



Accounting & Financial Reporting

# Quarterly Outlook

September 2009

KPMG LLP

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KPMG's *Quarterly Outlook* provides summaries of major developments that may impact your accounting and financial reporting in the current period and the near future.

This edition addresses reporting considerations relating to the SEC's *Dear CFO* letter to certain financial institutions about loan loss disclosures and the FASB *Accounting Standards Codification*<sup>™</sup>, which is effective for September 30, 2009 financial statements.

The *Upcoming Financial Reporting Matters* section discusses a number of accounting standards that have been issued but are not yet effective for the current reporting period. Although not yet effective, these standards are subject to SEC disclosure requirements about the impact of accounting standards issued but not yet adopted. That section describes recent FASB guidance on consolidation of variable interest entities, which will make it more difficult for such entities to remain "off-balance-sheet," and transfers of financial assets, which eliminates the concept of qualifying special purpose entities. Recent decisions by the EITF that will make it possible for some entities to achieve up-front revenue recognition for delivered items in multiple-element arrangements are also addressed.

The *Looking Ahead—Ongoing Standard-Setting and Other Activities* section provides a preview of financial reporting matters that are currently in-process, including the FASB and IASB projects on accounting for financial instruments.

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## Financial Reporting Matters for the Current Quarter

### SEC Recommends More MD&A Disclosures about Loan Losses

In August 2009, the SEC staff issued a Dear CFO letter to certain financial institutions expressing views about a number of disclosure issues that should be considered in preparing Management's Discussion and Analysis (MD&A) related to provisions and allowances for loan losses, including:

- Higher-risk loans – Certain types of loans, such as option-ARM products, junior lien mortgages, high loan-to-value ratio mortgages, interest-only loans, subprime loans, and loans with teaser rates, can have a greater risk of non-collection than other loans. Additional information about higher-risk loans may be useful to understand the risks associated with a company's loan portfolio and to evaluate any known trends or uncertainties that could materially impact a company's results of operations. For example, the staff suggested disclosing current loan-to-value ratios by higher-risk loan type and further segregating them by geographic region if concentrations exist.
- Changes in practices – If practices change for determining the allowance for loan losses, a company should explain why the change was made and, to the extent possible, quantify its effect. The staff also suggested that companies consider additional disclosures, such as how current economic factors affecting loan quality were incorporated into the allowance estimate.
- Declines in collateral value – A decline in the value of assets serving as collateral for loans may affect a company's ability to collect on those loans, so companies should disclose this information. The staff suggested disclosing the approximate amount or percentage of residential mortgage loans as of the end of the reporting period with loan-to-value ratios above 100%.

In addition to providing the disclosure recommendations, the SEC's letter contained a reminder that, while the determination of allowances for loan losses requires management to apply judgment, it is not appropriate to delay recognition of credit losses that can be estimated based on current information and events. The letter states that the SEC will take appropriate action if it believes that a financial institution's financial statements are inconsistent with GAAP.

**Effective Date:** There are no effective dates associated with Dear CFO letters. Companies should consider the contents of the letter when preparing their next quarterly or annual filing.

**For More Information:** The full text of the letter can be accessed at the SEC's Web site [www.sec.gov/divisions/corpin/guidance/loanlossesltr0809.htm](http://www.sec.gov/divisions/corpin/guidance/loanlossesltr0809.htm).

### The FASB Codification Has Arrived

The *FASB Accounting Standards Codification*<sup>TM</sup> is effective for interim and annual periods ending after September 15, 2009. The Codification is now the

exclusive authoritative reference for nongovernmental U.S. GAAP except for SEC rules and interpretive releases, which are also authoritative GAAP for SEC registrants.

The Codification brings together in one place all authoritative GAAP previously in the superseded GAAP hierarchy that has been issued by standard setters, e.g., FASB Statements, FASB Interpretations, EITF Abstracts, FASB Staff Positions, and AICPA Statements of Position and Audit and Accounting Guides. Nonauthoritative GAAP includes items previously in the GAAP hierarchy's lowest level (e.g., prevalent industry practice) and other accounting guidance, such as textbooks and articles.

