

# Insights

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## Accounting

### FAS 159's "Free Pass" Myth

Is your company considering early adoption of Financial Accounting Standards Board Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, (FAS 159) to take advantage of a perceived "free pass" opportunity located in FAS 159's transition provisions to restructure your investment portfolio? This perceived free pass is based on the belief that entities are able to "reclassify" held to maturity or available for sale investments that are currently valued at less than their cost basis (or "underwater") to the trading category and then sell such securities without recording a loss in the income statement. Would this strategy make sense for your organization? McGladrey & Pullen's National Office of Audit and Accounting recently published a white paper that discusses some of the reasons why companies are not rushing to take advantage of this perceived free pass opportunity. This white paper is available at [http://www.mcgladrey.com/Resource\\_Center/Audit/Articles/FAS159\\_FreePassMyth.html](http://www.mcgladrey.com/Resource_Center/Audit/Articles/FAS159_FreePassMyth.html).

### Derivatives: Reminder No. 3

This article is the last in a series of three biweekly articles presenting reminders about important basic requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Prior editions of *Insights* featured reminders about identifying derivatives and the documentation required for hedge accounting. This week we present a reminder about measuring hedge effectiveness accurately and periodically.

#### *Reminder No. 3 – Measure Hedge Effectiveness*

Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective during the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. Statement No. 133 does not specify a single method for either assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness. The appropriateness of a given method of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used.

Entities may not have to perform a detailed hedge-effectiveness analysis, however, if the critical terms of the hedging instrument and the hedged item are the same. The critical terms of a hedging instrument and a hedged item generally consist of:

- The notional and principal amounts;
- Receive/pay rates and the related bases;
- The contract term and maturity or remaining term;
- Repricing or reset dates; and

- Settlement and receive/pay dates.

For example, an entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability and an interest rate swap, and therefore avoid the documentation requirement related to hedge effectiveness if certain conditions are met. Statement No. 133 generally precludes application of this shortcut method when the interest-bearing asset or liability is prepayable at other than fair value. It is important to remember that this shortcut method can only be applied in very limited circumstances.

In those situations in which the critical terms of the hedging instrument and the hedged item are not identical, it is likely that the determination of hedge effectiveness could involve the use of various statistical techniques, including regression analysis. Another method for measuring ineffectiveness in cases where the critical terms of the hedging instrument do not match those of the hedged item (e.g., an interest-rate swap with reset dates different from those of the hedged variable-rate debt) would be to estimate the fair value of the swap with terms that are identical to those of the underlying variable-rate debt and compare the fair value of the “modeled” swap with the fair value of the actual swap.

### **McGladrey & Pullen Responds to Proposed Expanded Disclosures for Derivatives and Hedging Activities**

McGladrey & Pullen, LLP has submitted a comment letter to the Financial Accounting Standards Board (FASB) on the December 8, 2006 Exposure Draft (ED) of the proposed Statement of Financial Accounting Standards, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. Our Firm supports the overall purpose of the ED to address concerns that existing disclosure requirements for derivative instruments and related hedged items do not provide adequate information on the effect that derivative activities have on an entity's overall financial position, results of operations and cash flows. However, our Firm disagrees with the Board's proposal to stipulate prescriptive requirements, such as tabular formats, for what should be disclosed and how it should be disclosed. We believe that the proposed Statement should remove the prescriptive requirements and instead allow entities to determine the best way to provide the required information. In our comment letter, we responded to the issues for which specific comment was sought by the FASB, and also made observations about other matters. Our Firm's comment letter is posted on the FASB Web site at <http://www.fasb.org/oc/1510-100/51274.pdf>.

### **March EITF Developments**

At its March 28, 2007 meeting, the Financial Accounting Standards Board (FASB) ratified the final consensus for Emerging Issues Task Force (EITF) Issue No. 06-10, “Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements.” In this Issue, a consensus was reached that an employer should recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement in accordance with either FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, (if, in substance, a postretirement benefit plan exists) or APB Opinion No. 12, *Omnibus Opinion—1967*, (if the arrangement is, in substance, an individual deferred compensation contract) if the employer has agreed to maintain a life insurance policy during the employee's retirement or provide the employee with a death benefit based on the substantive agreement with the employee. A consensus also was reached that an employer should recognize and measure an asset based on the nature and substance of the collateral assignment split-dollar life insurance

arrangement. These consensuses also provide guidance related to disclosures, transition and effective dates.

