

Insights

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Accounting

Understanding and Applying FSP FAS 126-1 – Is That Nonpublic Entity Really Nonpublic?

This is the first of two articles on FASB Staff Position (FSP) No. FAS 126-1, *Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities*, to be published in *Insights*. This article addresses situations in which an entity is a conduit bond obligor. The next article will address the determination of whether those conduit debt securities are traded in a public market.

While FSP No. FAS 126-1 and its potential impact for nonpublic entities was previously addressed in the January 23, 2007, issue of *Insights*, the intent of these articles is to further assist in identifying situations in which an entity is an obligor for conduit debt securities that are traded in a public market, and accordingly, under FSP No. FAS 126-1 meets the definition of a public entity. A nonpublic or not-for-profit entity that meets the definition of public entity under FSP No. FAS 126-1 must include certain additional financial statement disclosures from which it had previously been exempt.

Is an Entity a Conduit Bond Obligor?

In late 2006, the Financial Accounting Standards Board (FASB) issued FSP No. FAS 126-1, which extended the reach of the definition of a public entity. The FSP amended several FASB Statements, an APB Opinion, and two AICPA Audit and Accounting Guides to “clarify” the definition of a public entity. This FSP necessitates that management may need to assess whether their entity is, indeed, not public.

A not-for-profit entity (for example, a hospital or museum), or a for-profit entity (of any size, ownership structure, or type of business), may raise cash through a governmental entity. A state or unit of a local government or an agency or instrumentality of a state or local government (governmental entity) can raise funds in the capital markets by issuing municipal bonds. As permitted by the Internal Revenue Code, a governmental entity can issue conduit debt securities, which are frequently called municipal bonds or industrial revenue bonds. A conduit debt security is an offering by a governmental entity that is not for its own use but for the use of a private party that becomes a conduit bond obligor. In these types of transactions, the governmental entity is the issuer of the security but normally has no subsequent liability or continuing involvement. The private party that receives the proceeds in the transaction is the obligor and is required to make or fund all interest and principal payments as they come due and also is required to satisfy future financial reporting requirements.

Examples of conduit bond obligors include a nonprofit senior living organization that has an industrial development revenue bond used to expand existing facilities and a refuse collection operation with industrial revenue bonds to fund construction of a transfer station and purchase new trucks and equipment. The following examples further illustrate the concept of conduit bond obligors:

- Manufacturer, Inc. is constructing a new plant in Mini, USA. Mini Municipality has issued a \$25 million industrial development revenue bond to fund the construction of this facility. Manufacturer, Inc. is required to make all interest and principal payments as they come due and must satisfy any future financial reporting requirements. Manufacturer, Inc. is a conduit bond obligor.
- Heath & Educational Facilities Authority issued \$150,000 in conduit municipal bonds to pay for the purchase of land and equipment to expand First Charter School, a not-for-profit organization. First Charter School is required to make all interest and principal payments as they come due and must satisfy any future financial reporting requirements. First Charter School is a conduit bond obligor.

In the financing transactions described in the preceding paragraphs the entity that receives the proceeds makes no filing with a state or federal regulatory agency, such as the SEC, nor does it need to meet any of the requirements for an exempt transaction, such as the sale of securities to accredited investors. Nevertheless, the FSP concludes that an entity that is an obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets) meets the definition of a public entity. Thus, if an entity (either a for-profit or a not-for-profit) is involved in a financing transaction as an obligor for conduit debt securities that are traded in a public market, it must include certain additional financial statement disclosures from which it had previously been exempt.

The January 23, 2007, issue of *Insights* provides a list of the pronouncements for which the definition of a public company was amended by the FSP and for which additional disclosures may now be required together with a brief explanation of how those disclosures would affect the entity. The FSP is also available in full at http://www.fasb.org/pdf/fsp_fas126-1.pdf.

The FSP is effective for fiscal periods, including interim periods, beginning after December 15, 2006.

Summaries of FASB Statements No. 141(R) and No. 160

The Financial Accounting Standards Board (FASB) recently issued two standards – FASB Statements No. 141 (revised 2007), *Business Combinations*, and No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, which will greatly impact many companies. McGladrey & Pullen's National Office of Audit and Accounting has created fact sheets that summarize these standards and their requirements. These fact sheets are available at [http://www.mcgladrey.com/Resource_Center/Audit/Articles/SummariesofFASBStatementsNo141\(R\)and160.html](http://www.mcgladrey.com/Resource_Center/Audit/Articles/SummariesofFASBStatementsNo141(R)and160.html).

Accounting for Interest after Recognition of Other-Than-Temporary Impairment

In accordance with generally accepted accounting principles, the holder of individual debt securities classified as either available-for-sale or held-to-maturity must determine whether a decline in fair value below the amortized cost basis is other than temporary. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as a new cost basis. The new cost basis may not be changed for subsequent recoveries in fair value.

