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AICPA National Conference on Banks & Savings Institutions

Accounting Update: What's New in Debit & Credit Land?

November 2007

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Agenda

- Fair Value Measurement (FAS 157)
- Fair Value Option (FAS 159)
- Impairment and valuation matters
- Pensions & Postretirement Plans (FAS 158)
- Deferred compensation & BOLI (EITF 06-4, 06-5 & 06-10)
- Materiality (SAB 108)
- Uncertain Tax Positions (FIN 48)
- ALLL and OREO observations
- Other interesting items

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Fair Value

- FAS 157, Fair Value Measurement – how to measure fair value
- FAS 159, Fair Value Option – provides the option to elect fair value for certain assets and liabilities
- Both are effective for fiscal years beginning after Nov. 15, 2007 and interim periods within.

FAS 157 – Fair Value Measurements

- FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 (January 1, 2008 for a calendar year entity)
- Prospective application except for an entity that
  - Was applying blockage factors
  - Is recognizing previously deferred day one gains (EITF 02-3) on adoption of Statement 157
  - Valued a hybrid instrument pursuant to Statement 155 at the transaction price
- If any of these exceptions apply differences between fair value and carrying amount on initial adoption → included in a cumulative-effect adjustment of beginning retained earnings

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Intended Result

Increase the consistency and comparability of fair value measurements by:

1. Creating a single definition of fair value
2. Establishing a framework for measuring fair value
3. Expanding disclosures about fair value measurements

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Amends 28 Pronouncements

- Leasing (FAS 13)
- Trouble debt restructuring (FAS 15)
- Oil and gas (FAS 19)
- Pensions (FAS 35, 87, 106)
- Insurance (FAS 60)
- Mortgage banking (FAS 65)
- Real estate (FAS 67)
- Financial instruments (FAS 107)
- Investments (FAS 115)
- Not-for-profit (FAS 124/136)
- Derivatives (FAS 133)
- Transfers of assets (FAS 140)
- Business combo's (FAS 141)
- Goodwill and intangibles (FAS 142)
- Asset retirement obligations (FAS 143)
- Liabilities and equity (FAS 150)
- Hybrids (FAS 155)
- Servicing (FAS 156)
- Guarantees (FIN 45)

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Scope

- Applies to financial and non-financial assets/liabilities
- Applies to accounting pronouncements that require or permit fair value measurements with some exceptions.
- Items measured at fair value, disclosed at fair value, and items subject to an impairment evaluation
- Existing "practicability" exceptions continue to apply

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Changing the Definition

- Exit price vs. entry price
- Orderly transaction assumes pre-measurement date exposure to market
- Market participants vs. "willing parties"
- Emphasizes market-based measurement, not an entity specific measurement
- Price in principal (or most advantageous) market from seller's perspective

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Changing the Definition

- Clarifies that restrictions on an asset should be considered if market participants would consider the effect of the restriction on pricing
- Fair value measurements of a liability shall reflect the reporting entity's credit risk
- Fair value of a large position (block) of financial instrument that trades in an active market should be measured simply as the quoted price x quantity (blockage discounts are prohibited)
- Statement 157 nullifies the exception found in footnote 3 of EITF 02-3 which prohibited recognition of day-one gains if the fair value is based on unobservable inputs

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Choosing the Appropriate Market

- Fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.
- Principal market is the market with the greatest volume and level of activity
- If no principal market, look to the most advantageous market (i.e. the market where you can maximize the amount received for an asset or minimize the amount paid for a liability to be assumed).

