McGladrey & Pullen
Certified Public Accountants

www.mcgladrey.com

Insights

A biweekly publication from the National Office of Audit and Accounting

May 15, 2007

By clicking on a heading in the Bookmark section on the left, you will go directly to that subject.

Accounting

McGladrey & Pullen Responds to Proposed Guidance for Quantifying Misstatements

McGladrey & Pullen, LLP has submitted a comment letter to the Financial Accounting Standards Board (FASB) on proposed FASB Staff Position (FSP) No. FAS 154-a, *Considering the Effects of Prior-Year Misstatements When Qualifying Misstatements in Current-Year Financial Statements*. We agree with the objective of the FSP to establish a single approach for all entities, whether or not an SEC registrant, for quantifying misstatements that could be material to users of financial statements. However we have two comments regarding the FSP's effective date and transition:

- We suggest a delay in the effective date of the FSP to a date six months after its issuance. This delay would make the FSP effective for financial statements issued for fiscal years ending after December 15, 2007 assuming the FSP is issued as expected in the second quarter of 2007.
- The proposed FSP states that misstatements existing in prior-year financial statements but not identified until the current year are precluded from being added to the prior-year evaluation during the transition period. We do not believe such misstatements should be precluded from the transition evaluation.

Our Firm's comment letter is posted on the FASB Web site at http://www.fasb.org/ocl/FSPFAS154A/51391.pdf.

Definition of "Settlement" in FIN 48

The Financial Accounting Standards Board (FASB) has received inquiries asking for clarification on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits under FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*. Specifically, is it appropriate for an enterprise to recognize a previously unrecognized tax benefit when the only factor that has changed since determining that a benefit should not be recognized is the completion of an examination or audit by a taxing authority? To answer this and other questions, the FASB has issued FASB Staff Position (FSP) No. FIN 48-1, *Definition of "Settlement" in FASB Interpretation No. 48.*

FSP FIN 48-1 amends FIN 48 to clarify that a tax position could be effectively settled upon examination by a taxing authority, although assessing whether a tax position is effectively settled is a matter of judgment because examinations occur in a variety of ways. In determining whether a tax position is effectively settled, an enterprise should make the assessment on a position-by-position basis, but an enterprise could conclude that all positions in a particular tax year are effectively settled. An enterprise should evaluate all of the following conditions when determining effective settlement:

- The taxing authority has completed its examination procedures including all appeals and administrative reviews that the taxing authority is required and expected to perform for the tax position.
- The enterprise does not intend to appeal or litigate any aspect of the tax position included in the completed examination.
- It is remote that the taxing authority would examine or re-examine any aspect of the tax position, considering the taxing authority's policy on re-opening closed examinations and the specific facts and circumstances of the tax position.

In the tax years under examination, a tax position does not need to be specifically reviewed or examined by the taxing authority to be considered effectively settled through examination. Effective settlement of a position subject to an examination does not result in effective settlement of similar or identical tax positions in periods that have not been examined. However, an enterprise may obtain information during the examination process that enables that enterprise to change its assessment of the technical merits of a tax position or of similar tax positions taken in other periods. If an enterprise that had previously considered a tax position effectively settled becomes aware that the taxing authority may examine or re-examine the tax position or intends to appeal or litigate any aspect of the tax position, the tax position is no longer considered effectively settled and the enterprise should re-evaluate the tax position in accordance with FIN 48.

The guidance in the FSP is effective upon the initial adoption of FIN 48. (FIN 48 is effective for years beginning after December 15, 2006.) The FSP is available in full at http://www.fasb.org/fasb_staff_positions/fsp_fin48-1.pdf.

TPAs Released for Employee Benefit Plans

The Accounting Standards Team of the American Institute of Certified Public Accountants has released three Technical Practice Aids (TPAs) relating to employee benefit plans, which are summarized as follows:

- TPA 6931.08, *Types of Investments Subject to SOP 94-4, as Amended by FSP AAG INV-1 and SOP 94-4-1.* This TPA addresses which types of investments are subject to the financial statement presentation and disclosure requirements of Statement of Position (SOP) No. 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, as amended by Financial Accounting Standards Board Staff Position (FSP) AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans*. Generally, the SOP and FSP conclude that investments held by employee benefit plans are required to be reported at fair value. An exception to this general requirement pertains to fully benefit-responsive investment contracts which are reported at contract value. For example, contract value is the appropriate measurement attribute for many stable value investments, such as guaranteed investment contracts. The type of investment contract dictates the measurement attribute (i.e., fair value or contract value) and the required disclosures. The TPA states that it is important to gain an understanding of the types of investments being held by the plan to determine the appropriate reporting and disclosures.