Going forward, accounting pronouncements issued by the FASB will be called *Accounting Standards Updates* (ASUs) and the related standard-setting activities will continue to be subject to the FASB's due-process procedures, including public Board meetings and published exposure documents with comment periods. ASUs are identified by the year of issuance followed by a number locating the pronouncement within the sequence of updates issued during that year. For example, the designation for the first new accounting pronouncement issued in 2010 would be "Accounting Standards Update No. 2010-01." All authoritative GAAP issued by the FASB will use this format, and there will be no further additions to the series of FASB Statements, FASB Interpretations, and FASB Staff Positions. Final consensuses of the Emerging Issues Task Force (EITF) that are ratified by the FASB also will be issued as ASUs.

The transition to the Codification may provide companies an opportunity to review their disclosures and make revisions using plain English descriptions of their policies or enhancing their descriptions of the accounting treatment for specific financial statement items and transactions, rather than referring to specific provisions in GAAP. We believe that in many cases it is more helpful to financial statement users to describe the specifics of the accounting policy applied in the financial statements rather than simply refer to the GAAP text. For example, a clear description of a company's accounting policies for share-based payment arrangements often would be more relevant to financial statement users than a general statement that the company follows an accounting standard such as Statement 123R (ASC 718).<sup>1</sup>

We understand that when references to authoritative GAAP are included in financial reports, the SEC staff will expect registrants to cite the relevant parts of the Codification rather than "legacy" GAAP in financial statements for interim and annual periods ending after September 15, 2009. Although the SEC staff may not require registrants to amend filings merely to change GAAP references to the Codification, the staff may consider providing a reminder in comment letters not to refer to legacy GAAP in future filings. We also understand that registrants should not use Codification references for the SEC content that is in the Codification and instead should continue to refer to the applicable SEC rule or regulation (e.g., Regulation S-X or a Staff Accounting Bulletin).

The SEC staff indicated in the June 2009 Center for Audit Quality SEC Regulations Committee meeting that after the Codification's effective date,

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<sup>1</sup> FASB Statement No. 123 (revised 2004), Share-Based Payment (FASB ASC Topic 718, Compensation—Stock Compensation), available at [www.fasb.org](http://www.fasb.org).

it does not expect companies to revise or amend financial statements previously filed for prior periods simply because subsequent financial statements for periods ending after September 15, 2009 refer to the Codification. For example, a company's December 31, 2008 Form 10-K, with references to only pre-Codification GAAP literature, may be incorporated by reference into a Form S-3 registration statement that becomes effective after September 15, 2009, even if the Form S-3 also incorporates by reference the September 30, 2009 Form 10-Q that refers to the Codification.

In addition to reviewing references to GAAP in financial statements, companies also should consider replacing and updating GAAP references in internal documents, such as accounting policy manuals.

**Effective Date:** Financial statements prepared for interim and annual periods ending after September 15, 2009.

**For More Information:** See [Defining Issues 09-30](#), [Statement 168](#), and the [FASB Codification](#).

## Upcoming Financial Reporting Matters

### More Consolidation of VIEs; QSPEs Eliminated

More variable interest entities (VIEs) are expected to be consolidated, and new criteria will govern whether transfers of financial assets are accounted for as sales as a result of recently issued Statements 166 and 167.<sup>2</sup> Although the Statements are not yet effective, the analysis and implementation effort will be significant for many companies. Companies that have interests in potential variable interest entities or engage in transfers of financial assets should be devoting resources now to prepare for the adoption of that guidance.

Statement 166, which amends Statement 140, eliminates the concept of a "qualifying special-purpose entity" (QSPE) and associated guidance, creates more stringent conditions for reporting a transfer of a portion of a financial asset as a sale, clarifies other sale-accounting criteria, and changes the initial measurement of a transferor's interest in transferred financial assets.<sup>3</sup>

Former QSPEs will be evaluated for consolidation based on the provisions of FIN 46R, as amended by Statement 167.<sup>4</sup> Statement 167 also changes the approach to determining a VIE's primary beneficiary (the reporting entity that must consolidate the VIE) and requires companies to continuously reassess whether they must consolidate VIEs.

