

Insights

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

Accounting

Application of FIN 46(R) to Investment Companies

At its issuance in December 2003, FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, (FIN 46 (R)) stated that "an enterprise subject to SEC Regulation S-X Rule 6-03(c)(1) shall not consolidate any entity that is not also subject to that same rule." FIN 46(R) also provided an indefinite deferral of its effective date for investment companies not subject to that rule but who are currently accounting for their investments in accordance with the specialized accounting guidance in the AICPA Audit and Accounting Guide, *Investment Companies* (Guide). This scope exception and deferral were, however, subject to change pending the outcome of proposed changes to the Guide. In anticipation of the expected June 2007 issuance of AICPA Statement of Position (SOP) 07-01, *Clarification of the Scope of the Audit and Accounting Guide "Investment Companies" and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, on May 11, 2007 the FASB issued FASB Staff Position (FSP) No. FIN 46(R)-7, *Application of FASB Interpretation No. 46(R) to Investment Companies*.

This FSP was issued to address the application of FIN 46(R) by an entity that accounts for its investments in accordance with the specialized accounting guidance in the Guide. SOP 07-01 will provide guidance on the circumstances in which the specialized accounting in the Guide should not be retained by a noninvestment company parent or equity method investor of an investment company. As a result, when an entity initially adopts SOP 07-01, it may be required to consolidate an entity that was previously not consolidated or require the entity that had previously consolidated an investment under FIN 46(R) to apply the specialized accounting in the Guide. At that time, the entity will be subject to the provisions of FIN 46(R) according to FSP No. FIN 46(R)-7.

If initial application of this FSP and SOP 07-01 requires an entity to change its accounting to conform to the guidance in this FSP and SOP 07-01, it should do so based on the applicable transition guidance in SOP 07-01.

The FSP is available in full on the FASB Web site at http://www.fasb.org/fasb_staff_positions/fsp_fin46r-7.pdf. *Insights* will discuss SOP 07-01 in greater detail at the time it is issued by the AICPA.

FIN 48 and Income Tax Basis Reporting

FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, provides guidance about accounting for uncertainties in income taxes reported in an entity's financial statements prepared in accordance with generally accepted accounting principles (GAAP). FIN 48 prescribes that only when a tax position taken on the entity's tax return is more likely than not (a probability of greater than 50 percent) of being sustained upon examination by the taxing authorities,

the tax effect of that position is to be recognized in the entity's financial statements. Otherwise, the tax benefit of that position is not to be recognized in which case FIN 48 requires extensive disclosure about the amounts of those unrecognized tax benefits.

Questions have frequently been raised about the effect FIN 48 may have on income tax basis financial statements. Before answering those questions, it is important to understand what the income tax basis of accounting represents. The income tax basis of accounting is a comprehensive basis of accounting an entity uses in the preparation of its financial statements. The income tax basis is used to determine asset and liability amounts for the periodic statements of assets, liabilities and owners' equity and the intervening revenue and expenses between those periods that are reportable for income tax purposes. Therefore, the recognition and measurement principles used by the entity in the preparation of the federal income tax returns must also be used for financial statement purposes. The income tax basis of accounting is a recognition and measurement model that is obviously different than that used for financial statements prepared in accordance with GAAP. There should be no GAAP modifications made to the amounts recognized in income tax basis financial statements, such as providing for loss contingencies, recording deferred income taxes, or recording deferred compensation accruals. Since the income tax basis of accounting is based on a different recognition and measurement model than GAAP basis accounting, the recognition and measurement requirements of FIN 48 do not apply to income tax basis financial statements.

GAAP provides extensive guidance on disclosures that are to be made in financial statements prepared on that basis. Such guidance does not exist for financial statements prepared on the income tax basis. Therefore, judgment needs to be applied as to what disclosures should be made in the notes to financial statements prepared on the income tax basis. In applying that judgment, care should be taken that the notes to financial statements prepared on the income tax basis (similar to those prepared in accordance with GAAP) are informative of matters that may affect the use, understanding and interpretation of those financial statements. For example, notes to financial statements prepared on the income tax basis should include disclosures such as those related to contingencies, risks and uncertainties, related-party transactions, subsequent events, commitments, and income tax matters.