In periods subsequent to the recognition of an other-than-temporary impairment loss for debt securities, the investor should account for the other-than-temporary impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment. That is, the discount or reduced premium recorded for the debt security, based on the new cost basis, should be amortized over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows. Thus, at maturity, the carrying value of the security would be equal to its par value.

Under this method, a portion or all of the other-than-temporary impairment charge would be accreted back into income over the remaining life of the security, depending on the amount and timing of future estimated cash flows.

At the date that the other-than-temporary impairment is recognized, if the holder of the debt security believes that the par value of the security will not be received, it may not be appropriate to accrete the resulting discount into earnings over the remaining life of the security. The holder of the debt security should apply its nonaccrual policies and regulatory guidance in determining when a debt security should be placed on nonaccrual status and therefore not accrete or amortize the discount or reduced premium created through the other-than-temporary impairment write down.

To determine the appropriate accounting for interest on securities subsequent to recognition of other-than-temporary impairment, it is necessary to consider the reason for the impairment and management's ability to reliably estimate the amount of the recovery. If other-than-temporary impairment was caused by an increase in interest rates, then it would be appropriate to accrete the discount into earnings over the remaining term of the security. If the other-than-temporary impairment is due to company-specific credit issues, management should assess whether it can reliably estimate the interest and principal that will be recovered. If management can reliably estimate the recovery, it may be appropriate to accrete the discount. If management cannot reliably estimate the recovery, then nonaccrual of interest may be appropriate.

Public Sector

Report on Internal Control for Entities Subject to PCAOB and Government Auditing Standards

Certain public companies may be required to have an audit conducted in accordance with standards issued by both the Public Company Accounting Oversight Board (PCAOB) and the Comptroller General, as contained in Government Auditing Standards (GAGAS). For example, auditors of lending institutions that participate in federally sponsored loan programs, such as those for housing and education, must meet the requirements of both sets of standards in conducting their work.

Government Auditing Standards may be used in conjunction with standards issued by the PCAOB, even though these standards are not incorporated into GAGAS. The use of the PCAOB's framework for assessing control deficiencies, however, could result in inconsistencies in reporting on internal control under GAGAS. To facilitate reporting of internal control deficiencies identified during audits conducted under both PCAOB and GAGAS standards, the U.S. Government Accountability Office has provided the following guidance:

- Auditors should include in the GAGAS report on internal control any material weaknesses contained in the opinion on the effectiveness of the company's internal control over financial reporting prepared based on PCAOB Auditing Standard (AS) No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.
- Auditors who prepare the GAGAS report using material weaknesses from their opinion on the effectiveness of the company's internal control over financial reporting based on AS 5 should also include in their report any other control deficiencies that meet the definitions of "material weakness" or "significant deficiency" as defined in the American Institute of Certified Public Accountants' Statement on Auditing Standards No. 112, *Communicating Internal Control Related Matters Identified in an Audit*.

- If auditors include in the GAGAS report the material weaknesses on the basis of the definition of "material weakness" contained in AS 5, the GAGAS report on internal control should clearly state that the PCAOB's standards and definition were used, describe the scope of work performed, and provide appropriate definitions of applicable PCAOB terminology.
- Auditors are reminded that they are required to comply with all other relevant GAGAS requirements related to reporting deficiencies in internal control, including developing findings and providing recommendations for corrective action if findings are sufficiently developed, obtaining views of responsible officials, ensuring appropriate report distribution, etc.

SEC

Use of Simplified Method to Estimate Stock Option Compensation Expense

Under Financial Accounting Standards Board Statement No. 123 (revised 2004), *Share-Based Payment*, companies may rely on algorithms such as the Black-Scholes-Merton pricing model to determine the amount of their stock option compensation expense. The Black-Scholes-Merton model, as well as other models, requires a company to estimate the expected term of an option grant. In March 2005 the SEC issued Staff Accounting Bulletin (SAB) No. 107, which, among other provisions, allowed companies without access to adequate historical data about employee exercise behavior to use a simplified approach for estimating the expected term of a "plain vanilla" option grant. The simplified rule for estimating the expected term of such an option was the average of the time to vesting and the full term of the option. Question 6 of Section D.2 in SAB 107 stated that companies could use this simplified method until December 31, 2007, at which time the SEC expected detailed historical information about employee exercise behavior to be available.

Because detailed information about employee exercise behavior is not currently available, the SEC has released SAB 110 to allow eligible public companies to continue using the simplified method described in SAB 107 for estimating their stock option compensation expense. The SEC will continue to accept the use of the simplified method on an interim basis beyond December 31, 2007, provided a company concludes that its own historical share option exercise experience doesn't provide a reasonable basis for estimating expected term. Examples of situations in which the SEC believes that it may be appropriate to use the simplified method include the following:

- A company does not have sufficient historical exercise data to provide a reasonable basis upon which to estimate expected term due to the limited period of time its equity shares have been publicly traded.
- A company significantly changes the terms of its share option grants or the types of employees that receive share option grants such that its historical exercise data may no longer provide a reasonable basis upon which to estimate expected term.
- A company has or expects to have significant structural changes in its business such that its historical exercise data may no longer provide a reasonable basis upon which to estimate expected term.