Statements 166 and 167 also require year-end and interim disclosures by both public and nonpublic companies that are similar to the disclosures previously required solely for public companies under a FASB Staff Position that was issued in December 2008.<sup>5</sup>

<sup>2</sup> FASB Statements No. 166, Accounting for Transfers of Financial Assets (FASB ASC Topic 860, Transfers and Servicing), and No. 167, Amendments to FASB Interpretation No. 46(R) (FASB ASC Topic 810, Consolidation), both available at [www.fasb.org](http://www.fasb.org).

<sup>3</sup> FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FASB ASC Topic 860, Transfers and Servicing), available at [www.fasb.org](http://www.fasb.org).

<sup>4</sup> FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities (FASB ASC Topic 810, Consolidation), available at [www.fasb.org](http://www.fasb.org).

<sup>5</sup> FASB Staff Position No. FAS 140-4 and FIN 46(R)-8, Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities (FASB ASC Topic 860, Transfers and Servicing), available at [www.fasb.org](http://www.fasb.org).

**Effective Date:** The Statements are effective (including for existing QSPEs) as of the beginning of a company's first fiscal year that begins after November 15, 2009 (January 1, 2010 for calendar-year-end companies), and for subsequent interim and annual reporting periods. Statement 166's disclosure requirements must be applied to transfers that occurred before and after its effective date. Early application is prohibited by both Statements.

**For More Information:** See [Defining Issues 09-27](#), [Statement 166](#), and [Statement 167](#).

## Revenue Recognition...Big Changes on the Way

On September 23, the FASB ratified two EITF consensuses that will significantly affect the revenue recognition accounting policies for companies across a wide range of industries for transactions that involve multiple deliverables and sales of software-enabled devices. In many cases, the new guidance will enable companies to recognize revenue on these types of transactions earlier than under current requirements. Under the first consensus (EITF 08-1), companies will be required to allocate revenue in arrangements involving multiple deliverables based on the estimated selling price of each deliverable, even though such deliverables are not sold separately either by the company itself or other vendors.<sup>6</sup> Under the second consensus (EITF 09-3), sales of tangible products that contain "essential" software will no longer be subject to the stringent revenue recognition requirements that apply to software licensing arrangements (SOP 97-2).<sup>7</sup>

**Multiple-Element Arrangements:** EITF 00-21 (ASC Subtopic 650-25) sets requirements that must be met for a company to recognize revenue from the sale of a delivered item that is a part of a multiple-element arrangement when other items have not yet been delivered. One of those requirements is that there be objective and reliable evidence of the fair value of the undelivered items.<sup>8</sup>

Under current standards the requirement for objective and reliable evidence of the fair value of an undelivered item is best satisfied by the price of a deliverable when it is sold separately by the company, often referred to as "vendor-specific objective evidence" (VSOE) of fair value. The current requirements also specify that third party evidence (TPE) of fair value, which is based on stand-alone sales prices of the vendor's or any competitor's largely interchangeable products or services, would meet the requirement in the absence of VSOE of fair value. However, for certain deliverables that may be included in a multiple-element arrangement (e.g., future products that have not yet been developed), objective and reliable evidence of fair value (either VSOE or TPE) is not available, often resulting in deferral of all revenue under the arrangement until those items have been delivered. Some people, including us, believe those requirements unnecessarily delay revenue recognition for certain arrangements.

The new guidance in EITF 08-1 addresses those concerns by eliminating the requirement that all undelivered elements have objective and reliable

<sup>6</sup> Final Consensus: EITF Issue No. 08-1, Revenue Arrangements with Multiple Deliverables, available at [www.fasb.org](http://www.fasb.org).

