

Accounting issues
Achieving Off-Balance Sheet Treatment

Principles of Consolidation:

- Generally based on having a "controlling financial interest" in another entity
 - Typically indicated by majority voting control
 - Also based on risks and rewards
- A Variable Interest Entity ("VIE") exists, in general, when voting interests are not necessarily indicative of a "controlling financial interest"

© 2009 FASB/IFAC. All rights reserved. FASB/IFAC is a not-for-profit organization. All rights reserved. FASB/IFAC is a not-for-profit organization. All rights reserved.

Accounting issues
Achieving Off-Balance Sheet Treatment – FAS 167

FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) ("FAS 167")

Effective Date

- Issued in June 2009 and became effective January 1, 2010 for calendar-year entities

An entity is a VIE and subject to FAS 167 if any of the following conditions exist:

- Total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support;
- As a group, the holders of the equity investment at risk lack:
 - The power to direct the activities of an entity that most significantly impact the entity's economic performance
 - The obligation to absorb the expected losses of the entity
 - The right to receive the expected residual returns of the entity
- The voting rights of some investors are not proportional to their economic obligations or rights, and substantially all of the entity's activities are conducted on behalf of an investor that has disproportionately few voting rights.

© 2009 FASB/IFAC. All rights reserved. FASB/IFAC is a not-for-profit organization. All rights reserved. FASB/IFAC is a not-for-profit organization. All rights reserved.

Accounting issues
Achieving Off-Balance Sheet Treatment – FAS 167

- If an entity is not within the scope of FAS 167, other consolidation literature applies.
- If an enterprise holds a variable interest in a VIE, it must continuously evaluate whether it has a controlling financial interest in the entity and, thus, is the entity's primary beneficiary. Only one enterprise, if any, is expected to be identified as the primary beneficiary.
- An enterprise shall be deemed to have a controlling financial interest in a VIE if it has both of the following characteristics:
 - The power to direct the activities of a VIE that most significantly impact the entity's economic performance
 - The obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE
- Enhanced and robust disclosures are required.

© 2009 FASB/IFAC. All rights reserved. FASB/IFAC is a not-for-profit organization. All rights reserved. FASB/IFAC is a not-for-profit organization. All rights reserved.

Accounting issues
Achieving Off-Balance Sheet Treatment – FAS 166

Questions often arise on legal letters as support for the true sale criterion of FAS 166 related to legal isolation, specifically relating to:

- Applicable jurisdictions
- Foreign jurisdictions
- Opinion language and qualifications
- Application of insolvency or receivership laws
- Substantive consolidation
- Consideration of all forms of recourse
- Consideration of all side agreements
- Auditor's ability to use and rely on opinion

© 2008 PwC LLP, a U.S. member firm of PwC network of member firms affiliated with the PwC network. All rights reserved.
PwC in the U.S.A., "PwC" refers to PwC LLP and separate subsidiaries of PwC network.

Accounting issues
Achieving Off-Balance Sheet Treatment – FAS 166

Qualified special purpose entities ("QSPEs")

- Prior to January 1 (for calendar-year entities), there was a concept of qualified special purpose entities:
 - Demonstrably distinct
 - Limits on permitted activities
 - Limits on the assets it can hold
 - Limits on sale from the QSPE
- Previously, QSPEs did not have to be consolidated. However, FAS 166 removed the concept of a QSPE from accounting literature, and all entities must now be evaluated for consolidation.

© 2008 PwC LLP, a U.S. member firm of PwC network of member firms affiliated with the PwC network. All rights reserved.
PwC in the U.S.A., "PwC" refers to PwC LLP and separate subsidiaries of PwC network.

**Fair Value
Accounting**

© 2008 PwC LLP, a U.S. member firm of PwC network of member firms affiliated with the PwC network. All rights reserved.
PwC in the U.S.A., "PwC" refers to PwC LLP and separate subsidiaries of PwC network.