A tax return can generally be filed when there is only a 33 1/3 percent probability of a tax position being sustained upon examination. That means there is a greater possibility of a tax position (such as an aggressive tax position) being disallowed upon examination by the taxing authorities in tax basis financial statements thus increasing the risk of the entity being assessed additional income taxes in a future period. Therefore, consistent with the general guidance about disclosures discussed in the preceding paragraph, it would be expected notes to the financial statements would include disclosures about this uncertainty, including, based on the facts and circumstances unique to the situation, the dollar amount of the range of exposure or the maximum amount of exposure. As a general rule, the more aggressive the tax position, the greater the need for disclosure. FIN 48 requires a description of tax years that remain subject to examination by major tax jurisdictions and our Firm believes that disclosure should similarly be included in income tax basis financial statements. Also, our Firm believes income tax basis financial statements should include disclosure as to the amount and classification of material amounts of interest and penalties included in the statement of revenue and expenses, similar to the requirement in FIN 48. Our Firm does not believe the other disclosures required by FIN 48 need be made in financial statements prepared on the income tax basis.

Auditing

Starting to Prepare for Your 2007 Audit

Preparing for your next financial statement audit may not be business as usual. Significant changes in the auditing profession will impact how auditors perform financial statement audits for periods beginning on or after December 15, 2006 and will also require some related preparation by their clients. Last March, the American Institute of Certified Public Accountants passed a sweeping set of new standards that revised many fundamental auditing principles for audits of nonpublic entities. These new standards include new requirements that auditors:

- Obtain a more robust understanding about their clients' operations, their business objectives and strategies, and their process for identifying and managing risks to achieving those objectives.
- Gain a deeper understanding of their clients' internal controls.
- Perform a more rigorous assessment of risks of material misstatement of the financial statements, whether due to error or fraud, with clearly documented linkage of the risks of material misstatement to the audit work performed.

The main objective of these new auditing standards is to strengthen and enhance the quality of the audit, an objective that we support. We also believe these standards will benefit all stakeholders in the financial reporting process, especially those who rely on your financial statements in making decisions about your company or organization. The new standards, however, will require us to perform more extensive risk assessment procedures than in the past, resulting in an additional up-front time commitment from both our audit personnel and your employees.

In general, the new standards will require us to gain a more in-depth understanding of your internal control than we obtained in the past. For example, previously we focused on understanding how significant classes of transactions were processed. We now must also understand the internal controls over those processes and evaluate whether the controls have been designed in a way that allows them to function effectively.

These new requirements also will require most clients to gain a more meaningful understanding of internal control and their responsibilities for its establishment and maintenance. We believe that most clients will decide to improve the documentation of their internal control policies and procedures and, in many cases to strengthen the controls themselves. For example, since the financial statements are your responsibility, if we currently draft the financial statements and footnotes, you will need to document how you oversee that process.

We will be devoting significant resources to training all of our audit personnel so they are able to perform financial statement audits as effectively and efficiently as possible. It will be important for audit clients to start preparing for their audits now by documenting control policies and procedures and strengthening controls where warranted. Your auditor can provide some details as to what your company or organization should consider doing between now and year end. Your 2007 audit will run smoothly if we all start to prepare now.

PEEC Proposes Framework for Meeting Fundamental Principles of Professional Conduct

The fundamental principles of the Code of Professional Conduct of the American Institute of Certified Public Accountants (AICPA) guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. These fundamental principles are:

- *Article I – Responsibilities*
- *Article II – The Public Interest*
- *Article III – Integrity*
- *Article IV – Objectivity and Independence*
- *Article V – Due Care*
- *Article VI – Scope and Nature of Services*

Specific threats to meeting the objectives of these fundamental principles may arise when providing professional services to clients and employers. Because it is impossible to address in the Code of Professional Conduct every situation that creates such threats or to specify the appropriate safeguards to mitigate or eliminate those threats, the AICPA Professional Ethics Executive Committee (PEEC) has drafted a *Framework for Meeting the Objectives of the Fundamental Principles*. The PEEC also has drafted related Interpretation 102-7, *Other Considerations: Meeting the Objectives of the Fundamental Principles*, under Rule 102, *Integrity and Objectivity*, of the Code, which states that AICPA members should refer to the proposed framework when making decisions on ethical matters that are not explicitly addressed by the Code.

