

# Insights

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## Accounting

### EITF Issues

The Financial Accounting Standards Board (FASB) recently ratified the final consensuses for the following Issues reached at the June 15, 2006 Emerging Issues Task Force (EITF) meeting:

- *EITF Issue No. 05-1, "The Accounting for the Conversion of an Instrument That Became Convertible upon the Issuer's Exercise of a Call Option"*

The accounting question being addressed in this Issue is how to account for the issuance of equity securities to settle a debt instrument that was not otherwise convertible but became convertible upon the issuer's exercise of a call option when the issuance of equity securities is pursuant to the instrument's original conversion terms. A consensus was reached that the issuance of equity securities to settle a debt instrument pursuant to its original conversion terms that became convertible upon the issuer's exercise of a call option should be accounted for as a conversion if the debt instrument contained a substantive conversion feature as of its issuance date. If the instrument did not contain a substantive conversion feature as of its issuance date, the equity securities issued to settle the debt instrument should be accounted for as a debt extinguishment. Also, Issue No. 03-7, "Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)," was amended to clarify that it does not apply to settlements within the scope of Issue 05-1.

- *EITF Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, 'Accounting for Compensated Absences'"*

The accounting question being addressed in this Issue is whether to accrue compensation cost related to a sabbatical leave, or similar benefit arrangement. A consensus was reached that an employee's right to a compensated absence under a sabbatical leave or other similar benefit arrangement that requires the completion of a minimum service period and in which the benefit does not increase with additional years of service, accumulates pursuant to paragraph 6(b) of Statement No. 43 for arrangements in which the individual continues to be a compensated employee and is not required to perform duties for the entity during the absence. Therefore, assuming all of the other conditions of paragraph 6 of Statement No. 43 are met, the compensation cost associated with a sabbatical leave or other similar benefit arrangement should be accrued over the requisite service period.

- *EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)"*

The accounting question being addressed in this Issue is how to report nondiscretionary amounts assessed by governmental authorities in connection with transactions with customers in the entity's income statement. A consensus was reached that the presentation on either a gross (included in revenues and costs) or a net (excluded from revenues) basis of any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer (such as sales, use, value-added, and some excise taxes) is an accounting policy decision that should be disclosed pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*. For any such taxes that are reported on a gross basis, a company should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant.

The FASB also approved draft abstracts of the following EITF Issues for which a tentative consensus was reached and which are available for comment until August 4, 2006 at [http://www.fasb.org/eitf/eitf\\_draft\\_abstracts.shtml](http://www.fasb.org/eitf/eitf_draft_abstracts.shtml):

- *EITF Issue No. 06-1, "Accounting for Consideration Given by a Service Provider to Manufacturers or Resellers of Equipment Necessary for an End-Customer to Receive Service from the Service Provider"*

Certain companies provide services to their customers that require the customers to purchase equipment in order to utilize their services. The required equipment often is manufactured and distributed by third-parties and sold through resellers. The accounting question being addressed in this Issue is whether any incentives given by service providers to third-party manufacturers or resellers should be accounted for in accordance with Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)." A tentative conclusion was reached that if the consideration given by a service provider to a manufacturer or reseller (that is not a customer of the service provider) can be linked contractually to the benefit received by the service provider's customer, the service provider should account for the consideration in accordance with Issue 01-9.

- *EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"*

The accounting question being addressed in this Issue is whether the postretirement benefit associated with an endorsement split-dollar life insurance arrangement is effectively settled in accordance with either FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, or APB Opinion No. 12, *Omnibus Opinion—1967*, upon entering into such an arrangement. The scope of this Issue is limited to the recognition of a liability and related compensation costs for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement periods. A tentative conclusion was reached that for a split-dollar life insurance arrangement within the scope of the Issue, an employer should recognize a liability for future benefits in accordance with Statement No. 106 or Opinion No. 12 (depending upon whether a substantive plan is deemed to exist) based on the substantive agreement with the employee.

- *EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4."*

The accounting questions being addressed in this Issue center on determining the *amount that could be realized under the insurance contract* in accordance with FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*. A tentative conclusion was reached that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the *amount that could be realized under the insurance contract*. A tentative conclusion also was reached that a policyholder should determine the *amount that could be realized under the life insurance contract* assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy).

The minutes of the June 15, 2006 EITF meeting are available at [http://www.fasb.org/eitf/06-15-06\\_mtg\\_minutes.pdf](http://www.fasb.org/eitf/06-15-06_mtg_minutes.pdf).

### Revised Texas Franchise Tax Could Affect Deferred Income Tax Calculations

On May 18, 2006, the state of Texas enacted House Bill (HB) 3, which replaces the state's existing franchise tax base and lowers the tax rate. This tax generally applies to corporations, limited liability companies, partnerships, professional associations, and joint ventures with operations in Texas. The new tax base is the taxable entity's margin. Margin equals the lesser of three calculations:

- Total revenue minus cost of goods sold;
- Total revenue minus compensation; or
- Total revenue times 70 percent.