<sup>7</sup> Final Consensus: EITF Issue No. 09-3, Certain Revenue Arrangements That Include Software Elements, available at [www.fasb.org](http://www.fasb.org), and AICPA Statement of Position No. 97-2, Software Revenue Recognition (ASC Subtopic 985-605, Software—Revenue Recognition, available at [www.fasb.org](http://www.fasb.org)).

<sup>8</sup> EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables (ASC Subtopic 650-25, Revenue Recognition—Multiple-Element Arrangements), available at [www.fasb.org](http://www.fasb.org).

evidence of fair value (VSOE or TPE) before a company can recognize the portion of the overall arrangement fee that is attributable to items that already have been delivered. In the absence of vendor-specific objective evidence and third-party evidence for one or more elements in a multiple-element arrangement, companies will estimate the selling prices of those elements. The overall arrangement fee will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those estimated selling prices are evidenced by VSOE or TPE, or are based on the company's judgment.

**Device Manufacturers:** SOP 97-2 (ASC Subtopic 985-605) addresses the accounting for revenue transactions involving software. Prior to adoption of the new guidance, SOP 97-2 applies to revenue arrangements for products or services that include software that is "more-than-incidental" to the products or services as a whole. Many tangible products in today's marketplace contain more-than-incidental software and, as a result, the revenue recognition guidance in SOP 97-2 is broadly applied to an extent that may not have been contemplated when those requirements were initially established. For example, sales of medical devices, networking equipment, telecommunications systems, "smart" phones, and related tangible products are often subject to software revenue recognition accounting requirements. Many companies and investors have expressed significant concerns, which we agree with, that the accounting treatment does not reflect the underlying economics in circumstances in which a product is delivered to a customer and no revenue is recognized because VSOE of fair value does not exist for another element of the arrangement that has not yet been delivered.

To address these concerns, the guidance in EITF 09-3 will exclude tangible products from the scope of software revenue accounting requirements (SOP 97-2) if the product contains both software and non-software components that function together to deliver a product's essential functionality. For those tangible products, the new guidance in EITF 08-1 will be applied and a greater proportion of the revenue from multiple-element arrangements involving tangible products that contain software will be recognized up front in many circumstances.

**Effective Date:** The consensuses for both EITF 08-1 and 09-3 will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. However, early adoption is permitted. If a company elects early adoption and the period of adoption is not the beginning of its fiscal year, the requirements must be applied retrospectively to the beginning of the fiscal year. Retrospective application to prior years is an option, but is not required. In the initial year of application, companies are required to make qualitative and quantitative disclosures about the impact of the changes.

In many circumstances, the new guidance in EITF 08-1 and 09-3 will require significant changes to a company's revenue recognition policies and procedures, including system modifications. Affected companies should expect that significant lead-time may be necessary to make those changes prior to adoption.

**For More Information:** See KPMG [Defining Issues 09-41](#).

## What is the Fair Value of a Liability?

Companies determining the fair value of a liability may use the perspective of an investor that holds the related obligation as an asset, according to new FASB guidance that modifies provisions originally in Statement 157 (ASC 820).<sup>9</sup> It addresses practice difficulties caused by the tension between fair-value measurements based on the price that would be paid to transfer a liability to a new obligor and contractual or legal requirements that prevent such transfers from taking place. No new fair-value measurements are required by the guidance.

The guidance reiterates that the definition of fair value for a liability is the price that would be paid to transfer it in an orderly transaction between market participants at the measurement date. It also reiterates that a company must reflect its own nonperformance risk, including its own credit risk, in fair-value measurements of liabilities.

In the absence of a quoted price in an active market for an identical liability at the measurement date, which generally would not be available because liabilities are not exchange-traded as liabilities, companies may apply approaches that use the quoted price of an investment in the identical liability or similar liabilities traded as assets or other valuation techniques consistent with the fair-value measurement principles in Statement 157 (ASC 820). The new guidance permits fair value measurements of liabilities that are based on the price that the company would pay to transfer the liability to a new obligor at the measurement date, which is consistent with existing guidance. However, the new guidance also permits a company to measure the fair value of liabilities using an estimate of the price it would receive to enter into the liability at that date. Such measurements could be achieved using a valuation technique that is consistent with an income-approach valuation technique (e.g., a discounted-cash-flow technique) or a market approach (e.g., a recent transaction involving the issuance of a similar liability, adjusted for differences between that transaction and the liability being measured).

