or services; available sources of supply materials, labor, or services; or market or geographical area in which it conducts its operations that might meet the three criteria above.

Concentrations of risk

Statement 107 addresses disclosure of concentrations of credit risk of all financial instruments. The following information should be disclosed for each significant concentration of credit risk:

- Information about the activity, region, or economic characteristic that identifies the concentration
- The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments
- The entity's policy of entering into master netting arrangements to mitigate the credit risk of financial instruments, information about the arrangements for which the entity is a party, and a brief description of the terms of those arrangements, including the extent to which they would reduce the entity's maximum amount of loss due to credit risk

The terms of certain loan products could increase a reporting entity's exposure to credit risk and result in a concentration of credit risk, either as an individual product type or as a group of products with similar features. Shared characteristics that might give rise to significant concentrations include, but are not limited to, borrowers subject to significant payment increases, loans with terms that permit negative amortization, and loans with high loan-to-value ratios. Judgment is required to determine whether loan products have terms that give rise to a concentration of credit risk.

Liquidity and capital resources

Management should determine that it has appropriately disclosed in MD&A the following information required by Item 303 of SEC Regulation S-K about liquidity and capital resources, to the extent material:

- Historical information regarding sources of cash and capital expenditures
- An evaluation of the amounts and certainty of cash flows
- The existence and timing of commitments for capital expenditures and other known and reasonably likely cash requirements
- Discussion and analysis of known material trends and uncertainties
- A description of expected changes in the mix and relative cost of capital resources
- Indications of which balance sheet or income or cash flow items should be considered in assessing liquidity
- A discussion of prospective information regarding sources of and needs for capital, except when otherwise clear from the discussion

The SEC staff expects a company's discussion of liquidity to identify the balance sheet, income, and cash flow items that are indicators of its liquidity. Examples of liquidity indicators include, but are not limited to, unused credit lines, debt-equity ratios, bond ratings, and restrictions under existing debt agreements. The discussion of short-term liquidity should focus on cash needs and sources of funds (for example, operating cash flows, lines of credit, commercial paper, securitization of receivables, other assets) to meet day-to-day operating expenses and material commitments up to twelve months in the future. The discussion of long-term liquidity should address material capital expenditures, significant balloon or other payments due on long-term obligations, and other demands or commitments (including any off-balance sheet items) to be incurred beyond the next twelve months. This discussion also should include proposed sources of funding required to satisfy these obligations.

The SEC staff expects the discussion of capital resources to include favorable (or unfavorable) material trends in sources of capital — including expected material changes in the mix and relative cost of capital resources (for example, changes among equity, debt, off-balance sheet financing arrangements). A company should consider disclosing, or could be required to disclose, the potential effect on its liquidity of (1) financing arrangements that are reasonably likely to be available to the company, and (2) financing arrangements that the company would like to use but are no longer available or are reasonably likely to become unavailable. For companies that have heavily relied on the mortgage securitization and commercial paper markets, current market conditions could indicate unfavorable trends in sources of capital. Thus, a discussion of the availability of these financing arrangements might be warranted.

Given current conditions, registrants should give specific consideration to disclosures regarding, among other relationships, their receivable positions with derivative counterparties and any financial guarantors (such as monoline insurers). In addition, registrants should disclose that funds from investments designated as held to maturity are not available for immediate use.

When an auditor's report expresses substantial doubt about an entity's ability to continue as a going concern, the SEC has mandated specific disclosures. In these situations, the SEC requires a company to not only provide disclosure in the notes to the financial statements of its financial difficulties and plans to overcome them, but also to present a detailed discussion in MD&A of cash flows covering the twelve-month period following the date of the financial statements. Such a discussion should be updated quarterly, as appropriate.

Quantitative and qualitative disclosures about market risk

Item 305 of SEC Regulation S-K (the Market Risk Rule) requires quantitative and qualitative market risk disclosures about all financial instruments to be presented outside the financial statements in both annual reports on Form 10-K and in registration statements.