The revised tax rate is 0.5 percent of the tax base for retailers, wholesalers, and eating and drinking establishments. The rate is 1 percent of the tax base for all other taxable entities. Changes made by HB 3 are effective for franchise tax reports originally due on or after January 1, 2008. Although this tax law change is not effective until it is applied to 2007 business activity, it could affect financial reporting in 2006 because of the enactment date.

Per FASB Statement No. 109, *Accounting for Income Taxes*, the "applicable tax rate" should be used to measure the deferred tax asset on deductible temporary differences and operating loss carryforwards, and the deferred tax liability on taxable temporary differences. The applicable tax rate is the enacted tax rate and tax laws expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be realized or settled, respectively. A tax law is enacted when tax legislation has been signed into law.

Presently enacted changes in tax laws and rates that become effective for a particular future year(s) are to be considered in determining the tax rate to apply to temporary differences reversing in that year(s). The effect on deferred tax assets and liabilities from an enacted change in tax laws or rates is recognized in income from continuing operations in the period of enactment, regardless of whether the tax legislation is retroactive or prospective. Calendar year-end companies will be required to include the effect of the change in the tax law in the year ending December 31, 2006.

Statement No. 109 also clarifies interim-period reporting of the effect of new tax legislation. The impact of tax law changes are recognized on a discrete basis in the interim period that includes the enactment date of the tax legislation and are not allocated to other interim periods. Calendar year-end companies that

issue interim-period financial reports will be required to include the effect of the change in the tax law in the quarter ended June 30, 2006.

More information about HB 3 is available at [http://www.window.state.tx.us/taxinfo/taxpubs/tx98\\_806.pdf](http://www.window.state.tx.us/taxinfo/taxpubs/tx98_806.pdf), which also provides a direct link to the newly enacted tax legislation.

### **FASB and IASB Draft Initial Chapters of Joint Conceptual Framework**

Currently, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are each guided by their own individual framework. Because these differ from each other in various respects, the boards agreed to the joint development of a common conceptual framework that brings together the existing frameworks of both boards. Recently, the boards each published for public comment the first two chapters of the conceptual framework setting forth their preliminary views on the objective of financial reporting and the qualitative characteristics of decision-useful financial information.

The FASB and the IASB invite comments on their preliminary views by November 3, 2006. The FASB's preliminary views are available at [http://www.fasb.org/draft/pv\\_conceptual\\_framework.pdf](http://www.fasb.org/draft/pv_conceptual_framework.pdf), and the IASB's preliminary views are expected to be available at [www.iasb.org](http://www.iasb.org) after July 17, 2006. In addition to these initial chapters, the boards plan further chapters addressing such matters as the definitions of assets, liabilities, revenues and expenses, how they are recognized and measured in financial statements, and the presentation of disclosures in financial statements.

## **Public Sector**

### **FIN 47 Also Applies to the Health Care Industry and Not-for-Profit Entities**

In March of 2005, the Financial Accounting Standards Board published FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations – an Interpretation of FASB Statement No. 143*, (FIN 47) to provide guidance for more consistent recognition of liabilities relating to conditional asset retirement obligations and more information about future cash outflows relating to these obligations. Statement No. 143, *Accounting for Asset Retirement Obligations*, requires entities to record an obligation, when incurred, for the cost of retiring assets through renovation, demolition or sale. For example, if a company is legally obligated to restore a building site back to a certain condition, it is required to accrue that obligation once the contract or law establishes the obligation, as opposed to at the end of the asset's useful life. In addition, these liabilities need to be recorded even if the entity plans to sell the facility versus actually performing the remediation.

Entities may mistakenly believe that FIN 47 only applies to companies in "dirty" industries, such as mining or nuclear power production, because they need to accrue clean up costs, such as land reclamation or nuclear decommissioning. Actually, asset retirement obligations exist in substantially all industries. Throughout the United States, the implementation of FIN 47 has resulted in universities, hospitals, nursing homes and medical clinics, among others, recognizing asset retirement obligations when none had previously been recognized.

For example, assume that Hospital A knows that some of its facilities contain asbestos and that these facilities are located in a state that requires asbestos abatement if the facilities undergo major renovations or are demolished. The hospital's ten-year strategic plan calls for major renovation of two of the buildings within the next five years. The hospital therefore has the information needed to estimate a range of potential dates for asbestos removal, the potential methods of removal, and the related costs and probabilities associated with the potential dates and methods. Consequently, the hospital is able to

estimate the fair value of the liability for the special handling of the asbestos for two of its buildings using an expected present value technique. The hospital would recognize the cumulative effect of initially applying FIN 47 as a change in accounting principle reflected as of the beginning of the first period presented.

