

# Insights

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## McGladrey & Pullen Responds to International Needs

The number of U.S. businesses with complex international activities continues to grow. This increase in international activity means that U.S. companies will require more comprehensive international services from their auditors. McGladrey & Pullen, LLP has responded to this need in a very tangible way. Effective October 2006, Bob Dohrer will be "on the ground" in Europe to facilitate McGladrey & Pullen audit services for companies with international operations.

Mr. Dohrer will spend over half of his time in Europe, headquartered in London, focusing primarily on international audit situations. The majority of his time will be spent assisting U.S. and foreign audit engagement teams in planning and reviewing international engagements to help ensure that the objectives of the engagement have been met effectively and efficiently. "I am very excited about this new opportunity," commented Mr. Dohrer, "It will be important that I spend time both in Europe and the United States because U.S. auditors will need to understand the work that needs to be done to audit a foreign entity, and conversely, foreign auditors will need to understand the requirements of U.S. auditing standards."

Leroy Dennis, the Firm's Executive Partner of Audit & Accounting, agrees, "Although our Firm has had the necessary resources to complete an international audit through our affiliation with RSM International, Bob's presence in Europe will be a great asset to any company doing business there. Bob is well-versed in both U.S. and international auditing standards, and I know that he will adapt to any international auditing situation quickly and competently."

Mr. Dohrer, currently a partner in the Firm's National Office of Audit and Accounting, is a member of the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) and serves on several AICPA task forces. In addition, as a member of a task force comprised of representatives of the eight largest public accounting firms, he deals with issues related to audits of internal control pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 and frequently interacts with the Public Company Accounting Oversight Board relative to these issues. Bob earned his Bachelor of Science in Accounting from Black Hills State University in 1988 and his Master of Professional Accountancy from the University of South Dakota in 1989.

## Accounting

### Combined Financial Statements under FIN 46(R)

FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, (FIN 46(R)) requires an enterprise to consolidate a variable interest entity (VIE) if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. From the time FIN 46(R) was first published, there has been much discussion about whether the primary beneficiary of a VIE could simply combine the

financial statements of the VIE with its financial statements, rather than consolidating them. The Accounting Standards Division of the American Institute of Certified Public Accountants recently released Technical Practice Aid (TPA) 1400.29, which concludes that if a reporting entity is the primary beneficiary of a VIE under FIN 46(R), it is not appropriate to issue combined financial statements rather than consolidated financial statements.

Three other TPAs were released providing guidance on related matters:

*TPA 1400.30, Stand-Alone Financial Statements of a VIE*

Because subsidiary-only financial statements are appropriate under generally accepted accounting principles (GAAP), this TPA concludes that it may be appropriate to present stand-alone financial statements of a VIE, although FIN 46(R) does not address this issue.

*TPA 1400.31, GAAP Departure for FIN 46(R)*

If a reporting entity is the primary beneficiary of a VIE under FIN 46(R) and the reporting entity does not consolidate the VIE, the auditor should express a qualified or an adverse opinion on the audited financial statements of the reporting entity. In deciding whether the effects of the GAAP departure are sufficiently material to require either a qualified or adverse opinion, the auditor should use qualitative as well as quantitative judgments. The significance of an item to a particular entity, the pervasiveness of the misstatement, and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

If an auditor concludes that a qualified opinion is appropriate, the GAAP departure should be disclosed in a separate explanatory paragraph preceding the opinion paragraph of the report. The opinion paragraph of the report should include the appropriate qualifying language and a reference to the explanatory paragraph. The explanatory paragraph should disclose the principal effects of the departure on financial position, results of operations, and cash flows, if practicable. If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a financial statement footnote, the explanatory paragraph may be shortened by referring to the footnote.

*TPA 1500.06, Application of FIN 46(R) to Income Tax Basis Financial Statements*

For income tax basis financial statements, consolidation is based on the Internal Revenue Code. Therefore, the consolidation requirements of FIN 46(R) would not apply to financial statements prepared under the income tax basis of accounting.