At its March 15, 2007 meeting, the EITF reached a tentative conclusion on EITF Issue No. 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities," that *nonrefundable* advance payments for future research and development (R&D) activities should be deferred and capitalized. Such amounts should be recognized as an expense as the goods are delivered or the related services are performed. Entities should continue to evaluate whether they expect the goods to be delivered or services to be rendered; if an entity does not expect the goods to be delivered or services to be rendered, the capitalized advance payment should be charged to expense. It should be noted that this tentative conclusion does not apply to *refundable* advance payments for goods and services to be used in future R&D activities, and entities should not apply any conclusion in this Issue by analogy to other types of advance payments. The draft abstract of this tentative conclusion was approved for exposure by the FASB and is available for public comment until May 3, 2007 at <http://www.fasb.org/eitf/EITF07-3DraftAbstract.pdf>.

At the March EITF meeting, the SEC staff announced the SEC staff's position relating to the determination of whether the characteristics of a host contract related to a hybrid financial instrument issued in the form of a share are more akin to a debt instrument or more akin to an equity instrument. This SEC staff announcement can be found in Topic No. D-109, "Determining the Nature of a Host Contract Related to a Hybrid Financial Instrument Issued in the Form of a Share under FASB Statement No. 133."

The SEC staff also announced that an amendment to Topic No. D-98, "Classification and Measurement of Redeemable Securities," was made to conform with FASB Staff Position No. EITF 00-19-2, *Accounting for Registration Payment Arrangements*, and to include the SEC staff's longstanding position regarding the relationship between Topic No. D-98 and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

Minutes of the March 15, 2007 EITF meeting are available at [http://www.fasb.org/eitf/03-15-07\\_mtg\\_minutes.pdf](http://www.fasb.org/eitf/03-15-07_mtg_minutes.pdf).

### Income Tax Convergence Project

FASB Statement No. 109, *Accounting for Income Taxes*, and International Accounting Standards (IAS) 12, *Income Taxes*, both account for taxes currently payable (or receivable) arising from current taxable income and also for future (deferred) taxes payable (or receivable) due to differences between book bases and tax bases of assets and liabilities. Although Statement No. 109 and IAS 12 are based on similar principles, there are certain differences in the application of those similar principles that result in noncomparability of financial information reported internationally. As a result, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are in the midst of a convergence project to improve the accounting for income taxes while reducing the existing differences between the two standards. Although the Boards individually deliberate and vote on project issues, they are sharing staff resources to coordinate the eventual issuance of their Exposure Drafts and final standards.

This convergence project might result in recognizing deferred taxes on differences that were previously exempt under U.S. generally accepted accounting principles (GAAP). The FASB has reached the following tentative decisions, among others, which will result in changes to current GAAP:

- The exception to the comprehensive recognition of deferred taxes in Statement No. 109 related to intercompany transfers will be eliminated. Eliminating this exception means that entities would be

required to recognize deferred tax assets or liabilities for temporary differences created by intercompany transfers of nonmonetary assets between tax jurisdictions.

- The exception to the recognition of deferred taxes related to foreign currency will be eliminated. Eliminating this exception means that entities would be required to recognize deferred tax assets or liabilities for differences related to foreign nonmonetary assets and liabilities that are remeasured from the local currency into the functional currency where the functional currency also is the reporting currency and that result from changes in exchange rates or indexing for tax purposes.
- In determining the point at which deferred tax assets and liabilities should be adjusted for the effect of a change in tax laws or rates, the FASB decided to require the use of an approach that is consistent with IAS for operations other than U.S. taxing jurisdictions. The IAS approach requires that deferred tax assets and liabilities be measured based on tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date.
- The FASB decided to add to certain existing disclosure requirements.

The FASB will continue deliberating issues in this project, including how the decision to measure deferred taxes at the undistributed rate would affect certain entities (such as real estate investment trusts and cooperatives) and whether to adopt proposals of the IASB relating to the definition of and accounting for special deductions. An Exposure Draft is expected to be issued for public comment in the third quarter of 2007. More information about the income tax convergence project is available at [http://www.fasb.org/project/short-term\\_intl\\_convergence\\_income\\_tax.shtml](http://www.fasb.org/project/short-term_intl_convergence_income_tax.shtml).