Market Participants

Market participants must be:

- Buyers and sellers in principal (or most advantageous) market
- Independent of reporting entity
- Knowledgeable
- Willing to transact, but not forced to do so
- Able to transact

Considerations for Assets & Liabilities

- Assets: Use of the asset by market participants that maximizes the value of the asset, or the group of assets within which the asset would be used, without regard to the intended use of the asset by the reporting entity.
- Liabilities: Fair value of a liability must consider the non-performance risk (risk obligation will not be fulfilled)
  - Entity's own credit risk
  - Delivery risk

Inputs into Valuation Techniques

- Observable inputs – inputs that reflect the assumptions **market participants** would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity
- Unobservable inputs – inputs that reflect the reporting entity's own assumptions about the assumptions **market participants** would use in pricing the asset or liability developed based on the best information available in the circumstances

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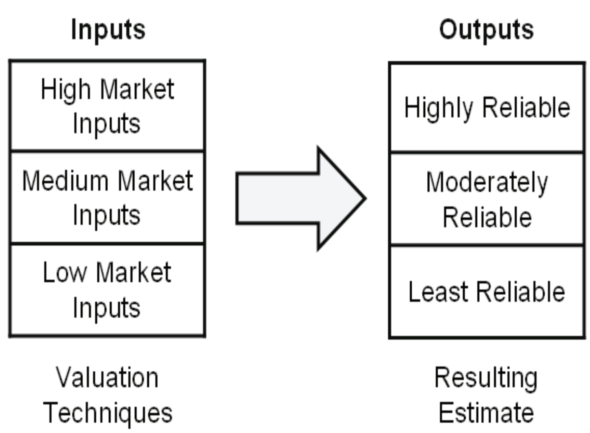
Inputs into Valuation Techniques



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Hierarchy of Inputs

- Level 1 - Quoted market prices in active markets for identical assets or liabilities
- Level 2 - Inputs other than level 1 inputs that are either directly or indirectly observable
- Level 3 - Unobservable inputs developed using the reporting entities' estimates and assumptions, which reflect those that market participants would use

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Hierarchy

- Hierarchy prioritizes inputs to valuation techniques, not the valuation techniques
- Inputs refer to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk
- Distinguishes between assumptions based on market data and assumptions (observable inputs) and an entity's own assumptions (unobservable inputs).
- Valuation techniques used to measure fair value shall (not should) maximize the use of observable inputs and minimize the use of unobservable inputs

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Potential examples of level inputs

Level	Inputs	Potential example of instruments
1	Quoted market prices in active markets for identical assets or liabilities	US Treasuries
2	Inputs other than level 1 inputs that are either directly or indirectly observable	Restricted investments
3	Unobservable inputs developed using the reporting entities' estimates and assumptions, which reflect those that market participants would use	Goodwill, mortgage servicing rights, municipal bonds

Disclosures

- Disclosures are meant to assist users in understanding the extent an entity uses fair value
- Disclosures focus on:
  - Inputs used to measure fair value
  - Level in the hierarchy in which the instrument falls
- Disclosures not required for items only disclosed at fair value
- Increased disclosures are required for level 3

The Fair Value Conundrum…

- To early adopt the fair value option or not….and what a ride is was!
- FAS 159, The Fair Value Option for Financial Assets and Financial Liabilities, issued Feb. 15, 2007
- See CAQ Alert #2007-14, FAS 159 Early Adoption Date Approaching – Factors to Consider, April 17, 2007

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Overview

- Effective beginning of the first fiscal year that begins after November 15, 2007 (January 1, 2008 for a calendar year-end entity)
- Objectives:
  - Provide the opportunity to mitigate income statement volatility without applying hedging accounting rules
  - Expand use of fair value
  - Convergence with IFRS

Overview

- Permits an election to report certain instruments at fair value with the changes in fair value included in earnings.
- Option is not available for:
  - Pensions, deferred comp, post retirement benefits
  - Stock option & purchase plans
  - Leases
  - Income tax
  - Deposit liabilities, withdrawable on demand

Election

- Initial and subsequent measurement
- Unrealized gains and losses recognized in earnings
- Applied to an entire instrument
- Irrevocable
- Instrument-by-instrument application

A Few Considerations…

- Irrevocable election – identify what you do and don’t want to carry at FV
- Impact of management’s prior assertions - The FV election does not “taint” the decision to carry other items on another basis. For investment securities, consideration still must be given to prior assertions on intent and ability to hold until recovery of FV.
- Companies should have the proper controls in place prior to electing the FV option.