The proposed Framework would apply to all AICPA members – those in public practice as well as those in business, industry, government, and education. In cases where a member identifies a threat to meeting the objectives of the fundamental principles that is not clearly insignificant, the member is required to apply safeguards to eliminate the threat or reduce it to an acceptable level. Because the nature of the threats and safeguards may differ for members in public practice and those not in public practice, the proposed Framework provides specific examples of threats and safeguards that are relevant to members in public practice, separate from those that are relevant to members who are not in public practice. In addition, the proposed Framework contains guidance on ethical conflict resolution that is relevant to all members.

Bruce Webb, National Director of Auditing for McGladrey & Pullen, LLP, chairs the PEEC, and commented, “The proposed Framework will provide valuable guidance for members in addressing specific circumstances that may affect their professional conduct. The Framework, however, may not be used to justify noncompliance with the requirements of the Code.”

The Exposure Draft of the proposed Interpretation and Framework is available in full at http://www.aicpa.org/download/ethics/May_15_2007_Exposure_Draft.pdf. Comments on the Exposure Draft will be accepted through August 15, 2007.

Public Sector

Circular A-133 Supplement Released

The Office of Management and Budget has released a March 2007 supplement to Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Circular A-133 sets forth standards for auditing states, local governments, and non-profit organizations that administer Federal financial assistance programs. The Compliance Supplement provides guidance regarding Federal programs’ objectives,

procedures, and compliance requirements. This Supplement also provides guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for Federal programs. For single audits, the Supplement replaces agency audit guides and other audit requirement documents for individual Federal programs. The March 2007 Supplement, which is effective for audits of fiscal years beginning after June 30, 2006, is available at http://www.whitehouse.gov/omb/circulars/a133_compliance/07/07toc.html.

SEC

PCAOB Revises Auditing Standard on Internal Control Over Financial Reporting

On May 24, 2007, the Public Company Accounting Oversight Board (PCAOB) approved new Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*. This standard supersedes PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. Among other revisions, the new standard:

- Directs the auditor to the most important controls and emphasize the importance of risk assessment;
- Revises the definition of a material weakness;
- Clarifies the role of materiality in the audit;
- Removes the requirement to evaluate management's process;
- Permits consideration of knowledge obtained during previous audits;
- Directs the auditor to tailor the audit to reflect the attributes of smaller and less complex companies; and
- Refocuses the multi-location testing requirements on risk rather than coverage.

In addition to the internal control standard, the PCAOB also adopted related Rule 3525, *Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting*, and conforming amendments to certain of its other auditing standards. The PCAOB's new standard and rule do not change current rules or regulations unless formally adopted by the SEC. You may monitor the McGladrey & Pullen's Web site for updates and current events.

SEC Issues SOX 404 Interpretive Management Guidance

Under current SEC rules, a public company that is not required to file annual and quarterly reports on an accelerated basis (i.e., a non-accelerated filer) is not required to provide management's report on internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404) until it files an annual report for a fiscal year ending on or after December 15, 2007. The auditor's attestation report on internal control over financial reporting is not required until a non-accelerated filer files an annual report for a fiscal year ending on or after December 15, 2008. To assist registrants in complying with the internal control reporting requirements, the SEC has issued guidance that will likely change the way in which management evaluates internal control over financial reporting. The guidance outlines steps that public company executives may take to tailor their evaluations to the complexity of their businesses.

The new guidance is organized around two principles - materiality and risk. First, management should evaluate the design of the controls that it has implemented to determine whether there is a reasonable possibility that a material misstatement in the financial statements would not be prevented or detected in a

timely manner. Second, management should gather and analyze evidence about the operation of the controls being evaluated based on its assessment of the risk associated with those controls. Because smaller public companies often have less complex internal control systems than larger public companies, this approach now enables smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances.

The SEC also approved rule amendments providing that a company that performs an evaluation of internal control in accordance with the interpretive guidance satisfies the annual evaluation required by Exchange Act Rules 13a-15 and 15d-15. Further, the SEC revised the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting to more clearly convey that the auditor is not evaluating management's evaluation process but is opining directly on internal control over financial reporting. It should also be noted that the SEC amended its rules to define the term "material weakness" as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

The effective date of the interpretive guidance and adopted rules will be 30 days from their publication in the Federal Register. The full text of the interpretive guidance and rules will be posted to the SEC Web site.