### **Lawrence W. Smith Appointed to FASB**

Lawrence W. Smith has been appointed to a five-year term as a member of the Financial Accounting Standards Board (FASB) beginning July 1, 2007. Mr. Smith is currently the FASB's Director of Technical Application and Implementation Activities and Chairman of the Emerging Issues Task Force. He is a past member of the Technical Standards Subcommittee of what is now the Professional Ethics Executive Committee of the American Institute of Certified Public Accountants.

Prior to joining the FASB in 2002, Mr. Smith was a partner at KPMG LLP. During his twenty-five year tenure at that firm, he served as a partner in KPMG's department of professional practice, as well as engagement partner and SEC reviewing partner on a number of international Fortune 1000 clients. He holds a master's degree in accounting from Northeastern University Graduate School of Professional Accounting and a bachelor's degree from the State University of New York at Albany.

Mr. Smith will replace Edward W. Trott who will retire from the FASB on June 30, 2007.

## **Auditing**

### **Improving the Clarity of ASB Standards**

In striving to improve the clarity of its standards, the International Auditing and Assurance Standards Board (IAASB) is in the process of redrafting its existing standards following new drafting conventions. As a result, each of the following will be clearly stated as a separate section within a redrafted IAASB standard:

- An introduction;
- The objective of the auditor with respect to the subject matter of the standard;

- Requirements that the auditor is required to follow;
- Guidance on the application of the standard, which is not required to be followed.

The Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants, which issues standards for audits of nonissuers in the United States, is interested in international convergence of both the content and format of auditing standards. A discussion paper, *Improving the Clarity of ASB Standards*, recently issued by the ASB seeks feedback on the following issues related to the appropriate format for Statements on Auditing Standards:

- Establishing objectives for each of the standards that provide a conceptual framework for the application of professional judgment, and the obligation related to the objective;
- Making structural and drafting improvements to make the standards easier to read and understand;
- Including special considerations in the audits of public sector entities and small entities in the explanatory material of a Statement on Auditing Standard; and
- Establishing a glossary of terms that would be presented in a separate section of the Codification of Statements on Auditing Standards.

The content of the ASB's discussion paper generally agrees with the IAASB format as summarized above – with one exception. The ASB is considering placing the explanatory application guidance related to a particular requirement in the standard immediately following the requirement, as opposed to in a separate section that is set aside for all explanatory material. In addition, the ASB is considering offsetting the requirements from the explanatory material through the use of a grey shaded box.

In reformatting its standards, the ASB would not plan to open any issues for reconsideration. The IAASB, on the other hand, allows the possibility of opening issues within a given standard for reconsideration. Both entities would also plan to issue any new standards using the new format.

Bob Dohrer, a partner in McGladrey & Pullen's National Office of Audit and Accounting and ASB member, emphasizes the ASB is seeking public comment as to the above issues, "The possibility of adopting a new format presents a fork in the road for U.S. auditing standards. Clarity in auditing standards will benefit both auditors and their clients so it is important that interested parties comment as to which format will be most useful. All of these issues will be redeliberated at the close of the comment period." The discussion paper is available for review and comment until June 15, 2007 at [http://www.aicpa.org/download/auditstd/Clarity\\_of\\_ASB\\_Standards\\_Discussion\\_Memo.pdf](http://www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf).

## SEC

### Tax Services for Persons in Financial Reporting Oversight Roles

Public Company Accounting Oversight Board (PCAOB) Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*, provides that a registered firm, subject to certain exceptions, is not independent of an audit client if the firm, or an affiliate of the firm, provides tax services during the audit and professional engagement period to a person in, or an immediate family member of a person in, a financial reporting oversight role at an audit client. As of November 1, 2006, registered firms have been required to comply with Rule 3523 as it relates to tax services provided while they serve as auditor of record for an audit client – that is, during the "professional engagement period."

As previously announced, the Board is revisiting the application of Rule 3523 to tax services provided during the "audit period" (the period covered by any financial statements being audited or reviewed). The Board has determined to extend the implementation schedule for Rule 3523 to allow sufficient time for consideration of comments on the issues raised in the concept release. Specifically, Rule 3523 will not apply to tax services provided on or before July 31, 2007, when those services are provided during the audit period and are completed before the professional engagement period begins.