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A Few Considerations…

- Regulatory Considerations:
  - Reporting (e.g. schedule RC-Q)
  - Guidance issued in June 2006 by the Basel Committee on Banking Supervision, “Supervisory guidance on the use of the fair value option for financial instruments by banks”
  - Market Risk rules
- Bookkeeping considerations: Changes in FV are recorded through income. FAS 159 does not address how to account for changing in fair value such as dividend income, interest income, or interest expense.

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A Few Considerations…

- The adoption is recorded by an adjustment to opening R/E. The difference between FV and BV is removed from the balance sheet. Examples include unamortized deferred costs, fees, premiums, and discounts, ALLL and accrued interest.
- Disclosure including management's reasons for electing fair value
- Concurrent adoption of FAS 157

FV as we know it is changing!

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Disclosures: Objectives

- Management's rationale for electing or partially electing the FVO
- How changes in FV impact earnings
- Information that would have been required if the entity did not elect the FVO
- Differences between contractual cash flows and fair value for certain items

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Impairment - Investments

- FSP FAS 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments
- Applies to all impairments not just credit quality issues (Q46, FAS 115 FASB Q&A)
- The FSP says follow:
  - SAB 59 (applies to both debt and equity securities)
  - Par. 16 of FAS 115
  - EITF 99-20
  - APB 18 (par. 6)

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CAQ White Papers

- The Center for Audit Quality (CAQ) has issued three white papers:
  - Measurements of Fair Value in Illiquid (or Less Liquid) Markets
  - Consolidation of Commercial Paper Conduits
  - Accounting for Underwriting and Loan Commitments
  - See CAQ Alert #2007-51 (Oct. 3, 2007)

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FHLB Stock – Accounting Issues

- Accounting: classified as a restricted security, carried at cost and evaluated for impairment.
- Follow impairment guidance in par. 8i of SOP 01-6:

  "When evaluating FHLB stock for impairment, its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value"

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Pensions & Postretirement Plans

- FAS 158: "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans"
  - Phase 1: Funded status is recognized in B/S
  - Phase 2: Reconsider FAS 87, FAS 88 and FAS 106

- Balance Sheet portion
  - Public - years ending after Dec. 15, 2006 (Dec. 31, 2006 for calendar year ends)
  - Private – years ending after June 15, 2007 (Dec. 31. 2007 for calendar year ends) w/ certain disclosure required at Dec. 31, 2006

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The Math: Initial Recognition

PBO	$ (2,500)	
Plan assets	1,465	
Unfunded (liability)	(1,035)	Liability under FAS 158
Items not yet recognized:		
Transition obligation	280	DR to AOCI*
Prior service cost	425	DR to AOCI*
Actuarial loss	220	DR to AOCI*
Total unrecognized	925	
Accrued (liability)	$ (110)	Liability pre-FAS 158, generally

* Offset by any deferred tax asset

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Important Note on Adoption

- Some did not implement the transition provisions of SFAS 158 as required.
- The adjustments are recognized directly in equity capital as components of the ending balance of AOCI, net of tax - not as a component of current period OCI.
- See Center for Audit Quality (CAQ) Alert #2007-30 for examples – issued June 25, 2007

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Other Considerations

- Change in measurement date:
  - Must measure at the balance sheet date
  - Effective date - fiscal years ending after Dec. 15, 2008
  - Two choices for transition
- Regulatory Capital
  - Agencies Announce Interim Decision on Impact of FAS 158 on Regulatory Capital
  - Issued Dec. 14, 2006

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BOLI/COLI and Deferred Compensation

- Three standards issued by the EITF:
  - EITF 06-4 Endorsement / Split Dollar Arrangements
  - EITF 06-5 Cash Surrender Value
  - EITF 06-10 Collateral Assignments

- Premise: BOLI/COLI and deferred compensation plans should be accounted for separately

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EITF 06-4: Deferred Comp (The Liability)

- EITF 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"
- Q: How should the employer account for the benefit of endorsement split-dollar life insurance arrangements?
- A: The benefit to the employee after the employee retires is a post-employment benefit and must be accrued for over the service period. So accrue what was promised, for example:
    - Death benefit
    - An agreement to maintain the policy – accrue the post retire mortality cost