**Effective Date:** The new guidance is effective for interim and annual periods beginning after August 27, 2009, and applies to all fair-value measurements of liabilities required by GAAP.

**For More Information:** See [Defining Issues 09-37](#) and [ASU 2009-05](#).

## Looking Ahead—Ongoing Standard-Setting and Other Activities

### Estimating the Fair Value of Alternative Investments

Investors will be permitted, as a practical expedient, to estimate the fair value of investments in investment companies without a readily determinable fair value using net asset value per share if the FASB finalizes its proposed guidance as expected.<sup>10</sup>

The practical expedient could also be used in estimating fair value for investments in foreign and other entities (for example, real estate funds) that

<sup>9</sup> FASB Accounting Standards Update 2009-05, *Measuring Liabilities at Fair Value*, available at [www.fasb.org](http://www.fasb.org).

<sup>10</sup> Proposed FASB Staff Position No. FAS 157-g, *Estimating the Fair Value of Investments in Investment Companies That Have Calculated Net Asset Value per Share in Accordance with the AICPA Audit and Accounting Guide, Investment Companies*, available at [www.fasb.org](http://www.fasb.org), and *AICPA Audit and Accounting Guide, Investment Companies*, May 2008 (ASC Topic 946, *Financial Services-Investment Companies*, available at [www.fasb.org](http://www.fasb.org)).

have the attributes of investment companies and calculate net asset value or its equivalent consistent with the measurement principles of the AICPA Audit and Accounting Guide, *Investment Companies*. In general, the practical expedient would allow companies to use the net asset value as a fair value estimate when the investment does not have a readily determinable fair value.

The new guidance is also expected to contain incremental disclosure requirements for investments that are within the scope of its guidance.

**Effective Date:** The new guidance is expected to be effective for periods ending after December 15, 2009. Early adoption is expected to be permitted.

**For More Information:** See [Defining Issues 09-35](#), [Defining Issues 09-25](#), and [Proposed FSP FAS 157-g](#).

## FASB Proposes to Expand Disclosures about Fair-Value Measurements

Reporting entities would be required to disclose information about how alternative inputs could affect their fair-value measurements as well as additional information about their fair-value measurements, all at a greater level of disaggregation, if a new FASB proposal is adopted without change.<sup>11</sup> The additional disclosures would include information about the effect of "reasonably possible" alternative Level 3 inputs and transfers in or out of the Level 1 and 2 categories of inputs, increased disclosures of activity in Level 3 fair-value measurements, and other disclosures about inputs and valuation techniques.

The proposal would apply to all companies that provide disclosures about fair-value measurements under U.S. GAAP. If the proposal is adopted, it will more closely align the fair-value disclosures required by U.S. GAAP with those required by International Financial Reporting Standards.

Comments on the proposal are due October 12, 2009.

**Effective Date:** Most of the proposed disclosure requirements would be effective for interim and annual reporting periods ending after December 15, 2009. The sensitivity disclosures for Level 3 fair-value measurements would be effective for interim and annual periods ending after March 15, 2010.

**For More Information:** See [Defining Issues 09-39](#) and [Proposed Accounting Standards Update](#).

## Financial Instruments: FASB and IASB Consider Major Changes

The FASB and the IASB have projects underway to address the accounting for financial instruments. The two boards have agreed to work together on the project; however, they have also elected to deliberate separately. The IASB is addressing the project in three phases:

- Phase 1 – Classification and measurement. The IASB anticipates finalizing this phase in time to allow for, but not require, early application for 2009 financial statements. An exposure draft was issued on July 14, 2009 and the comment period ended on September 14, 2009.

<sup>11</sup> FASB Proposed Accounting Standards Update, Improving Disclosures about Fair Value Measurements, available at [www.fasb.org](http://www.fasb.org).