In another example, assume that Hospital B also knows that some of its facilities contain asbestos and that these facilities are located in the same state that requires asbestos abatement if the facilities undergo major renovations or are demolished. However, Hospital B has no plans to renovate or demolish any of the facilities that would trigger a future outflow of cash for asbestos remediation. The Hospital is also not aware of any need for major renovations caused by technology changes, operational changes, or other factors. Additionally, the Hospital is unsure as to whether it will ever renovate but instead sell the facilities "as is" once the facilities are near or at the end of their useful life. The hospital has concluded that it does not have the information needed to estimate the range of time over which the entity may need to remove the asbestos and consequently cannot reasonably estimate the fair value of the liability. Hospital B is not required to estimate or record the abatement liability, but the circumstances must be disclosed in the financial statements. However, in the future when this information becomes available, such as when Hospital B makes plans to renovate or demolish the facility, it will need to record the fair value of the abatement liability using an expected present value technique.

Interpretation 47 was effective no later than the end of fiscal years ending after December 15, 2005. If FIN 47 was not properly implemented in the financial statements of a period for which it was effective, such an error must be reported as a prior-period adjustment. The full text of the Interpretation is available at <http://www.fasb.org/pdf/fin%2047.pdf>.

### **Technical Bulletin Clarifies Reporting of Medicare Part D Payments**

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 provides for a prescription drug benefit under Medicare Part D as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D.1. Recently, the Governmental Accounting Standards Board (GASB) published a Technical Bulletin to clarify the reporting of payments that an employer or a defined benefit other postemployment benefit (OPEB) plan receives from the federal government under Medicare Part D. The Technical Bulletin analyzes the following four questions:

- How should an employer account for and report a Medicare Part D payment from the federal government to the employer?
- How does a Medicare Part D payment from the federal government to an employer affect the accounting for the transaction and financial reporting by a defined benefit OPEB plan?
- How should an employer account for and report a Medicare Part D payment from the federal government to the plan?
- How should a defined benefit OPEB plan account for and report a Medicare Part D payment from the federal government to the plan?

The Technical Bulletin is effective immediately, except for portions of answers pertaining to the measurement, recognition, or required supplementary information requirements of GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. Those provisions should be applied simultaneously with the implementation of Statement No. 43 or 45.

## SEC

### COSO Guidance for Smaller Public Companies

In adopting its rules with respect to Section 404 of the Sarbanes-Oxley Act of 2002, the SEC specified that management must base its evaluation of the effectiveness of a company's internal control over financial reporting on a suitable, recognized control framework that is established by a group that has followed due-process procedures. The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) 1992 *Internal Control – Integrated Framework* satisfies that criteria and has been widely used by management and auditors in fulfilling SOX 404 requirements. Concerns have been expressed, however, that such a framework is not appropriately tailored to a small business internal control environment. In response to these concerns, COSO has issued guidance on the use of its framework to address the needs of smaller businesses in *Internal Control Over Financial Reporting - Guidance for Smaller Public Companies*.

The new document is not intended to replace or modify the original COSO internal control framework, but rather to provide guidance for smaller public companies and their auditors in applying the framework when assessing and reporting on the effectiveness of internal control over financial reporting. The document outlines 20 fundamental principles that constitute effective internal control over financial reporting and are equally applicable to larger and smaller businesses, governmental agencies, and not-for-profit organizations. The report defines each principle, describes its attributes, lists a variety of approaches smaller companies can use to incorporate the principles, and includes real-world examples of how smaller companies have effectively applied the principles.

A free executive summary of the new guidance is available at [http://www.coso.org/Publications/SB\\_Executive\\_Summary.pdf](http://www.coso.org/Publications/SB_Executive_Summary.pdf), and the complete guidance can be purchased at <https://www.cpa2biz.com/stores/coso3>.

### SEC Solicits Feedback on Guidance for the Management Assessment Process

On May 17, 2006, the Public Company Accounting Oversight Board (PCAOB) and the SEC announced a series of actions they intend to take to improve the implementation of the Section 404 internal control requirements of the Sarbanes-Oxley Act of 2002 (SOX 404). One of the SEC's stated intentions is to issue additional guidance for management on how to complete its assessment of internal control over financial reporting as required by SOX 404, with such guidance expected to be responsive to the circumstances of smaller public companies. To prepare for the release of such guidance, the SEC recently issued a Concept Release soliciting views on supplementary guidance for the management assessment process.

The SEC published the Concept Release so that any additional guidance developed for management regarding its evaluation and assessment of internal control over financial reporting will address the needs and concerns of public companies, consistent with the protection of investors. The Concept Release seeks feedback on the following areas in which the SEC anticipates issuing guidance for management:

- Identifying risks to financial statement account and disclosure accuracy and the related internal controls that address the risks, including how management might use company-level controls to address the risks;
- Objectives of the evaluation procedures and methods or approaches available to management to gather evidence to support its assessment;

- Factors management should consider to determine the nature, timing, and extent of its evaluation procedures and;
- Documentation requirements, including overall objectives of the documentation and factors that might influence documentation requirements.

The Concept Release, which is available in full at <http://www.sec.gov/rules/concept/2006/34-54122.pdf>, also solicits views on whether guidance should be provided in additional areas.

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