

# AICPA Audit Risk Alert

## 2011/12

Accounting Issues and Developments

# Developments to be covered

- **Business combinations**
- **Troubled Debt Restructuring**
- **Disclosures about credit quality and ALLL**
- **Embedded credit derivatives**
- **Fair Value Measurements**
- **Goodwill impairment test**
- **Milestone method**

# Continued

- **Modification of loans within a pool**
- **Multiple deliverable revenue arrangements**
- **Share based payment awards**
- **Software elements**

# Business combinations

- **Disclosure of supplementary pro forma information**
- **ASU 2010-29**
- **Applicable to public entities only**
- **Requires:**
  - If the entity presents comparative information then it must disclose revenues and earnings of the combined entity as if the combination had occurred at the beginning of the comparable prior period
  - Expands disclosure requirements to include the nature of material non-recurring pro forma adjustments attributable to the combination
- **Effective for combinations occurring on or after first annual reporting period beginning after 12/15/2011**

Slide 3

# Troubled debt restructuring

## ■ ASU 2011-01

- Deferral of effective date for disclosures about TDR's, required by ASU 2010-20
- Impacts public entities
- Is deferred is in place until the FASB can complete its deliberations on what constitutes a TDR

## ■ ASU 2011-02: *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*

- Effective for public companies for interim or annual periods beginning after 06/15/2011.
- Effective for nonpublic entities for annual periods ending after 12/15/2012. with early adoption permitted

# Troubled Debt Restructuring

- **The ASU clarifies what constitutes a TDR and is intended to assist creditors in the determination and to eliminate diversity in practice**
- **A creditor must conclude, that both of the following exist:**
  - The restructuring constitutes a concession to the debtor
  - The debtor is experiencing financial difficulties
- **Considerations**
  - Borrower lacks access to funds at a market rate for similar risk profile
  - A restructuring that results in a delay of payment that is insignificant may not be a TDR
  - A lender may conclude that a debtor is in difficulty even if there is no payment default. Lender must evaluate the probability of a default in the foreseeable future.

# Disclosures about credit quality and ALL

- **ASU 2010-20**
- **Effective for public entities for interim or annual periods ending after 12/15/2010**
- **Effective for nonpublic entities for annual reporting periods ending after 12/15/2011**
- **Designed to improve users understanding of an entities credit quality and its allowance for loan losses**

# Disclosures about credit quality and ALL

- **Entities must provide disaggregated disclosures at two defined levels: portfolio segment and class of financing receivables**
- **Required disclosures include:**
  - Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables
  - The aging of past due financing receivables at the end of the reporting period by class of financing receivables
  - The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
- **Scopes out short term trade receivables or receivables measured at FV or lower of cost or FV**

# Embedded credit derivatives

- **ASU 2010-11: *Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives***
- **Effective for all entities at the beginning of first quarter beginning after 06/15/2010**
- **Provides clarification of the type of embedded credit derivatives that are exempt from the bifurcation requirement; Specifically only one type qualifies: one that is related only to the subordination of one financial instrument to another**
- **All other embedded credit derivatives must be bifurcated and accounted for separately**

# Fair Value Measurements

- Two ASU's related to fair value
- ASU 2010-06: *Improving Disclosures about Fair Value Measurements*
- Effective in two parts:
  - General disclosures for interim and annual reporting periods beginning after 12/15/2009
  - Disclosures about purchases, sales, issuances and settlements in the Level 3 roll forward for interim and annual periods beginning after 12/15/2010

# Fair Value Measurements

## ■ Requirements of ASU 2010-06

- Disclose separately significant transfers in and out of Level 1 and 2, including the rationale for the transfers
- The level 3 activity should be presented broadly with information about purchases, sales, issuances and settlements
- An entity should disaggregate disclosures to provide fair value measurements for each class of assets and liabilities. A class is often a subset of a financial statements line item. Judgment should be used in determining the level of disaggregation.
- For level 2 and 3 measurements, the entity should disclose the valuation methodology and significant inputs used to measure values for recurring and nonrecurring measurements.

# Fair Value Measurements

- **ASU 2011-04: *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs***
- **Effective for public entities for interim and annual periods beginning after 12/15/2011; for non-public entities for annual periods beginning after 12/15/2011**
- **Harmonizes remaining differences between the two sets of standards with respect to fair value measurements**

# Fair Value Measurements

## ■ Highlights:

- Highest and best use valuation concept is not applicable to financial assets and liabilities
- Specifies that measuring fair value for instruments in equity should also be done from a market participants' perspective
- Requires disclosure of quantitative information for level 3 measurements
- Discounts and premiums should be applied when a market participant would do so. Not applicable to level 1 measures.
- Sensitivity to changes in the inputs for level 3 measurements (non-public entities are scoped out)
- Disclosing fair value level for items not measured at fair value in the statements of financial position; for Topic 825 disclosures (non-public entities are scoped out)
- Entity's use of an asset which is not highest or best

# Goodwill impairment test

- **ASU 2010-28: *When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts***
- **Effective for public entities with years beginning after 12/15/2010 and for non-public entities for years beginning after 12/15/2011, with early adoption permitted**
- **Addresses a common issue in practice, which led to some inconsistencies in application; under one approach, there never could be a goodwill impairment if you assumed that a fair value of entity would always exceed zero.**

