

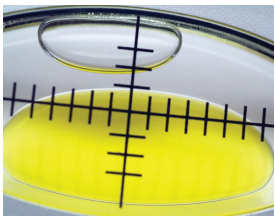
# ACCOUNTING LITIGATION SERVICES

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**New guidelines and definitions and the current financial crisis** are changing our approach – to reporting and interpreting financial information, characterizing materiality in the absence of a controlling standard, and maintaining consistency in financial reporting in the global marketplace. In this edition of our *Accounting Litigation Services Bulletin*, we examine these evolving issues and their possible effects in a litigation context.

## Fair Value Measurements: Understanding the New Guidelines

by Bruce L. Blacker



**UNDERSTANDING THE RECENTLY IMPLEMENTED GUIDELINES** for fair value measurements is essential to accurately reporting and properly interpreting financial information. Fair value

takes into account what market participants are paying and receiving for assets and liabilities at a specified measurement date. However, implementing the guidelines for fair value can be complicated, requiring the use of professional judgment in many instances – especially in volatile economic environments.

The current credit crisis has revealed the complexities and challenges of valuing certain financial instruments using fair value. Notably, mortgage-backed securities (MBS) collateralized with subprime mortgages – highly valued and frequently traded only a short time ago – are now shrouded in uncertainty and rarely traded.

### MEASUREMENT IS KEY

Fair value measurement is intended to provide financial reporting that is useful, relevant, reliable, comparable, and consistent. The primary accounting issue at the heart of proposed changes is measurement. The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157: Fair Value Measurements (SFAS 157) in September 2006. While earlier pronouncements involving valuation focused on *what* to measure at fair value, SFAS 157 focuses on *how* to measure fair value, and provides a standard method for all items for which GAAP requires the use of fair value. Therefore, the real challenge of fair value measurement is meeting these qualitative requirements while operating within the fundamental constraints of cost effectiveness, materiality, and conservatism. **(CONTINUED ON PAGE 2)**

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# Fair Value Measurements *(continued from page 1)*

## SFAS 157 Objectives

SFAS 157 took effect for financial statements issued for fiscal years beginning after November 15, 2007. As amended by FASB Staff Position FAS 157-2, issued on February 12, 2008, the effective date was deferred to fiscal years beginning after November 15, 2008 for non-financial assets and non-financial liabilities.

The objectives of SFAS 157 are to:

- Define fair value.
- Establish a framework for measuring fair value.
- Expand disclosures about fair value measurements.

## WHAT IS FAIR VALUE?

SFAS 157 provides a new definition of fair value: the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Rather than the historical-cost approach, SFAS 157 is market-based, requiring consideration of what other market participants might pay. In other words, the value is no longer based on what you paid for an asset but rather on the price at which you can sell it (the exit price).

## INPUTS TO VALUATION

The amount of data available to measure fair value will dictate how the valuation of an asset or liability is determined. Common valuation techniques identified by SFAS 157 are: the market approach, the income approach, and the cost approach. These models require inputs reflecting the assumptions market participants would use in pricing an asset or liability. In some circumstances, multiple valuation techniques should be used. The results should be evaluated and weighed, ultimately resulting in a single conclusion of fair value.

SFAS 157 inputs refer broadly to those reflecting the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. Inputs may be observable (based on market data obtained from independent sources, such as stock exchange prices) or unobservable. Without an active market for an asset or liability, unobservable inputs reflect the reporting entity's own assumptions. The SFAS

157 Standard provides a fair value hierarchy that gives highest priority to quoted prices in active markets (Level 1) and lowest priority to unobservable inputs (Level 3) (See chart below). Complexities exist in identifying the source data for the Level 3 unobservable inputs used to determine fair value; policies and procedures will need to be developed to identify and document the fair values that use unobservable inputs. Nonetheless, the Standard requires the assumptions to be based on the best information available in the circumstances.