- TPA 6931.09, *Financial Statement Presentation When a Plan Invests in a Common Collective Trust Fund or in a Master Trust That Holds Fully Benefit-Responsive Investment Contracts.* This TPA concludes that the financial statement presentation requirements in paragraph 15 of SOP 94-4, as amended by FSP AAG INV-1 and SOP 94-4-1, apply to a plan's investment in a common collective trust (CCT) fund or master trust that holds fully benefit-responsive investment contracts.
- TPA 6931.10, *Financial Statement Disclosure Requirements When a Plan Invests in a Common Collective Trust Fund or in a Master Trust That Holds Fully Benefit-Responsive Investment Contracts.* This TPA concludes that plans that directly invest in CCT funds, or similar vehicles that hold fully benefit-responsive investment contracts, do not need to include the disclosures detailed in FSP AAG INV-1 and SOP 94-4-1 in the plan's financial statements. Such disclosures would be included in the financial statements of the CCT, in accordance with paragraph 11 of the FSP. For plans that invest in a master trust that holds fully benefit-responsive investment contracts, the notes to the financial statements should include the disclosures required in paragraph 15 of SOP 94-4, as amended by FSP AAG INV-1 and SOP 94-4-1 related to the fully benefit-responsive investment contracts held by the master trust.

These TPAs are available in full at http://www.aicpa.org/download/acctstd/TIS6931.08.pdf. The TPAs and related FSP should be read in their entirety to gain a full understanding of the TPAs.

Please note the numbering of the above TPAs reflects a re-organization of Section 6930 in the *Technical Practice Aids* that will occur shortly.

FASB Interpretation No. 39 Amended

FASB Interpretation (FIN) No. 39, *Offsetting of Amounts Related to Certain Contracts,* defines conditional contracts as "those whose obligations or rights depend on the occurrence of some specified future event that is not certain to occur and that could change the timing of the amounts or of the instruments to be received, delivered, or exchanged." Exchange contracts are defined as "those that require a future exchange of assets or liabilities rather than a one-way transfer of assets." Examples of conditional or exchange contracts include forwards, interest rate swaps, currency swaps and options. Questions have been raised about whether a contract whose obligations or rights depend solely on the occurrence of a default or termination would meet the definition of a conditional contract. The Financial Accounting Standards Board has issued FASB Staff Position (FSP) No. FIN 39-1, *Amendment of FASB Interpretation No. 39,* to replace the terms *conditional contracts* and *exchange contracts* with the term *derivative instruments* as defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

Questions also have been raised about whether a reporting entity that is party to a master netting arrangement can offset the fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against the fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with paragraph 10 of FIN 39. Paragraph 10 permits a reporting entity to offset fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement without applying the condition that a reporting entity intends to set-off. FSP No. FIN 39-1 amends FIN 39 to permit a reporting entity to offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments executed with the same counterparty under the same master netting arrangement that have been offset in accordance with paragraph 10 of FIN 39.

The guidance in this FSP is effective for fiscal years beginning after November 15, 2007, with early application permitted. The effects of applying the FSP are to be recognized as a change in accounting principle through retrospective application for all financial statements presented unless it is impracticable to do so. The FSP is available in full at http://www.fasb.org/fasb_staff_positions/fsp_fin39-1.pdf.

Freestanding Warrants and Embedded Conversion Options

Complex accounting rules address the measurement and classification of detachable (or freestanding) warrants, convertible debt, and convertible or redeemable preferred stock. Recently, Robert Dyson explained the application of some of those complex rules in "Freestanding Warrants and Embedded Conversion Options," an article in the April, 2007 edition of *The CPA Journal.* The article is available at http://www.mcgladrey.com/Resource_Center/dysonarticle.pdf.

Mr. Dyson is a CPA and a managing director with RSM McGladrey, Inc. RSM McGladrey Inc. and McGladrey & Pullen LLP have an alternative practice structure. Though separate and independent legal entities, the two firms work together to serve clients' business needs.