- Phase 2 – Impairment methodology. The IASB anticipates publishing an exposure draft in October 2009.
- Phase 3 – Hedge accounting. The IASB anticipates issuing an exposure draft in December 2009.

In contrast, the FASB decided that constituents should be able to comment on a complete model and anticipates issuing an exposure draft in late 2009 or early 2010 with any final standard likely not effective until 2011 at the earliest.

A number of differences have arisen to date between the IASB's proposal and the preliminary decisions made by the FASB, which could lead to significant differences in the recognition, measurement, and presentation of financial assets and liabilities.

The IASB's Exposure Draft on classification and measurement would require all financial instruments to be measured at fair value with changes recognized in net income, except for those financial instruments that have only basic loan features and are managed on a contractual-yield basis, which would be measured at amortized cost. The FASB's preliminary decisions related to recognition and measurement would require all financial instruments to be measured at fair value, with changes either being recognized in net income or other comprehensive income, except for an entity's own debt, which would be measured at amortized cost. Based on the FASB's tentative decisions, it is likely that more financial instruments would be required to be measured at fair value than under the proposed measurement model included in the IASB's exposure draft.

The Boards will continue to develop a comprehensive model for accounting for financial instruments, including hedge accounting. The Boards plan to deliberate the issues relevant to this project separately and then meet in an attempt to reconcile differences in their technical decisions.

**Effective Date:** To be determined.

**For More Information:** See the [Project Update](#) posted on the FASB Web site and [Defining Issues 09-33](#).

## Credit Loss Disclosures Getting a Closer Look from the FASB

Companies would have to disclose additional information about the allowance for credit losses and the credit risks inherent in loan and lease portfolios if a proposed FASB Statement is adopted without change as an Accounting Standards Update.<sup>12</sup>

The disclosures would include information about accounting policies for estimating the allowance for credit losses, qualitative and quantitative information about the credit risk inherent in the financing receivable portfolio, the methods used in determining the components of the allowance for credit losses, and quantitative information about the changes in receivables and the related allowance for credit losses. Comparative disclosures would be required only for periods ending after the proposed effective date.

<sup>12</sup> Proposed FASB Statement, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, available at [www.fasb.org](http://www.fasb.org).



**This is a publication of KPMG's  
Department of Professional Practice.  
212-909-5600**

**Contributing authors:**

Mark M. Bielstein  
Brian C. Stevens  
Bryan M. McCorry  
Heather L. Doxey

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**Effective Date:** If adopted as currently proposed, the new disclosure requirements would be required for interim or annual reporting periods ending after December 15, 2009 (effective December 31, 2009 for calendar-year-end companies).

**For More Information:** See [Defining Issues 09-29](#) and [Proposed FASB Statement](#).

## **SEC Proposes to Expand Executive Compensation Disclosures**

The SEC recently proposed a rule that would significantly increase registrants' disclosures about executive compensation and corporate governance in proxy and information statements.

One of the biggest changes would require that the full grant date fair value of equity-based awards given to executives and directors be reported as compensation in the year granted, even if the award will be earned and recognized as compensation cost in the company's financial statements over several years. The SEC stated that investors generally consider the amount of equity compensation awarded during a fiscal year to be more informative than the dollar amount recognized for financial reporting purposes.

Compensation Discussion and Analysis disclosure would also be broadened to include a new section about how overall employee compensation policies create incentives that can affect a company's risk management. The proposal would also require expanded disclosure about the use of compensation consultants and the potential conflicts of interest when consultants provide both executive compensation services and other consulting services. Corporate governance disclosures would be expanded to discuss the leadership structure, including whether the CEO and Chair positions are filled by the same individual and why that leadership structure is appropriate.

**Effective Date:** If approved, the rule would be effective for the 2010 proxy season.

**For More Information:** The proposed rule can be accessed at <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>.

The descriptive and summary statements in this newsletter are not intended to be a substitute for the texts of the FASB Codification, FASB pronouncements, EITF consensuses, SEC staff announcements, or any other potential or actual accounting literature or SEC regulations. Companies applying GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.