## Hierarchy of Input Levels



One challenge in implementing the Standard is how to determine the most advantageous market if there is no principal market for assets, defined as the market with the greatest volume and level of activity. If a stock were traded on multiple exchanges with different prices, the reporting company would have to determine the most advantageous market by monitoring the prices in each market and using the price that maximizes the net amount that would be recovered. While transaction costs should be considered in arriving at this amount (i.e., determining the most advantageous market), they should not be used to measure the asset's fair value.

Determining market participants is difficult, and requires further professional judgment. Auditors and valuation experts must consider the market participant guidance in SFAS 157, which sets forth that the market participants must be independent of the reporting entity, knowledgeable about the asset or liability, and able and willing to transact. ■

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# Material or Immaterial? That Is the Question

by Elizabeth A. Evans

AT THE END OF ANY STATEMENT OF FINANCIAL ACCOUNTING STANDARDS (SFAS), one will find the note: “The provisions of this Statement need not be applied to immaterial items.” Purchase and merger agreements generally have provisions allowing the buyer/acquirer to terminate the purchase or merger if there has been a material adverse change in the seller’s or target’s financial condition during the period between the signing of the agreement and its final execution. Hence, the terms “material” and “immaterial” are important to accountants and attorneys. But what exactly do these terms mean?



## DEFINITIONS OF MATERIALITY

The SEC and accounting literature make clear that there is no “bright line” standard. Put differently, there is no single mathematical measurement (for example, five percent of net income) of materiality. There must be a full analysis of relevant considerations, according to Staff Accounting Bulletin (SAB) No. 99, “Materiality.” In short, information is considered material if it affects the total mix of information, including both qualitative and quantitative factors, available to a shareholder.

The general language of SAB 99 also can be found in FASB Concepts Statement No. 2 (CON 2) where the omission or misstatement of an item is considered material if the judgment of a reasonable person would have been changed or influenced by the inclusion or correction of the item. CON 2 stresses that materiality can be measured only by factual analysis, and that small amounts may be material.

Without a bright line standard, what guidelines should be used to ascertain whether data are material? According to SAB 99, some of the factors that may make information material include whether a misstatement:

- Masks a change in earnings or other trends.
- Hides a failure to meet analysts’ consensus expectations for the firm.
- Changes a loss into income or vice versa.
- Concerns a segment or some portion of the firm that management has

tion of materiality in that omissions or misstatements are considered material if they could influence the economic decisions of the users of financial statements. IAS 1 is much briefer in addressing this matter than SAB 99 or CON 2, and does not contain examples of factors that would make an item material.

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It is much easier to tell a client whether an item is material than whether it is immaterial. An accountant or attorney can point to specific factors describing material items, but there is no corresponding list of factors that definitively describes immaterial information.

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identified as playing a significant role in the firm’s operations or profitability.

- Affects the firm’s compliance with loan covenants.
- Alters management’s compensation (for example, increases bonuses).
- Involves concealment of an unlawful transaction.

International Accounting Standard No. 1 (IAS 1) presents a similar defini-

## MATERIAL ADVERSE CHANGE (MAC) CLAUSES

As for clauses in purchase/merger agreements related to material adverse effects or material adverse changes (MAC), consider the guidance found in *IBP v. Tyson Foods*, 2001 WL 675330 (Del. Ch. June 15, 2001). In that case, Tyson sought to terminate its merger with IBP because IBP restated its 2000 earnings on account of fraud at an IBP subsidiary. The parties **(CONTINUED ON PAGE 4)**

## Material or Immaterial? *(continued from page 3)*

pointed to differing percentages in support of their positions. Tyson, desiring to call off the merger, stated that the restatement revealed a decline in IBP's net earnings of more than 50 percent from the previous year. IBP, desiring that the merger be consummated, pointed out that the restatement reduced its equity by less than three percent.