Accounting issues
Fair Value Accounting and Its Implications for Financial Products – FAS 157

Overview of FASB Statement No. 157, Fair Value Measurements ("FAS 157")

Why a standard on fair value measurement

- Different definitions of fair value and limited guidance for applying those definitions in GAAP
- Guidance dispersed among many accounting pronouncements that require fair value measurements
- Differences in that guidance created inconsistencies that added to the complexity of applying GAAP

What does FAS 157 do?

- Establishes a single authoritative definition of fair value to be used when fair value measurements are required or permitted by other accounting
- Creates a framework for measuring fair value
- Expands disclosures about the use of fair value

FAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

- Exit price notion (vs. entry price)
- Emphasis on market participants

© 2009 FASB/IFAC. All rights reserved. FASB/IFAC is a not-for-profit organization. All rights reserved.
Reprinted from FASB, "FASB Statement No. 157, Fair Value Measurements," 14

12

Accounting issues
Fair Value Accounting and Its Implications for Financial Products – FAS 157

Key Concepts

- Unit of Account
 - A fair value measurement is for a particular asset or liability
 - Measurement should consider attributes specific to the asset or liability
 - Unit of account determined by other applicable GAAP
- Principal market or most advantageous market
 - Principal market: market in which the reporting entity would transact with the greatest volume and level of activity
 - Most advantageous market: market in which the reporting entity would transact with the price that maximizes the amount considering transaction costs
- Highest and best use of an asset
 - In-use
 - In-exchange

© 2009 FASB/IFAC. All rights reserved. FASB/IFAC is a not-for-profit organization. All rights reserved.
Reprinted from FASB, "FASB Statement No. 157, Fair Value Measurements," 14

13

Accounting issues
Fair Value Accounting and Its Implications for Financial Products – FAS 157

Valuation Techniques

- Market approach
- Income approach
- Cost approach

Inputs to valuation techniques may be observable or unobservable

- Observable inputs – reflect assumptions market participants would use in pricing, which are developed based on market data obtained from sources independent of the reporting entity
- Unobservable inputs – reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing, which are developed based on the best information available

Disclosures

- Fair value hierarchy table
- Level 3 roll forward table (amount of detail to increase in 2010 and 2011)
- Significant transfers into and out of Level 1 and 2 measurements (new requirement beginning in 2010)

© 2009 FASB/IFAC. All rights reserved. FASB/IFAC is a not-for-profit organization. All rights reserved.
Reprinted from FASB, "FASB Statement No. 157, Fair Value Measurements," 14

14

Accounting issues
 Fair Value Accounting and Its Implications for Financial Products – FAS 157

Inputs to valuation techniques may be observable or unobservable

Hierarchy of Inputs to Valuation Techniques	
Level	Input
1	Quoted prices in active markets for identical assets or liabilities.
2	Observable prices in active markets for similar assets or liabilities. Prices for identical or similar assets or liabilities in markets that are not active. Directly observable market inputs for substantially the full term of the asset or liability, e.g., interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, default rates, and credit spreads. Market inputs that are not directly observable but are derived from or corroborated by observable market data.
3	Unobservable inputs based on the reporting entity's own assumptions about the assumptions that a market participant would use, including inputs derived from extrapolation and interpolation that are not corroborated by observable market data.

© 2008 FASB/IFAC. All rights reserved. This document is the property of FASB/IFAC. It is not to be distributed outside of FASB/IFAC.

Accounting issues
 Fair Value Accounting and Its Implications for Financial Products – FAS 159

Overview of FASB Statement No. 159, The Fair Value Option for Financial Assets and Liabilities

What is the fair value option?

- Companies may elect to measure certain assets and liabilities at fair value with changes in value recognized in earnings each reporting period.
- Applied on an instrument by instrument basis (with limited exceptions)
- "Irrevocable" election (unless a new election date occurs)
- Applied only to entire instrument, and not to only specified risks, specific cash flows, or portions of the instrument
- Requires a one-time cumulative-effect adjustment to retained earnings upon adoption
- Applicable for most calendar year companies by January 1, 2008

© 2008 FASB/IFAC. All rights reserved. This document is the property of FASB/IFAC. It is not to be distributed outside of FASB/IFAC.