Financial Statement Presentation Project

For the past three years, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working on a joint project to establish a common standard for presentation of information in financial statements. The resulting standard will apply to all public and nonpublic business entities, but will not apply to nonbusiness entities (not-for-profit organizations or defined benefit plans). This project will specifically address the organization and presentation of financial information on the face of the financial statements; the project will not include a comprehensive review of the notes to the financial statements. However, it may result in amendments to existing disclosure requirements as a consequence of changes made to amounts reported on the face of the financial statements or new disclosure requirements when the project objective cannot be achieved on the face of the financial statements. The Financial Statement Presentation Project consists of three phases.

Phase A

Phase A of the project addresses what constitutes a complete set of financial statements and requirements to present comparative information. Tentative decisions made to date include:

- A complete set of financial statements for a reporting period includes:
    - Statements of financial position that show balances of assets, liabilities, and equity as of the beginning and end of the period.
    - A statement of earnings and comprehensive income that shows for a period of time the changes in assets and liabilities other than those arising from transactions with owners in their capacity as owners. (The IASB, however, will allow either a single statement approach or a two-statement approach for presenting non-owner changes in equity.)
    - A statement of changes in equity that shows the changes in assets and liabilities arising from transactions with owners in their capacity as owners.
    - A statement of cash flows that shows inflows and outflows of cash.

- Comparative information consisting of, at a minimum, a complete set of financial statements for two annual periods (the current and prior annual period) is required. Therefore, three statements of financial position, two statements of earnings and comprehensive income/recognized income and expense, two statements of changes in equity, and two statements of cash flows would be required. The IASB, however, would only require the presentation of a statement of financial position at the beginning of the comparative period when it contains a reclassification or restatement.

Phase B

Phase B addresses the more fundamental issues for presentation of information on the face of the financial statements. Discussions thus far have included:

- Defining the totals and subtotals to be reported in each financial statement so as to present a cohesive financial picture of the entity. This includes the use of the same categories in all of the financial statements such that the relationships between items on the different financial statements are clear. Guidelines have been prepared to define which items would be included in each of the following categories:
  - Business (operating and investing)
  - Discontinued Operations
  - Financing
  - Equity
  - Income Taxes
- Developing principles for aggregating and disaggregating information in a manner that would be useful in predicting future cash flows.
- Considering FASB Statement No. 95, *Statement of Cash Flows,* and International Accounting Standard (IAS) 7, *Cash Flow Statements,* including a preference for the use of the direct method and discontinuing the notion of *cash equivalents* in financial statement presentation.

The initial output for Phase B is a discussion document that is expected to be published in the fourth quarter of 2007.

Phase C

Phase C will address presentation and display of interim financial information in U.S. GAAP. The IASB may reconsider the requirements in IAS 34, *Interim Financial Reporting.*

Complete details about the Financial Statement Presentation Project can be found at http://www.fasb.org/project/financial_statement_presentation.shtml.

SEC

Form 10-Q Disclosures Related to FIN 48

FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, is effective in the first interim period for fiscal years beginning after December 15, 2006. A calendar-year-end SEC registrant must adopt FIN 48 January 1, 2007 and report the effects of adoption in its quarterly filing for March 31,

2007. SEC Regulation S-X Rule 10-01(a) requires interim financial information to include disclosures of significant changes in accounting principles and practices since the end of the most recently completed fiscal year. The condensed financial information in a first-quarter Form 10-Q or 10-QSB of a calendar-year-end registrant therefore will need footnote disclosure of the adoption of FIN 48 if it has or is expected to have a material impact on the company.

Item 303(b) of SEC Regulation S-K requires management's discussion and analysis (MD&A) of the registrant's financial condition and results of operations included in interim–period financial information to discuss material changes in financial condition from the end of the preceding fiscal year to the date of the most recent interim balance sheet provided. This discussion should include material changes to contractual obligations as required by Regulation S-K Item 303(a)(5) which, in the view of the SEC staff, encompasses liabilities recognized under FIN 48. Calendar-year-end registrants that have not yet filed their Form 10-Qs should evaluate whether the inclusion of FIN 48 liabilities in the disclosures of contractual obligations would represent a material change to the disclosures included in the most recent Form 10-K. If the inclusion of FIN 48 liabilities in the contractual obligations disclosures would represent a material change, a company should use judgment to determine the appropriate means of conveying this information to investors.