The court, citing SAB 99 and CON 2, stated that material would be evaluated from the viewpoint of Tyson and in light of the total mix of information available. Hence, the MAC clause should be interpreted in light of the specific transaction, and the events under consideration must be unknown to the buyer. The court ruled that because Tyson had a long-term strategic plan for the acquisition of IBP, the MAC must

have long-term rather than short-term consequences. Under these conditions, the court found that the restatement did not meet the required standards. The restatement was a one-time effect and had no long-term significance. Further, the court found Tyson knew of the causes of the restatement prior to signing the merger agreement. In summary, the court concluded that Tyson was suffering from "buyer's remorse" and ordered it to acquire IBP under the terms of the merger agreement.

### CONCLUSION

With all the SEC and accounting literature at hand, accountants and attorneys have found one blind spot: it is much easier to tell a client whether an item is material than whether it is immaterial. In other words, an accountant or attor-

ney can point to specific factors describing material items, but there is no corresponding list of factors that definitively describes immaterial information. Nor is there definitive guidance on whether meeting only one of those factors makes an item material even if there is offsetting evidence related to other factors. The court's decision in *IBP v. Tyson Foods* is the best guidance on immateriality, but its specific subject matter is a MAC clause. An SFAS provision excusing its application to "immaterial items" is of limited use when the definition of "immaterial" is uncertain. ■

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### CASE HIGHLIGHT: Analysis Group Assists in Complex Tax Matter

In *AWG Leasing Trust v. United States of America*, the U.S. District Court for the Northern District of Ohio sustained an



IRS determination of tax liability related to a sale-in/lease-out transaction executed by AWG Leas-

ing Trust, an entity of taxpayers KeyCorp and PNC Bank. At issue was a \$423 million transaction in which the taxpayers purportedly purchased a German facility, contemporaneously leased the plant back to its original owner, and then claimed tax deductions for depreciation. The Court denied

the claimed depreciation and interest expense deductions, and upheld the IRS's imposition of penalties for substantial understatement of tax liability. KeyCorp and PNC Bank will owe at least \$88 million for the 1999-2003 tax years, and substantially more for subsequent years.

Managing Principal **Richard M. Starfield** and Vice President **Elizabeth A. Eccher** supported our affiliates, Professor **Thomas Z. Lys**, who testified on the economic substance of the transaction and related financing issues, and **Manfred Ernst, Ph.D.** and **Morris Shinderman**, in their analyses of complex leasing and valuation issues related to the AWG transaction. ■

# The Convergence of Global Reporting Standards: Implications for Accountants and Investors

by John M. Lacey

**A REVOLUTION IS TAKING PLACE THAT IS CHANGING THE FACE OF FINANCIAL REPORTING.** Until recently, accounting standards around the world have resembled a Tower of Babel. Today we stand on the brink of having one set of accounting standards that will be used worldwide, as more than 100 countries have committed to adopting a set of international accounting standards. The U.S. Securities & Exchange Commission (SEC) recently proposed a timeline for the transition from U.S. Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS). The SEC also eliminated the requirement that foreign private entities using IFRS must reconcile their financial statements to U.S. GAAP. Both the Financial Accounting Standards Board (FASB) and the SEC have committed to the convergence of IFRS and U.S. GAAP. Should investors be concerned that they will receive less information, or very different information, under IFRS? Or should they rejoice that they will find it easier to compare financial reports originating in different parts of the world? Probably a little of both.

## BACKGROUND

The motivation for change came from the International Organization of Securities Commission's desire to develop a single set of accounting standards that could be used on exchanges around the world. The International Accounting Standards Board (IASB) evolved from that process as a worldwide accounting standards-setting body. The IASB is an independent, privately funded entity based in London. Its 14 members come from 10 countries and have a variety of functional backgrounds. Each Board member is appointed by the Trustees of the IASB Foundation, and has one vote. Currently, there are three Board members from the United States, seven from Europe, one from South Africa, one from Australia, and two from Asia, including the most recent appointee from China.