A VIE that is not consolidated under the income tax basis of accounting is analogous to a 60 percent-owned subsidiary that would be consolidated under GAAP but is not consolidated under the income tax basis of accounting because the threshold for consolidation under the Internal Revenue Code is 80 percent ownership. In determining which disclosures are appropriate in income tax basis financial statements, the primary beneficiary of the VIE should perform the same analysis as would the parent of the 60 percent-owned subsidiary. Examples of matters that might require disclosure are related-party transactions, guarantees, and commitments.

The TPAs are available in full at [http://www.aicpa.org/download/acctstd/FIN\\_46\\_R\\_TPAs.pdf](http://www.aicpa.org/download/acctstd/FIN_46_R_TPAs.pdf).

## Public Sector

### Preliminary Views on the Accounting and Financial Reporting for Derivatives

The Governmental Accounting Standards Board (GASB) has issued its preliminary views on major issues related to the accounting and financial reporting for derivatives by state and local governments. Currently, most derivatives are recognized at historical prices in a government's balance sheet. Financial statement disclosures for derivatives are outlined in Technical Bulletin (TB) 2003-1.

The GASB's proposal would require that derivatives covered in the scope of the preliminary views document be reported at fair value in the financial statements as well as the change in that fair value. If, however, a derivative is effectively hedging (reducing) the risk it was created to address, then the annual changes in the derivative's fair value would be deferred and reported in a government's balance sheet as deferred charges or deferred credits. Much of this preliminary views document discusses the hedge effectiveness criteria that would need to be met to demonstrate that a hedging derivative is effective in reducing a government's exposure to an identified financial risk.

The GASB proposes that the disclosures of TB 2003-1 be incorporated and expanded to cover derivatives within the scope of the preliminary views document even if they are reported at fair value. Further, under some methods of evaluating hedge effectiveness, the ineffective portion of an otherwise effective hedge would be disclosed in the notes to the financial statements. The Board also proposes including a summary of derivative activity during the period as a note disclosure.

The preliminary views document was issued to seek comments at a relatively early stage of the project. Comments should be submitted by July 28, 2006 to the Director of Research and Technical Activities, Project No. 26-4P at [director@gasb.org](mailto:director@gasb.org). The GASB also will be conducting several public meetings in association with this project.

The document containing GASB's preliminary views on the accounting and financial reporting for derivatives by state and local governments is available in full at [http://www.gasb.org/exp/pv\\_derivatives.pdf](http://www.gasb.org/exp/pv_derivatives.pdf). A plain-language supplement that summarizes these views for financial statement users and others without an accounting background is available at [http://www.gasb.org/plain-language\\_documents/derivatives\\_plain-language.pdf](http://www.gasb.org/plain-language_documents/derivatives_plain-language.pdf).

## SEC

### SEC Approves PCAOB Ethics and Independence Rules

The Securities and Exchange Commission has approved ethics and independence rules concerning contingent fees and tax services that were proposed by the Public Company Accounting Oversight Board (PCAOB). The rules include a general obligation requiring a registered public accounting firm and its associated persons to be independent of the firm's audit clients throughout the audit and professional engagement period, and the following specific new rules:

#### *Contingent Fees*

Rule 3521 treats registered public accounting firms as not independent of their audit clients if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission. A contingent fee includes any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged

unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service. However, a fee is not a contingent fee if the amount is fixed by courts or other public authorities and not dependent upon a finding or result. Please note that this rule does not recognize the exception for tax services where we can demonstrate a reasonable expectation, at the time of the fee arrangement, of a substantive review by the taxing authority. Rule 3521 will not apply to contingent fee arrangements that were paid in their entirety, converted to fixed fee arrangements, or otherwise unwound before June 18, 2006.

#### *Certain Tax Services*

Rule 3522 treats a registered public accounting firm as not independent if the firm provides non-audit services to the client related to marketing, planning or opining in favor of the tax treatment of a transaction that is a confidential transaction under U.S. Treasury regulations or a transaction that is based on an aggressive interpretation of applicable tax laws and regulations. Aggressive tax positions are those that are initially recommended, directly or indirectly, by the auditor and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws. This new rule does not prohibit a registered public accounting firm from providing routine tax return preparation, tax compliance services, or international assignment tax services to its audit clients. Rule 3522 will not apply to tax services that were completed by a registered public accounting firm no later than June 18, 2006.