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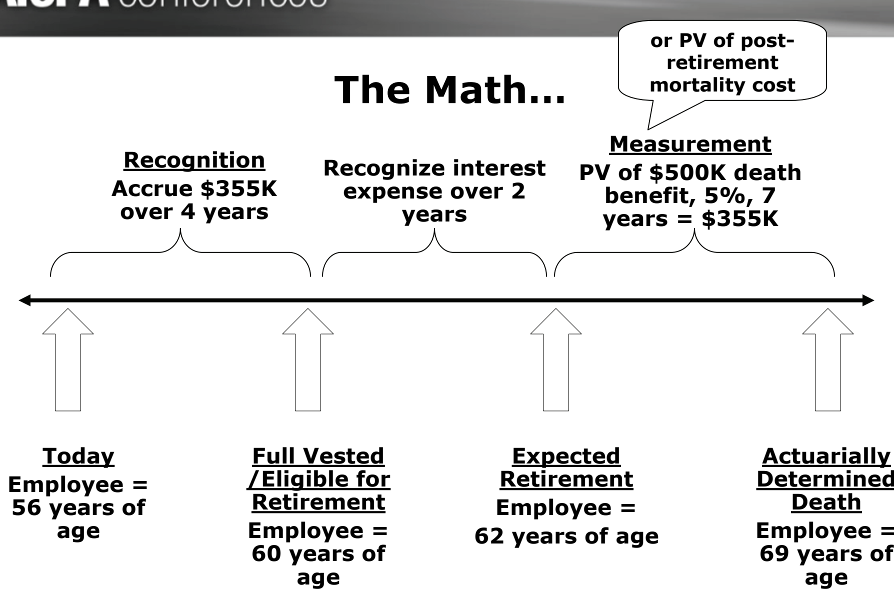
The Math…



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EITF 06-5: CSV (The Asset)

- EITF 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4."
- Carry at CSV, including other amounts that can be realized, and record changes in earnings; discretionary payments are not considered
- Watch provisions that waive surrender charges on a group basis – must evaluate on individual policy.
- No valuation haircut for contractual restrictions on the employer's ability to cancel the policy but this should be disclosed.

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EITF 06-10: Collateral Assign (Asset)

- EITF 06-10, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements"
- The employee (or the estate or trust) owns and controls the insurance policy. The asset is a receivable from the employee, rather than the CSV of a policy.
- Based on the nature and substance of the arrangement:
  - Assess future cash flows the employer is entitled to and the employee's obligation and ability to repay the loan.
  - Asset should be lesser of loan or CSV of policy if the arrangement limits the amount to CSV.

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EITF 06-10: Collateral Assign (Liability)

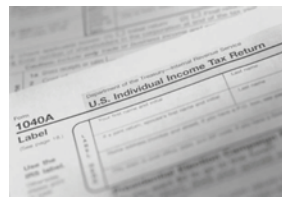
- Like 06-4, a company should record a liability associated with a collateral assignment split-dollar life insurance arrangement based on the substantive agreement
- Analyze whether the employer remains subject to the risks or rewards associated with the underlying insurance contract:
  - If the employer has effectively agreed to maintain a life insurance policy (fund the premiums) during the employee's retirement, there is a post retirement obligation.

Status and Effective Dates

- Most controversial was EITF 06-4
  - EITF received 119 comment letters
- Effective dates…
  - EITF 06-4 – fiscal years beg. after Dec. 15, 2007
  - EITF 06-5 - fiscal years beg. after Dec. 15, 2006
  - EITF 06-10 – fiscal years beg. after Dec. 15, 2007

Uncertain Tax Positions

- FIN 48 "Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109"
  - Issued June 2006
  - Effective for fiscal year beginning after Dec. 15, 2006 (so Jan. 1, 2007 for calendar-year ends).



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Uncertain Tax Positions (cont.)