Although the SEC's MD&A rules do not specifically require companies to include the contractual obligations table in quarterly reports, the inclusion of an updated table is one way in which disclosure of material changes could be accomplished. Another method would be to provide a discussion of the impact of FIN 48 liabilities in the contractual obligations table. Although there are various formats that these disclosures might follow, the ultimate goal of the disclosures is to provide transparent information so investors can understand the impact of uncertain tax positions on the company's liquidity.

If an updated table is prepared and if a company can make reliable estimates about the periods in which cash outflows relating to its FIN 48 liabilities are expected to occur, it should include those estimates in the relevant columns of the contractual obligations table. For instance, any FIN 48 liabilities that are classified as a current liability in the company's balance sheet should be presented in the "Less than 1 Year" column in the contractual obligations table. However, there is often a high degree of uncertainty regarding the timing of future cash outflows associated with some FIN 48 liabilities, and, in those cases, a registrant might be unable to make reasonably reliable estimates of the period of cash settlement with the respective taxing authority (e.g., unrecognized tax benefits for which the statute of limitations might expire without examination by the respective taxing authority). If a company cannot make reliable estimates of the cash flows by period, the company should consider alternative methods of conveying relevant information to investors. For instance, the company might consider including its FIN 48 liabilities in an "all other" column in the table with transparent note disclosure. Rather than creating an "all other" column, the company might rely on footnote disclosure alone, including quantitative information. To the extent any FIN 48 liabilities are excluded from the contractual obligations table or included in an "other" column, a footnote to the table should disclose the amounts excluded and the basis for such exclusion.

For guidance regarding certain other required disclosures under FIN 48 in Form 10-Q in the period of adoption, see also a discussion document issued by the SEC Regulations Committee at http://www.aicpa.org/caq/download/AppendixA_FIN48_092606_revised.pdf.

Guides for Researching on the SEC Web Site

The SEC has issued two useful guides for researching federal securities laws and public companies:

- The first guide provides an overview of how to research the federal securities laws through the SEC Web site. While the federal statutes and the SEC rules and regulations have the force of law, other SEC-issued documents vary in degree to which they carry the force of law. For this reason, the guide states that research on the federal securities laws should be conducted in the following order:
    - Federal Statues
    - SEC Rules and Regulations
    - SEC Concept Releases
    - SEC Interpretive Releases
    - SEC Staff Interpretations

  The guide provides suggestions for researching in each of these categories and can be accessed in full at http://www.sec.gov/investor/pubs/securitieslaws.htm.
- The SEC also has issued a guide that provides information on how to research public companies through EDGAR, which provides free public access to corporate information and SEC filings. The guide includes an overview of and tips for using EDGAR, together with answers to related frequently-asked questions. This guide can be accessed in full at http://www.sec.gov/investor/pubs/edgarguide.htm.

International

Exposure Drafts for Three Redrafted ISAs

In striving to improve the clarity of its standards, the International Auditing and Assurance Standards Board (IAASB) is continuing to redraft some of its existing standards. 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 approved for public comment exposure drafts of three proposed International Standards on Auditing (ISAs):

- ISA 200 (Revised and Redrafted), *Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing*;
- ISA 250 (Redrafted), *The Auditor's Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements*; and
- ISA 500 (Redrafted), *Considering the Relevance and Reliability of Audit Evidence*.

Proposed ISA 200 was revised to incorporate the relevant provisions of the amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*, which was re-issued in January 2007. This proposed ISA also describes the nature of an audit of financial statements and related concepts that provide the basis for a proper understanding of the conduct of an audit, the overall objective of the auditor, and the objectives and requirements stated in the ISAs. The requirement for the auditor to obtain sufficient appropriate audit evidence has been moved to proposed ISA 200 from existing ISA 500. As a result of the repositioning of this requirement, proposed ISA 500 focuses on the auditor's responsibility to design and perform audit procedures to obtain relevant and reliable audit evidence. Proposed ISA 250 basically has been redrafted in accordance with new IAASB conventions.

The IAASB has now issued four final ISAs drafted in accordance with the new conventions and 15 exposure drafts of ISAs. The IAASB expects to issue 15 more exposure drafts in 2007 and to complete all 34 ISAs as final standards by the end of 2008. The complete set of ISAs is currently expected to be effective for audits of financial statements for periods beginning on or after December 15, 2008.

Comments on the exposure draft of proposed ISA 250 are requested by July 31, 2007. Comments on the exposure drafts of proposed ISAs 200 and 500 are requested by September 15, 2007. The exposure drafts are available for comment at http://www.ifac.org/Guidance/EXD-Outstanding.php.