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

Rule 3523 treats a registered public accounting firm as not independent if the firm provides tax services to a person in a financial reporting oversight role at the audit client, or an immediate family member (spouse, spousal equivalent or dependent) of such person. The term "financial reporting oversight role" means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them. This includes the chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer or any equivalent position. This rule does not apply to outside directors (including those who are members of the audit committee) or to certain persons in a financial reporting oversight role at affiliates of the audit client. Rule 3523 will not apply to tax services being provided pursuant to an engagement in process on April 19, 2006, provided that such services are completed on or before October 31, 2006. An engagement is in process if an engagement letter has been executed and work of substance has commenced.

Rules 3521, 3522, and 3523 are effective during the "audit and professional engagement period," which includes both the period covered by any financial statements being audited or reviewed and the period of the engagement (from the time the initial arrangement letter is signed or audit procedures begin until the SEC is notified that the company is no longer the firm's audit client.)

#### *Audit Committee Pre-approval of Certain Tax Services*

Section 202 of the Sarbanes-Oxley Act already requires all non-audit services that the auditor proposes to perform for an issuer client to be pre-approved by the audit committee. The new independence rules more clearly define the audit committee pre-approval process for permissible tax services and impose specific requirements on the auditor. Per Rule 3524, in connection with seeking audit committee pre-approval to perform any permissible tax service, the auditor must:

- Describe, in writing, to the audit committee the scope of the service, the fee structure and any side letter or other amendment to the original engagement letter, and any referral agreement, referral fee or fee sharing arrangement between the audit firm and any other person promoting, marketing or recommending the service.
- Discuss with the audit committee the potential effects of the services on the independence of the firm; and
- Document the substance of those discussions.

It is not necessary to supply the audit committee with a copy of each tax service arrangement letter; however, comprehensive documentation that spells out the terms of each non-audit service should be provided to the audit committee. Such documentation should be sufficiently detailed that there can never be any doubt as to whether a particular service was brought to the audit committee's attention. Through discussion with the audit committee, the auditor must convey information sufficient to help them distinguish between tax services that could have a detrimental effect on our independence and those that would be unlikely to have a detrimental effect.

Rule 3524 will not apply to any tax service pre-approved on an engagement-by-engagement basis before June 18, 2006. With respect to tax services provided to audit clients whose audit committees pre-approve tax services pursuant to policies and procedures, Rule 3524 will not apply to any such tax service that is begun by April 20, 2007.

#### *Individuals Held Responsible*

Finally, Rule 3502, which is effective April 29, 2006, codifies the principle that persons associated with a registered public accounting firm (e.g., individual accountants) can be held responsible when certain of their actions contribute to a firm's violation of relevant laws, rules, or professional standards.

#### *Implementation Guidance*

In approving the rules, the SEC indicated that it expects the PCAOB to issue additional guidance as requested by a number of the commenters to facilitate implementation of the proposed rules. Our firm was among the commenters requesting additional implementation guidance on certain of the rules.

### **Advisory Committee Issues Final Report**

The Advisory Committee on Smaller Public Companies, which was established by the SEC to examine the impact of the Sarbanes-Oxley Act of 2002 (SOX) and other federal securities laws on smaller public companies, has released its final report. Consistent with the draft report, the primary recommendation in the final report is to establish a system of scaled securities regulation for "smaller public companies", generally those with market capitalization of less than \$787 million. Smaller public companies would then be stratified into two groups - "microcap" companies (those with market capitalization of less than \$128.2 million) and "smallcap" companies (those with market capitalization between \$128.2 million and \$787.1 million). It is the Committee's belief that this overarching scaling principal could be incorporated into existing and new securities regulations.

Other primary recommendations of the Committee include the following:

- Unless and until a framework for assessing internal control over financial reporting is developed that recognizes the unique characteristics of smaller public companies, microcap companies with less than \$125 million in annual revenue and smallcap companies with less than \$10 million in annual product revenue should be exempt from all of the SOX 404 internal control reporting

requirements, subject to achieving certain corporate governance standards and the reporting of any known material weaknesses. Smallcap companies with less than \$250 million in annual revenue but greater than \$10 million in annual product revenue and microcap companies with between \$125 and \$250 million in annual revenue should be exempt from the external audit requirement of SOX 404, but be required to complete management's assessment of internal controls under SOX 404 and achieve certain additional corporate governance standards.