Accounting issues
 Fair Value Accounting and Its Implications for Financial Products – FAS 159

Scope of Eligible Items:

All entities may elect the fair value option for the following eligible items:

- Recognized financial assets and liabilities (except as otherwise noted)
- Firm commitments that would otherwise not be recognized at inception and involve only financial instruments
 - Example: A forward purchase commitment for a loan that is not readily convertible to cash
- Written loan commitments
- Rights and obligations under insurance contracts or warranties that can be settled by paying a third party to provide goods or services
- Host financial instrument resulting from bifurcation of an embedded nonfinancial derivative instrument

© 2008 FASB/IFAC. All rights reserved. This document is the property of FASB/IFAC. It is not to be distributed outside of FASB/IFAC.

Accounting issues
Fair Value Accounting and Its Implications for Financial Products – FAS 159

Recently Issued Guidance

- FASB Staff Position FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly"
- FASB Staff Position FAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instruments"
- Accounting Standards Update 2009-05, "Measuring Liabilities at Fair Value"

Instruments with Debt and Equity Characteristics

Accounting issues
Instruments with Debt and Equity Characteristics - Background

FASB Concepts Statement No. 6, Elements of Financial Statements, provides the following definitions:

Liabilities

- Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
 - Principal concept is that of an economic obligation.

Equity, or net assets

- The residual interest in the assets of an entity that remains after deducting its liabilities.
 - Equity is only defined by not meeting the definition of an asset or liability.

Conceptual question – should the definitions of liabilities and equity focus on:

- Ownership relationship?
- Settlement?
- Both?

Accounting issues
Instruments with Debt and Equity Characteristics - Background

SEC speech by David Kane in 2000 provided the following guidance:

Indicators that an instrument is more akin to debt

- Securities have a principal amount and fixed final maturity date with periodic cash payments
- Securities have no potential for capital appreciation or growth in the principal amount of the investor's investment
- Sponsor was unable to obtain a legal opinion concluding that the securities would be deemed to be equity under the law
- Securities are marketed as debt securities

Indicators that an instrument is more akin to equity

- Securities treated as equity instruments for both tax and ERISA purposes
- There is minimal capital subordinate to the risk-linked securities
- Holders of the risk-linked securities have very limited creditor rights

Accounting issues
Instruments with Debt and Equity Characteristics- FASB Project

The Liabilities and Equity project

Project-Phase I	<p>Phase I: FAS 150, <i>Accounting for Certain Instruments with Characteristics of both Liabilities and Equity</i>, May 2003</p> <p>Addresses classification of certain financial instruments, including:</p> <ul style="list-style-type: none"> - Mandatorily redeemable financial instruments - Obligations to repurchase the issuer's equity shares by transferring assets - Certain obligations to issue a variable number of shares
Project-Phase II	<p>Phase II: Develop a comprehensive final standard</p> <p>Objectives are as follows:</p> <ul style="list-style-type: none"> • Issue a final Statement that will supersede and replace FAS 150 • Single comprehensive set of standards for classifying all financial instruments • Modified joint approach with the IASB • Complete and representational • Improve classification, measurement, and presentation • Provide decision-useful information about an entity's obligations

Accounting issues
Instruments with Debt and Equity Characteristics – EITF 00-19

Basic concepts from EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19")

Characteristics of Equity

- Contracts that require physical settlement or net-share settlement
- Contracts that give the company a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement), assuming that additional criteria is met (if applicable)

Characteristics of assets or liabilities

- Contracts that require net-cash settlement (including a requirement to net cash settle the contract if an event occurs and if that event is outside the control of the company)
- Contracts that give the counterparty a choice of net-cash settlement or settlement in shares (physical settlement or net-share settlement)