SEC Proposes Changes to Certain Reporting Requirements for Smaller Companies

On May 23, 2007, the SEC decided to propose changes to certain of its registration and disclosure requirements for smaller companies, as well as private offerings of securities. The details of these proposals will be posted to the SEC Web site soon and are expected to include the following:

- Expanding the eligibility for the SEC's scaled disclosure and reporting requirements for smaller companies by making the scaled requirements available to all companies that have a public float of less than \$75 million. The SEC also proposes to simplify its disclosure and reporting requirements for smaller companies by combining the "small business issuer" and "non-accelerated filer" categories into one "smaller reporting companies" category. To further simplify its disclosure and reporting requirements for smaller reporting companies, the SEC proposes to integrate current Regulation S-B disclosure requirements into the disclosure requirements of Regulation S-K and rescind the use of "SB" forms.
- Revising the eligibility requirements for the use of Forms S-3 and F-3 to allow companies that do not meet the current public float requirements of the forms to nevertheless register primary offerings of their securities, subject to a restriction on the amount of securities those companies may sell pursuant to the expanded eligibility standard in any one-year period.
- Providing new exemptions for compensatory employee stock options so Exchange Act registration requirements would not be triggered solely by a company's compensation decisions.
- Establishing a new exemption from the Securities Act registration provisions in new Rule 507 of Regulation D for sales of securities to a new category of qualified purchasers with respect to which the issuer could engage in limited advertising. The SEC also proposes to add an investments-owned standard to the current total assets and net worth standards under which investors can qualify as "accredited" in other Regulation D offerings. Further the SEC plans to provide for adjustments to the definition of "accredited investor" in Regulation D to account for inflation beginning in 2012.

- Shortening the holding period for restricted securities of reporting companies to six months and reintroducing a provision that tolls the holding period for up to six months while the security holder is engaged in certain hedging transactions.

"Many of these proposals are consistent with the findings of the SEC Advisory Committee on Smaller Public Companies. The Committee made several recommendations regarding corporate disclosure and reporting requirements for smaller public companies, and the process, requirements and exemptions relating to offerings of securities by smaller companies," said Leroy Dennis, executive partner – assurance services for McGladrey & Pullen LLP, and member of the Committee. Chartered in 2005, the Advisory Committee's objective was to assess the regulatory system for smaller companies under the securities laws of the United States, and make recommendations for changes.

Strengthening the Competitiveness of U.S. Capital Markets

U.S. Treasury Secretary Henry M. Paulson, Jr. believes that the backbone of a marketplace investors can trust is formed by a transparent financial reporting system and a vibrant auditing profession. Therefore, he recently announced two initiatives to enhance the competitiveness of U.S. capital markets - focusing on strengthened financial reporting and a more sustainable auditing profession:

- Because restatements of financial statements have soared during the past decade from 116 in 1997 to 1,876 in 2006, the Treasury Department plans to commission a rigorous analysis of the factors driving financial statement restatements and their impact on investors and the capital markets.
- The Treasury Department also intends to charter a non-partisan committee to develop recommendations to consider options available to strengthen the auditing industry's financial soundness and its ability to attract and retain qualified personnel.

Commenting on Secretary Paulson's focus on a more sustainable auditing profession, Leroy Dennis, executive partner – assurance services for McGladrey & Pullen, LLP, stated, "In the past, an audit was seen as a commodity. Today an audit is seen by investors and lenders as an independent line of enforcement of financial reporting standards. It is seen as a vital filter that provides confidence to users of financial statements."

The Treasury Department also expressed its support of the SEC and the Financial Accounting Standards Board's efforts to enhance financial reporting transparency and accessibility for investors. The Treasury Department would like to see the continued convergence of U.S. generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS), and agrees with the SEC's action to eliminate by 2009 the U.S. GAAP reconciliation requirement of IFRS-reporting companies. These actions are expected to encourage international companies to list on U.S. exchanges and to increase investor opportunities.

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