- A private offering exemption that would not prohibit general solicitation and advertising for transactions with certain purchasers should be adopted.
- Permission should be granted for microcap companies to apply the same effective dates that the Financial Accounting Standards Board provides for private companies in implementing new accounting standards.
- Additional guidance should be considered for all public companies with respect to materiality related to previously issued financial statements.
- A de minimis provision in the application of the SEC's auditor independence rules should be implemented.

Joseph (Leroy) Dennis, Executive Partner of McGladrey & Pullen, LLP and a member of the SEC Advisory Committee, commented on the Committee's work, "After a complete, attentive, and open 13-month course of action, the Advisory Committee is pleased to make its recommendations to the SEC on behalf of smaller public companies throughout the United States. I would like to thank everyone who became actively involved in this process and took the time to thoughtfully respond to the Committee's draft report. The public's response played an important part in our decision-making."

The Committee's final report is available in full at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>. The Committee's recommendations will not change current rules or regulations unless formally adopted by the SEC.

### **SFAS 123(R) Disclosures in Interim Financial Statements for Public Companies**

The interim disclosure requirements of FASB Statement No. 123(R), *Share-based Payment*, are extensive and may require significantly more effort to prepare as compared with disclosures under the prior standards. When a company adopts SFAS 123(R) in an interim period (e.g., the first quarter), the SEC rules require that all annual disclosures required by SFAS 123(R) be included in the Form 10-Q filing since a company would not yet have a Form 10-K on file that includes the annual SFAS 123(R) disclosures. This requirement was discussed by the SEC staff in a speech at the 2005 AICPA National Conference on Current SEC and PCAOB Developments in December and can be found on the SEC's Web site at <http://www.sec.gov/news/speech/spch120505sb.htm>. Companies should continue to include these disclosures in their subsequent Form 10-Q filings until a Form 10-K is filed that reflects the company's adoption of SFAS 123(R). The required disclosures are listed in paragraphs 64-65, 84, and A240-A242 of SFAS 123(R).

In applying the SEC rules, a company with a December 31, 2005 year end would include in the March 31, 2006 Form 10-Q financial statement footnotes the required SFAS 123(R) annual disclosure as of and for the period ended March 31, 2006. For example, the roll-forward of options granted, expired and terminated for the period would be from January 1, 2006 to March 31, 2006 and the corresponding period of the prior year. Information about valuation methods, assumptions, ending balances, etc. would all be as of and for the period ended March 31, 2006. To the extent any required information is available and relevant for the

same quarter of the prior year (i.e., March 31, 2005), it should be included. In subsequent quarters, the disclosures would be updated with the quarterly (and year-to-date) information.

### **SEC Reporting and FASB Update Forum for Mid-sized and Smaller Public Companies**

McGladrey & Pullen, LLP assisted The SEC Institute, Inc. in developing its *SEC Reporting and FASB Update Forum for Mid-sized and Smaller Public Companies* to be held on June 1 and 2 in Orlando and October 16 and 17 in Las Vegas.

"This Forum will be focused exclusively on addressing the unique accounting and SEC reporting needs of mid-sized and smaller public companies," said Jay Hanson, National Director of Accounting for McGladrey & Pullen, LLP and chairperson for the Forum. "Instructors will be dedicated to providing useful and pertinent information." Those who attend the forum will:

- Hear from the co-chair and other members of the SEC's Advisory Committee on Smaller Public Companies about their activities to ease the burden on smaller public companies;
- Hear from SEC officials with the Division of Corporation Finance and the Office of the Chief Accountant;
- Find out about FASB developments affecting companies now—including SFAS 123(R) (share-based payments) and EITF 00-19 (convertible debt and warrants);
- Find out about COSO's new control framework for smaller businesses; and
- Learn about new SEC enforcement trends and the implications for a mid-sized or smaller company.

A complete Forum schedule and related registration material are available from The SEC Institute at [www.secinstitute.com](http://www.secinstitute.com) or 800.529.1550. Arrangements have been made to give our clients a substantial discount to attend this forum. The registration deadline for the June forum is May 15.

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