Market risk is a broad term referring to economic losses due to adverse changes in the fair value of a financial instrument. The Market Risk Rule affects most registrants as nearly all have financial instruments that expose them to market risk.

The quantitative disclosures are intended to provide an investor with a greater ability to assess the registrant's exposure to market risk and must be disclosed in one of three ways: (i) a comprehensive table (that is, tabular presentation) that would schedule cash flow amounts by maturity dates for all instruments that are sensitive to future changes in interest rates, currency exchange rates, commodity prices, or other market factors, (ii) a sensitivity or "shock" analysis that would quantify the effect of at least one hypothetical move in market conditions relating to each market risk factor, or (iii) specified "value at risk" disclosures (the most complex of the three options) that are intended to measure the potential exposure to adverse market movements over a specified time period with a selected likelihood of occurrence.

Registrants are required to disclose various elements of the modeling techniques used to derive the quantitative disclosures as well as relevant assumptions or limitations of the amounts. In addition, the Market Risk Rule requires disclosure of the reasons for material changes in the amount of reported market risk when compared to the information reported in the prior year.

The qualitative disclosures include discussion of a company's primary risk exposures, its objectives for managing those exposures, and actual or expected material changes in the primary market risk exposures. The qualitative disclosures should provide a context for the required quantitative disclosures.

The disclosures are only required when the exposure to market risk is material. Under the SEC's rules, a materiality assessment must be made for each market risk exposure category (for example, interest rate, foreign currency) within the trading and other-than-trading portfolios. Materiality assessments are based on the fair value of market risk sensitive instruments as of the end of the reporting period, as well as the materiality of the potential loss in future earnings, fair values, or cash flows from reasonably possible near-term market movements. The SEC's rules provide the following guidelines for evaluating whether a potential loss is material: (i) the magnitude of past market movements, (ii) expectations about the magnitude of reasonably possible future market movements, and (iii) potential losses that could arise from leverage, option, and/or multiplier features.

The Market Risk Rule clarifies that the market risk disclosures must be updated in quarterly reports (that is, Form 10-Qs) when there have been material changes in information reported for the most recently completed fiscal year.

Management should carefully evaluate its market risk disclosures and consider whether updated disclosures are required in annual and quarterly reports.

Critical accounting policies and estimates

The SEC believes that MD&A should make investors aware of the sensitivity of financial statements to the methods, assumptions and estimates underlying the financial statements. FR-72 provides interpretive guidance concerning the preparation, format and content of MD&A including guidance related to critical accounting estimates. FR-72 notes that "such disclosure should supplement, not duplicate, the description of accounting policies that are already disclosed in the notes to the financial statements. The disclosure should provide greater insight into the quality and variability of information regarding financial condition and operating performance. While accounting policy notes in the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should present a company's analysis of the uncertainties involved in applying a principle at a given time or that variability that is reasonably likely to result from its application over time."

In particular, the SEC staff has noted that registrants' disclosures about critical accounting policies are often too general and should be expanded to include a description of the significant estimates and assumptions made by management. Some of the areas that the SEC staff has commented on include, but are not limited to:

- Allowance for loan losses
- Contingencies
- Derivatives
- Goodwill and other asset impairments
- Inventory
- Pensions and other postretirement benefit costs and obligations
- Recognition of intangible assets as part of a business combination
- Revenue recognition
- Share-based payments

Fair value

The SEC staff has issued two illustrative letters to registrants identifying a number of fair value related disclosures that companies should consider in preparing their MD&A. The SEC staff issued the initial letter in March 2008 addressing disclosures related to fair value measurements for financial instruments that are not currently actively traded and whose effects have had, or are reasonably likely to have, a material effect on the financial condition or results of operations of certain registrants.