The PCAOB has issued a concept release to solicit comments regarding the possible effects on a firm's independence of providing tax services to a person covered by Rule 3523 during the portion of the audit period that precedes the beginning of the professional engagement period, and other practical consequences of applying the restrictions imposed by Rule 3523 to that portion of the audit period. The concept release is available for comment until May 18, 2007 at [http://www.pcaobus.org/rules/docket\\_017/2007-04-03\\_release\\_%202007-002.pdf](http://www.pcaobus.org/rules/docket_017/2007-04-03_release_%202007-002.pdf). Any rule amendment that is adopted by the PCAOB must be submitted to the SEC for approval.

Also in the area of ethics and independence, the PCAOB staff has issued six questions and answers on PCAOB Rule 3523 and Rule 3522, *Tax Transactions*. The statements contained in the staff questions and answers are not rules of the PCAOB, nor have they been approved by the PCAOB. The staff questions and answers are available at [http://www.pcaobus.org/Standards/Staff\\_Questions\\_and\\_Answers/2007/Tax\\_Services.pdf](http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2007/Tax_Services.pdf).

### **Proposed Standard on Evaluating Consistency of Financial Statements**

Two actions of the Financial Accounting Standards Board (FASB) have prompted the Public Company Accounting Oversight Board (PCAOB) to propose certain changes to its auditing standards:

- In May 2005, the FASB issued Statement No. 154, *Accounting Changes and Error Corrections*, which superseded Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*. Statement No. 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. Among other requirements, the Statement also redefines the term "restatement" to refer only to "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements."
- The FASB has also issued an exposure draft of a proposed Statement, *The Hierarchy of Generally Accepted Accounting Principles*, which would incorporate generally accepted accounting principles (GAAP) hierarchy into the accounting standards.

The PCAOB's current interim standard on the auditor's responsibilities for evaluating the consistency of the application of GAAP is AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, which generally reflects the provisions of APB 20. To better align its auditing standards with Statement No. 154, the PCAOB is proposing a new auditing standard, *Evaluating Consistency of Financial Statements*, which would supersede AU sec. 420, and conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, of its interim auditing standards. The proposed new standard would retain the basic principles of AU sec. 420 - evaluating the consistency of the issuer's application of GAAP and reporting on inconsistencies. The proposed standard would update these requirements and align them more closely with Statement No. 154 by omitting accounting guidance that is currently included in AU sec. 420; requiring the auditor's report to recognize the issuer's correction of a material misstatement (regardless of whether it involves the application of an accounting principle); and clarifying that the auditor's

report should indicate whether an adjustment to prior-period financial statements results from a change in accounting principle or the correction of a misstatement.

Currently, a description of the GAAP hierarchy resides only in AU sec. 411, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"*, of the auditing standards. Because the GAAP hierarchy identifies the sources of accounting principles and the framework for selecting principles to be used in preparing financial statements, the PCAOB agrees that these requirements are more appropriately located in the accounting standards. Accordingly, the PCAOB is proposing to remove the GAAP hierarchy from its auditing standards.

The proposed auditing standard and changes to existing interim auditing standards are available for comment until May 15, 2007 at [http://www.pcaobus.org/Rules/Docket\\_023/2007-04-03\\_Release\\_No.\\_2007-003.pdf](http://www.pcaobus.org/Rules/Docket_023/2007-04-03_Release_No._2007-003.pdf). Any new auditing standard or amendment to interim standards that is adopted by the PCAOB must be submitted to the SEC for approval.

## International

### Revision to Accounting for Certain Borrowing Costs

The International Accounting Standards Board has revised International Accounting Standard (IAS) 23, *Borrowing Costs*, to remove the option of immediately recognizing as an expense borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset (an asset that takes a substantial period of time to get ready for use or sale). An entity is therefore required to capitalize such borrowing costs as part of the cost of the asset. However, the revised Standard does not require the capitalization of borrowing costs relating to assets measured at fair value, and inventories that are manufactured or produced in large quantities on a repetitive basis, even if they take a substantial period of time to get ready for use or sale. The revised Standard achieves convergence in principle with FASB Statement No. 34, *Capitalization of Interest Cost*. Revised IAS 23 applies to borrowing costs relating to qualifying assets for which the commencement date for capitalization is on or after January 1, 2009. Earlier application is permitted.

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