# Goodwill impairment test

■ **The ASU requires that such entities undertake a qualitative analysis to determine whether it is more than not that a goodwill impairment exists, based on consideration of adverse qualitative factors, such as:**

- a. A significant adverse change in legal factors or in the business climate
- b. An adverse action or assessment by a regulator
- c. Unanticipated competition
- d. A loss of key personnel
- e. 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
- f. The testing for recoverability under the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10 of a significant asset group within a reporting unit
- g. Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

# Goodwill impairment testing

- **Additional development: ASU 2011-08: *Testing Goodwill for Impairment***
- **Will be effective for years beginning after 12/15/2011 with early adoption permitted**
- **Adds an initial qualitative step wherein an entity may make a determination that it is more likely than not that fair value is less than carrying value. Based on similar criteria.**
- **If it is determined that is not the case, there is no requirement to perform steps 1 and 2, however companies may continue to do so**

# Milestone Method of revenue recognition

- **ASU 2010-17: *Milestone Method of Revenue Recognition***
- **Effective for fiscal and interim periods beginning after 06/15/2010, with early adoption permitted**
- **Generally applicable only in research and development arrangements that frequently include payment provisions based on achieving certain milestones over the course of the contract**

# Milestone Method of revenue recognition

- **The guidance permits revenue to be recognized based on achieving the milestone if it is substantive. The consideration earned should be:**

- 1. Be commensurate with either of the following:
  - a. The vendor's performance to achieve the milestone
  - b. The enhancement of the value of the item delivered as a result of specific outcome resulting from the vendor's performance to achieve the milestone
- 2. Relate solely to past performance
- 3. Be reasonable relative to all deliverables and payment terms in the arrangement.

# Modification of loans within a pool

- **ASU 2010-18: *Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset***
- **Effective prospectively for loans accounted for within pools for first interim or annual periods ending after 07/15/2010**
- **Addresses diversity in practice, by making it clear that modifications of loan within a pool do not result in removal of such loans, even if they meet the definition of a TDR.**
- **An entity will still be required to consider impairment of the pool in which the modified loan is included if cash flows of the pool are expected to change.**

# Multiple deliverable revenue arrangements

- **ASU 2009-13: *Multiple-Deliverable Revenue Arrangements***
- **Effective prospectively for revenue arrangements entered into in years beginning after 06/15/2010.**
- **This guidance will potentially impact many revenue transactions and require more vendors to separate consideration for transactions that have many elements.**
- **It does not affect industries with existing guidance, such as construction or software vendors, but will impact those industries that needed to consider software as a component of hardware sales**

# Multiple deliverable revenue arrangements

## ■ Main provisions:

- Arrangements with multiple deliverables shall be divided into separate units of account if both of the following criteria are met:
  - The items have value to the customer on a standalone basis; that is they are either sold separately by the vendor or the customer can resell the item (whether or not a market exists)
  - If the arrangement has a general right of return, delivery or performance is consider probable and in control of the vendor
- Consideration is allocated to the deliverables, using the relative selling price method, based on:
  - Vendor Specific Objective Evidence if available
  - Third party evidence if VSOE is not available
  - Estimated selling price if neither available

# Share based payment awards

- **ASU 2010-13: *Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades***
- **Effective dates: for fiscal years and interim periods beginning after 12/15/2010**
- **Clarifies that an employee award with a strike price denominated in a currency other than the entities functional currency should not be considered to contain a condition that is not market, performance or service based and therefore should not be classified as a liability.**

# Software elements

- **ASU 2009-14: *Certain Revenue Arrangements That Include Software Elements***
- **Effective prospectively for arrangements entered into in fiscal years beginning after 06/15/2010**
- **Changes the accounting model to scope out of software revenue recognition guidance sales of tangible products that include a significant software component that function together and in which the software is essential**

# Software elements

## ■ Determining whether software is essential is based on judgment with the following guidance:

- If sales of the tangible product without the software elements are infrequent, a rebuttable presumption exists that software elements are essential to the functionality of the tangible product.
- A vendor may sell products that provide similar functionality, such as different models of similar products. If the only significant difference between similar products is that one product includes software that the other product does not, they will be considered the same product for the purpose of evaluating factor (above)
- A vendor may sell software on a standalone basis. The vendor also may sell a tangible product containing that same software. The separate sale of the software does not lead to a presumption that the software is not essential to the functionality of the tangible product.
- Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product's functionality.
- The non-software elements of the tangible product must substantively contribute to the tangible product's essential functionality. For example, the tangible product should not simply provide a mechanism to deliver the software to the customer.

# SEC Work Plan for Consideration of IFRS

- Staff continues to evaluate whether and how US registrants would migrate to IFRS
- A developing strategy is one referred to as “condorsement,” wherein the FASB would endorse new IFRS standards over a period of time after sufficient evaluation of the impact on US capital markets
- The AICPA is recommending that US registrants be provided an option to adopt IFRS for their periodic reporting

# IFRS for SME Option

- **One option for smaller private entities is to adopt IFRS for Small and Medium Size Entities.**
- **IFRS for SME's is generally less complex than US GAAP, with some of the following differences:**
  - Simplified disclosures related to pensions, leases and financial instruments
  - LIFO method for inventory is not permitted
  - Goodwill and indefinite lived intangibles are amortized over a period not to exceed ten years
  - Depreciation is based on a component approach
  - Accounting for income taxes is simplified
  - Reversal of impairment charges is allowed
  - More use of cost for financial assets and liabilities