The SEC staff issued a second letter in September 2008 that re-emphasizes the fair value considerations highlighted in the March 2008 letter and recommends that registrants continue to evaluate whether they can provide clearer, more transparent disclosures about the judgments and assumptions underlying their fair value measurements, the sensitivity of those measurements to the assumptions made, and details about the methodology and inputs used. In addition, the September 2008 letter identifies new disclosure considerations associated with the fair value measurement of financial instruments. These considerations relate to the classification of those estimated within the fair value hierarchy classification, incorporation of credit risk (particularly related to derivatives), determination of active markets, effect of liquidity, and use of broker quotes or pricing services.

The letters were sent to companies that reported a significant amount of asset-backed securities, loans carried at fair value or the lower of cost or market, and derivative assets and liabilities in the financial statements in their most recent Form 10-K. Although the letters were sent primarily to financial institutions, the suggestions are applicable to any registrant.

It is our understanding that nothing in the SEC's illustrative letters is intended to change the existing guidance in Statements No. 157 or 159. Instead, both letters highlight additional MD&A disclosures that companies should consider in order to enhance the transparency of the determination and effects of fair value measurements on their financial statements.

Off-balance sheet arrangements and variable interest entities

The SEC staff has stated that it is reviewing disclosures related to the sub-prime lending issue as part of its normal review process and has recommended better disclosures about a variety of different issues in the current credit environment. The SEC staff believes that MD&A is the best place to provide information important to investors beyond the minimum disclosure requirements contained in GAAP and SEC rules. Specifically, the SEC staff has recommended additional disclosures for off-balance sheet arrangements with VIEs.

Item 303 of SEC Regulation S-K specifies MD&A disclosure requirements for off-balance sheet arrangements that are reasonably likely to have a material current or future effect on a registrant. The SEC staff suggests the following additional disclosures for registrants with a material exposure to commercial paper conduits, structured investment vehicles (SIVs), collateralized debt obligations (CDOs), or similar entities:

- Categories and rating of assets the off-balance sheet entity holds
- Weighted-average life of assets the off-balance sheet entity holds
- Forms of funding (commercial paper, medium-term notes, etc.) and weighted-average life of the funding the off-balance sheet entity utilizes
- Any material difficulties the off-balance sheet entity has experienced in issuing its commercial paper or other financing during the period
- Any material write-downs or downgrades of assets the off-balance sheet entity holds
- Maximum limit of the losses to be borne by any first loss note holders
- Types of variable interests the registrant holds in the off-balance sheet entity
- Detailed disclosure regarding the registrant's obligations under the liquidity facilities. For example:
    - Whether there are triggers associated with its obligations to fund
    - Whether there are any terms that would limit its obligation to perform
    - Any obligations under the facilities (for example, to purchase the off-balance sheet entity's assets or commercial paper), and their material terms
    - Whether there are any other liquidity providers, and if so, how the registrant's obligation ranks with the other liquidity providers
- Whether the registrant purchased commercial paper or other securities issued by any off-balance sheet entities that it manages, and whether any agreement required it to make these purchases, or otherwise, the reasons for such purchase
- Whether the registrant provided or assisted the off-balance sheet entity in obtaining any other type of support, or whether it has a current intention to do so
- Potential effect on debt covenants, capital ratios, credit ratings, or dividends, should the registrant be required to consolidate the entity or incur significant losses associated with the entity

The SEC staff encourages registrants to disclose the amount of any material loss it expects to realize as a result of its involvement with any material off-balance sheet entity.

The SEC staff believes these recommended disclosures will provide useful insights for investors into the quality of the assets held in the off-balance sheet entity. Significant judgment will be required in determining the level of disclosure. That is, the more material the exposure, the more likely additional disclosure could be beneficial. Also, MD&A disclosures might be aggregated for various off-balance sheet entities to the extent they are comparable.