The Board's mission is to develop, in the public interest, a single set of high-quality, understandable, and enforceable global accounting standards that requires transparent and comparable information in general purpose financial statements. As it develops IFRS, the IASB follows a rigorous and open due process. The Board also cooperates with national accounting



standard-setters to achieve convergence in standards around the world. Both the U.S. and Japan are cooperating with the IASB in the process of harmonizing their standards with IFRS.

## ADOPTION BY THE EU; CHANGES IN THE U.S.

In 2005, more than 7,000 European companies adopted IFRS, as mandated by the EU. Additionally, China and Russia have both adopted versions of IFRS.

In November 2007, an important development occurred in the U.S. – the SEC ruled that foreign companies filing their annual reports on Form 20-f could use IFRS without the otherwise-required reconciliation to U.S. GAAP. This unprecedented move allowed foreign filers to use IFRS for their 2007 and later reports. In August 2008, the SEC issued a proposed schedule for full adoption of IFRS in the U.S. The proposal, if adopted, will permit certain large multinational companies to file using IFRS as early as 2010. According to the SEC, about 110 companies would qualify. The road map would require larger companies to adopt IFRS instead of U.S. GAAP beginning in 2014. Smaller public companies would be required to adopt IFRS later.

The FASB and IASB are working together to make the two sets of standards compatible. In 2006, the two standards boards agreed to remove the need for reconciliation of their respective standards by 2008. But the SEC moved more quickly and discontinued the requirement for **(CONTINUED ON PAGE 6)**

# Convergence of Global Reporting Standards *(continued from page 5)*

standards reconciliation as of 2007. Then, in an April 2008 report, the Committee of European Securities Regulators wrote that U.S. GAAP and IFRS are converging, and will continue to evolve together. The report concluded that the two standards are effectively equivalent to each other, and recommended that the European Commission find U.S. GAAP equivalent to IFRS for use in EU markets.

The key to convergence of the standards is their many commonalities. Ultimately, the question is not *whether* IFRS will be accepted in the U.S., but *how*.

A recent move by the American Institute of Certified Public Accountants (AICPA) paved the way for CPAs to provide reports on financial statements prepared in accordance with IFRS to U.S. companies, including non-public companies. There also is a proposed IFRS for Small- and Medium-Sized Enterprises that would allow smaller companies to adopt an abbreviated version of IFRS. This, combined with the AICPA ruling, could lead to an option for small businesses in the U.S. to get a CPA's report on financial statements following an abbreviated version of IFRS.

## KEY DIFFERENCES BETWEEN IFRS AND U.S. GAAP

Many have called the IFRS "principles-based" and U.S. GAAP "rules-based." While current U.S. accounting standards are certainly based upon principles, those standards are much more specific, and they have many more examples of their application than IFRS. IFRS also are principles-based, but provide less specific guidance and fewer examples. As a consequence, more judgment is required in the application of IFRS than of the more specific standards in the U.S. Both the SEC and the FASB have agreed to move to a more principles-based approach to standard-setting, and recent standards issued by the FASB have followed this approach.

IFRS has more fair value reporting while U.S. GAAP has not moved away from historical cost as quickly. While using

## Comparing U.S. GAAP Options and IFRS:

**Plant and Equipment** – U.S. GAAP requires reporting of plant assets at cost, less accumulated depreciation. Using IFRS, assets can either be reported at cost or revalued to fair value. Interest must be capitalized under U.S. GAAP, but it is optional under IFRS.

**Intangible Assets** – U.S. GAAP requires reporting of specifically identifiable intangible assets at cost, less amortization. Using IFRS, such assets can be reported either at cost or can be revalued to fair value. This means that assets such as patents, copyrights, and brand names can be revalued periodically. U.S. GAAP requires expensing R&D costs, while IFRS allows the capitalization of development costs.