If a company uses the simplified method, it should disclose the use of the method, the reason why the method was used, the types of share option grants for which the method was used if the method was not used for all share option grants, and the periods for which the method was used if the method was not used in all periods. Once relevant detailed external information about exercise behavior becomes widely

available for companies to make more refined estimates of expected term, the SEC will no longer accept use of the simplified method.

SAB 110 is available in full at: <http://www.sec.gov/interps/account/sab110.htm>.

Tool Enables Comparison of Executive Compensation

The SEC has launched an online tool that enables investors to compare executive compensation for 500 of the largest U.S. companies. The Executive Compensation Reader uses XBRL data of companies that have filed proxy statements to allow investors quick access to total annual pay, as well as amounts for salary, bonus, stock, options and company perks. Executive compensation figures can be compared with other companies by sorting according to industry, public market cap, or revenue. The new tool is available at <http://216.12.130.224/compensation/action/main/list.action>.

International

Three Redrafted Auditing Standards Issued

In striving to improve the clarity of its standards, the International Auditing and Assurance Standards Board (IAASB) continues to redraft its existing International Standards on Auditing (ISAs). Key elements of the new drafting conventions include: basing each standard on the objective of the auditor with respect to the subject matter of the standard; separating the requirements that the auditor is required to follow from guidance on their application; eliminating the present tense to describe actions by the auditor, which raised ambiguity about whether such actions were required; and other structural and drafting improvements to enhance the overall readability and understandability of the standards. Standards redrafted in this way are described as "redrafted." If further revision has been undertaken, a standard is described as "revised and redrafted."

Recently, the IAASB issued three final standards that reflect its new clarity drafting conventions:

- ISA 230 (Redrafted), *Audit Documentation*, explains in clearer terms what is expected of the auditor in fulfilling the requirement to document compliance with ISAs, and provides clarifying guidance regarding the circumstances in which it is appropriate for the auditor to prepare audit documentation relating to the use of professional judgment. The flow of the requirements in the redrafted ISA, particularly in relation to changes to audit documentation after the date of the auditor's report, has also been clarified.
- ISA 260 (Revised and Redrafted), *Communication with Those Charged with Governance*, has been fully revised. The ISA contains new requirements and guidance dealing with the communication process, including a specific requirement for the auditor to evaluate the adequacy of the two-way communication between the auditor and those charged with governance.
- ISA 720 (Redrafted), *The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements*, requires the auditor to read other information in documents containing audited financial statements and the corresponding auditor's report, and to respond appropriately when such information could undermine the credibility of the financial statements.

The complete set of clarified ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The clarified ISAs are available in full at <http://www.ifac.org/store>.

The IAASB also has issued Exposure Drafts of two proposed ISAs that have been revised to reflect the new clarity drafting conventions. ISA 501 (Redrafted), *Audit Evidence Regarding Specific Financial*

Statement Account Balances and Disclosures, and ISA 520 (Redrafted), *Analytical Procedures*, are available for comment until March 31, 2008, at <http://www.ifac.org/EDs>.

Proposed Standards Regarding Internal Control

The International Auditing and Assurance Standards Board (IAASB) has proposed the following International Standards on Auditing (ISAs), which reflect the importance of internal control within audited entities and at their service organizations, and the auditor's responsibility to communicate identified deficiencies in internal control to those charged with governance:

- Proposed International Standard on Auditing (ISA) 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Third Party Service Organization*, follows a risk-based approach in detailing the auditor's responsibilities to obtain audit evidence when an entity uses one or more service organizations. This may include obtaining reports prepared by the auditors of those organizations.
- Proposed International Standard on Assurance Engagements (ISAE) 3402, *Assurance Reports on Controls at a Third Party Service Organization*, complements proposed ISA 402 (Revised and Redrafted) in that reports prepared in accordance with proposed ISAE 3402 will be capable of providing appropriate audit evidence under the proposed ISA. Proposed ISAE 3402 will help to bring consistency in reporting on controls at service organizations, thereby assisting such organizations to meet the needs of clients and their auditors. In particular, it should ensure that reports issued in one country are likely to meet the requirements of the auditors of user entities in other countries.
- Proposed ISA 265, *Communicating Deficiencies in Internal Control*, deals with the auditor's responsibility to communicate to management and those charged with governance deficiencies in internal control that have been identified by the auditor. It distinguishes between significant and other deficiencies in order to establish requirements to communicate to the appropriate levels within the audited entity. It requires significant deficiencies to be communicated in writing to those charged with governance.

The Exposure Drafts are available for comment at <http://www.ifac.org/EDs>. Comments on proposed ISA 402 (Revised and Redrafted) and proposed ISA 265 are due by April 30, 2008; comments on proposed ISAE 3402 are due by May 31, 2008.

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