Literature references

- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*
- FASB Statement No. 157, *Fair Value Measurements*
- FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115*
- Statement of Position 94-6, *Disclosures of Certain Risks and Uncertainties*
- SEC Regulation S-K Item 305, *Quantitative and Qualitative Disclosures about Market Risk*
- SEC Regulation S-K Item 303(a), *Management's Discussion and Analysis of Financial Condition and Results of Operations*
- SEC FR-72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*
- EY Financial Reporting Developments, *Fair Value Measurements- FASB Statement 157* (Score No. BB1462)
- EY publication, *2007 SEC Annual Reports* (Score No. CC0244)
- EY publication, *2008 Quarterly Financial Reporting* (Score No. CC0245)
- EY publication, *Summary of FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115* (Score No. BB1388)
- EY publication, *SEC Comments and Trends, an analysis of current reporting issues* (Score No. BB1589)
- September 2008 SEC Staff Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements), http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm
- March 2008 SEC Staff Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements), http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm

Appendix: Abbreviations used in this publication

Standard	Abbreviation
FASB Statement No. 5, *Accounting for Contingencies*	Statement 5
FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced, an amendment of ARB No. 43, Chapter 3A*	Statement 6
FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*	Statement 15
FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*	Statement 48
FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*	Statement 65
FASB Statement No. 66, *Accounting for Sales of Real Estate*	Statement 66
FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor, an amendment of ARB No. 43, Chapter 3A*	Statement 78
FASB Statement No. 87, *Employers' Accounting for Pensions*	Statement 87
FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*	Statement 88
FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*	Statement 106
FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*	Statement 107
FASB Statement No. 109, *Accounting for Income Taxes*	Statement 109
FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits, an amendment of FASB Statements No. 5 and 43*	Statement 112
FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan, an amendment of FASB Statements No. 5 and 15*	Statement 114

Standard	Abbreviation
FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*	Statement 115
FASB Statement No. 123 (R), *Share-Based Payment*	Statement 123 (R)
FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*	Statement 124
FASB Statement No. 132 (R), *Employers' Disclosures about Pensions and Other Postretirement Benefits an amendment of FASB Statements No, 87, 88, and 106*	Statement 132 (R)
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*	Statement 133
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement 125*	Statement 140
FASB Statement No. 141, *Business Combinations*	Statement 141
FASB Statement No. 142, *Goodwill and Other Intangible Assets*	Statement 142
FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*	Statement 144
FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*	Statement 146
FASB Statement No. 157, *Fair Value Measurements*	Statement 157
FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements 87, 88, 106, and 132 (R)*	Statement 158
FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115*	Statement 159
FASB Concepts Statement No. 6, *Elements of Financial Statements*	Concepts Statement 6
FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others an interpretation of FASB Statement No. 5, 57, and 107 and rescission of FASB Interpretation No. 34*	FIN 45
FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51*	FIN 46(R)
FASB Staff Position No. SOP 46 (R)- 5, *Implicit Variable Interests*	FSP FIN 46(R)-5
FASB Staff Position No. 115-1/124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*	FSP 115-1/124-1

Standard	Abbreviation
APB Opinion No. 22, *Disclosure of Accounting Policies*	APB 22
Accounting Research Bulletin 43, *Restatement and Revision of Accounting Research Bulletins*	ARB 43
DIG Implementation Issue G10, *Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative*	DIG Issue G10
EITF Issue No. 96-19, "Debtor's Accounting for a Substantive Modification and Exchange of Debt Instruments"	EITF 96-19
EITF Issue No. 98-14, "Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements"	EITF 98-14
EITF 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"	EITF 99-20
EITF Issue No. 02-7, "Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets"	EITF 02-7
Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*	SOP 94-6
Statement of Position 97-2, *Software Revenue Recognition*	SOP 97-2
Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*	SOP 98-1
Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*	SOP 01-6
Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*	SOP 03-3
SEC Staff Accounting Bulletin No. 59, *Noncurrent Marketable Equity Securities*	SAB 59
SEC Regulation S-K Item 303(a), *Management's Discussion and Analysis of Financial Condition and Results of Operations*	Item 303 (a) of Regulation S-K
SEC Regulation S-K Item 305, *Quantitative and Qualitative Disclosures about Market Risk*	Item 305 of Regulation S-K
FR-72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*	FR-72

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