- A tax position is any position taken in a tax return, or expected to be taken in a tax return not yet filed, that is used in measuring current or deferred taxes.
- Includes a decision not to file a tax return, allocations or shifts of income between jurisdictions, characterization of income, a decision to exclude income, a decision to classify a transaction, entity or other position as tax exempt.
- No detection risk: cannot factor in probability of being audited. Companies are to presume they will be audited.
- Shown as cumulative effect to retained earnings upon adoption.

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Uncertain Tax Positions (cont.)

- Auditor expectations
  - Documentation of analyses and conclusions
  - Established internal controls
- Independence considerations
- Observations

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Materiality

- SAB 108, Materiality, issued Sept. 13, 2006
- Effective for years ending after Nov. 15, 2006
- Evaluate all prior year and anticipated current year misstatements using two approaches
- Need to establish a written policy
- Impact of adoption posted to opening R/E, disclosures required.

Materiality

- Rollover
  - Income statement approach
  - Balance sheet errors accumulate
- Iron Curtain
  - Balance sheet approach
  - Correction of error
- An adjustment is required if either approach yields a material misstatement.

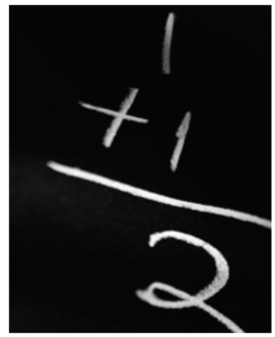
Materiality – Private Companies

- FASB's project, FSP FAS 154-a, "Evaluation and Correction of Errors Identified from the Quantification of Misstatements Associated with the Carryover or Reversing Effects of Prior Year Misstatements on Current Year Financial Statements"
  - At the Aug.1, 2007 meeting, FASB decided not to issue a final FSP and removed the project from its agenda.

For private companies!

ALLL and OREO Matters

- Regulatory Initiatives on the ALLL
- Status of the ALLL disclosure project
- Accounting for Other Real Estate Owned



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ALLL: Interagency Guidance

- Revisions to the 1993 Policy Statement and Frequently Asked Questions
  - Issued Dec. 13, 2006
  - Addresses:
    - allowances for off-balance sheet items
    - historical net charge-off rates
    - directional consistency
    - unallocated amounts
    - peer data

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ALLL: Documentation Observations

- Common improvements to documentation
  - Average years of historical losses
  - Use of peer data
  - Qualitative factors mentioned in multiple areas
  - Support for qualitative factors
    - Poor linkage
    - Inconsistent indicators
    - Discusses events which haven't occurred
  - Unallocated portion

ALLL: Disclosures Project

- Project started in early 1999
- FASB adds project in 1Q 2007
  - Objective: to address ALLL disclosures for financing receivables (loans and finance leases pursuant to FAS 13, Accounting for Leases).
  - Proposal scheduled for 1Q 2008

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Other Real Estate Owned

- FAS 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings
- FAS 66, Accounting for Sales of Real Estate
- FAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets and FASB Staff Position FAS 144-1
- APB 21, Interest on Receivables and Payables

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And last but not least....

- Business combinations
- Transfers
- Other standards effective this year
- Other projects of interest

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Business Combinations: FAS 141R

- Project developed jointly with IASB to reconsider aspects that were not deliberated in FAS 141
- Effective for annual periods beg. after Dec. 15, 2008
- Key changes:
  - Acquisition costs are expensed as incurred
  - Costs expected to be incurred are not assumed liabilities
  - Contingent consideration is an estimated liability
  - No allowance carryover
  - Includes mutual thrift combinations

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FAS 140 – 3 Developments

- Sub-Prime Matters
- Repurchase Financing Agreements Proposal, FSP 140-d
- Transfers of Financial Assets
  - Deals with all transfers, isolation issues, securitizations, etc.
  - Two proposals issued previously
  - Revised proposal scheduled for 4Q2007

This proposal deals with loan participations

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A Few Other Thoughts….

- FAS 155, Accounting for Certain Hybrid Financial Instruments
- FAS 156, Accounting for Servicing of Financial Assets
- Derivatives disclosures - scheduled 4th Q
- EPS – revised proposal scheduled 3rd Q
- IFRS / IASB Coming to America?

Questions?

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