**Investments** – There are more options to carry investments at fair value under IFRS. Even real estate investments can be carried at fair value instead of historical cost.

**Inventories** – LIFO is not allowed under IFRS. The selection of an inventory cost-flow method (FIFO or weighted average) is supposed to be consistent with the physical flow of the merchandise. The computation of Lower of Cost or Market Inventory defines "market" as net realizable value. Under U.S. GAAP, market is defined as replacement cost, with an upper and lower bound. Moreover, once inventory is written down under U.S. GAAP it cannot be written back up. Under IFRS, inventory can be written back up.

**Revenue Recognition** – U.S. GAAP does not have a singular revenue recognition accounting standard. Instead, revenue recognition guidance is peppered throughout the many written accounting standards. By contrast, IFRS provides guidance on revenue recognition in a single standard for many circumstances and is, in some circumstances, different from U.S. GAAP. For example, the International Accounting Standards include guidance about revenue recognition for construction contractors in which it requires the use of completed contract accounting for construction contracts, instead of percentage of completion accounting. By contrast, for U.S. GAAP, percentage of completion accounting is preferable.

# Convergence of Global Reporting Standards *(continued from page 6)*

current fair values is more relevant to users than historical costs, in situations where comparable market price information is not available, current fair value information may be less reliable than the historical cost.

The key to convergence of the two standards is their many commonalities. IFRS is closer to the British and U.S. systems of financial reporting than to those formerly used in Continental Europe or elsewhere in the world. Ultimately, the question is not *whether* IFRS will be accepted in the U.S., but *how*.

## LOOKING AHEAD

Should investors be concerned about receiving inconsistent or inadequate information under IFRS versus GAAP? Yes. There is less disclosure required under IFRS, and the standards

themselves will mean differences in the financial statement amounts reported. For example, more fair values are used in IFRS than in GAAP, and the measurement of such fair value may not be consistent across companies.

However, reporting standards convergence also will facilitate investment and credit decisions by making it easier to compare financial reports originating in different parts of the world. The convergence of IFRS and U.S. GAAP will bring both costs and benefits, but will offer tremendous opportunity to those ahead of the curve. ■

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## CLOSING NOTE: FASB Proposal

In June 2008, the Financial Accounting Standards Board (FASB) issued a proposed statement of financial accounting standards that would amend FASB No. 5 *Accounting for Contingencies* and No. 141(R) *Business Combinations*. Under this proposal, FASB would require firms that are defendants in lawsuits to disclose either the amounts sought by the plaintiffs or the company's best estimate of its maximum exposure to loss. A company also may disclose its best estimate of possible loss or range of loss if it believes the required disclosure is not representative of actual exposure.

Defense and plaintiff attorneys differ in their opinion about these proposed disclosures. Plaintiff attorneys argue that this additional transparency benefits investors. Defense attorneys argue that this disclosure process has the ability to undermine attorney-client privilege, and that initial disclosures based on limited information may set unreasonable expectations. Auditors wonder how they will assess a "valuation of litigation." And companies complain about the high costs of this new proposal.

The proposal states that these new disclosure requirements were to apply to annual financial statements for fiscal years ending after December 15, 2008, and to annual and interim statements for subsequent fiscal years.

FASB has not yet finalized the proposal, and plans to consider further discussion on disclosure ideas before making any amendment final. ■

## New Accounting Affiliates

**Robin Cooper**, Professor in the Practice of Management Accounting at the Goizueta Business School at Emory University, specializes in the design and use of cost management systems.

**Thomas Lys**, the Eric L. Kohler Chair in Accounting and Professor of Accounting Information and Management at the Kellogg School of Management, is an expert in real estate finance, financial reporting, securities analysis, and mergers and acquisitions.

**Douglas J. Skinner**, the John P. and Lillian A. Gould Professor of Accounting at The University of Chicago Booth School of Business, concentrates on corporate finance and financial policy. ■

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