

Insights

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Accounting

FASB Ratifies EITF Final Consensuses

At its June 25, 2008 meeting, the Financial Accounting Standards Board (FASB) ratified the final consensuses for the following Issues reached at the June 12, 2008 Emerging Issues Task Force (EITF) meeting:

- *EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock"*

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, specifies that a contract (that would otherwise meet the definition of a derivative under that Statement) issued or held by the reporting entity that is both indexed to its own stock and classified in stockholders' equity in its statement of financial position should not be considered a derivative financial instrument for purposes of applying that Statement. Issue No. 07-5 provides guidance for determining whether an equity-linked financial instrument (or an embedded feature) is indexed to an entity's own stock, using a two-step approach. First, the instrument's contingent exercise provisions, if any, must be evaluated, followed by an evaluation of the instrument's settlement provisions. The guidance in this Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. This guidance will likely change the classification of many non-public entity warrants. Look for further guidance in a future *Insights* article.

- *EITF Issue No. 08-3, "Accounting by Lessees for Maintenance Deposits"*

Certain lease agreements include provisions requiring the lessee to make deposits with the lessor to financially protect the lessor if the lessee does not properly maintain the leased asset. This Issue addresses how a lessee should account for a maintenance deposit under an arrangement accounted for as a lease. This Issue applies to the lessee's accounting for maintenance deposits paid by a lessee under an arrangement accounted for as a lease that are refunded only if the lessee performs specified maintenance activities. The Issue concludes that maintenance deposits within its scope must be accounted for as a deposit asset. This Issue is effective for fiscal years beginning after December 15, 2008, including interim periods within those fiscal years.

- *EITF Issue No. 08-4, "Transition Guidance for Conforming Changes to Issue No. 98-5"*

The objective of this Issue is to provide transition guidance for conforming changes made to Issue No. 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" that resulted from Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," and FASB Statement No. 150, *Accounting for*

Certain Financial Instruments with Characteristics of both Liabilities and Equity. This transition guidance is unique in that the current changes reflect matters that should have been addressed in the past, but were missed. Issue No. 08-4 concludes that conforming changes made to Issue No. 98-5 that result from Issue No. 00-27 and Statement No. 150 are effective for financial statements issued for fiscal years ending after December 15, 2008.

Minutes of the June 12, 2008 EITF meeting are available at http://www.fasb.org/eitf/06-12-08_mtg_minutes.pdf.

Valuing Liabilities with a Guarantee Measured at Fair Value

Debt securities are often issued with credit enhancements obtained from an unrelated third party or related party. For example, debt may be issued with a financial guarantee from an unrelated third party that guarantees the issuer's payment obligations. That guarantee is generally purchased by the issuer who then combines it with the debt and issues the combined security to an investor. By issuing debt combined with the guarantee, the issuer is able to obtain a lower interest rate and/or receive higher initial proceeds.

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, allows an entity to measure its financial assets and liabilities at fair value subject to certain requirements. Furthermore, Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires disclosure of the fair value of all financial instruments, with certain exceptions. Statement No. 157, *Fair Value Measurements*, states that the fair value of a liability must reflect the nonperformance risk (that is, the risk that the obligation will not be fulfilled) relating to that liability. As a result, questions have arisen regarding whether the issuer should consider the effect of a third-party credit enhancement when measuring the liability at fair value under Statement No. 157.

At its June 12, 2008, meeting, the Emerging Issues Task Force (EITF) addressed whether an issuer of debt with a third-party guarantee that is inseparable from the debt instrument should treat the debt and the guarantee as one unit of accounting or two units of accounting when the measurement attribute for that debt is fair value. The EITF reached a tentative conclusion in Issue No. 08-5, "Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement" that the issuer of debt with a third-party credit enhancement that is inseparable from the debt instrument must not include the effect of the credit enhancement in the fair value measurement of the liability. However, the issuer must disclose the existence of a third-party credit enhancement on its issued debt.

The draft abstract of EITF Issue No. 08-5 is available for comment until August 4, 2008 at <http://www.fasb.org/eitf/0805DA.pdf>. The next EITF meeting where this Issue could be discussed and finalized is September 2008. The Issue is proposed to be effective on a prospective basis in the first reporting period beginning after the date of ratification of the consensuses by the Financial Accounting Standards Board.

McGladrey & Pullen Comments on Proposed FSP

On May 30, 2008, the Financial Accounting Standards Board (FASB) issued proposed FASB Staff Position (FSP) No. FAS 133-b and FIN 45-c, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45*. Recently, McGladrey & Pullen, LLP issued a letter of comment supporting the proposed FSP because we believe it will achieve the FASB's objective of improving disclosures about credit derivatives and guarantees. Our letter also offered the following comments for consideration by the FASB:

- Paragraph 10.a. requires disclosure of "the current status of the payment/performance risk of the credit derivative" for each statement of financial position presented. We are unclear as to whether

the FASB intends the current status to be as of the financial statement date, the date of the report, or another date. We also fail to understand the benefits of comparative disclosure for this information. We recommend clarification of the terminology, and removal of the comparative requirement.

- The effective date for this proposed FSP is for fiscal years and interim periods ending after November 15, 2008. We recommend changing the proposed FSP's effective date to coincide with FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. Therefore the effective date would be for interim periods beginning after November 15, 2008.

The proposed FSP is available at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas133-b&fin45-c.pdf.

Public Sector

Accounting for Derivative Instruments

The Governmental Accounting Standards Board (GASB) has issued GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. This Statement specifically requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting. Statement No. 53 also improves disclosures, requiring a summary of the government's derivative instrument activity, its objectives for entering into derivative instruments, and their significant terms and risks.

Statement No. 53 addresses hedge accounting requirements, providing specific criteria that governments will use to determine whether a derivative instrument results in an effective hedge. Changes in fair value for effective hedges that are achieved with derivative instruments will be recognized in the reporting period to which they relate. The changes in fair value of these hedging derivative instruments do not affect current investment revenue, but are instead reported as deferrals in the statement of net assets or the balance sheet. Derivative instruments that either do not meet the criteria for an effective hedge or are associated with investments that are already reported at fair value are classified as investment derivative instruments for financial reporting purposes. Changes in fair value of those derivative instruments are reported as part of investment revenue in the current reporting period.

Statement No. 53 is effective for financial statements for reporting periods beginning after June 15, 2009, with earlier application encouraged. A question-and-answer fact sheet about the Statement is available at http://www.gasb.org/project_pages/Derivatives_Final_Statement_Fact_Sheet.pdf.

Webinar Regarding New Requirements for 403(b) Plans

On July 26, 2007, the U.S. Treasury Department published the long-awaited final regulations for 403(b) plans. These regulations are aimed at aligning 403(b) plans, available only to certain not-for-profits, churches, and public school systems, with the 401(k) plans available to "for profit" plan sponsors. The new regulations are effective for most 403(b) plans with taxable years beginning on or after January 1, 2009.

As a result of these regulations, plan sponsors must bring their existing 403(b) plans up to par with the new requirements. RSM McGladrey, Inc. has developed a technical paper regarding these new requirements, which is available at http://www.rightfitretirementpartner.com/media/pdf/403bplanguidance_Aug07_.pdf. Also, RSM McGladrey Retirement Resources is sponsoring a free live CPE webinar on Thursday, July 24, at 2 p.m. Central Time to overview the most important changes, such as those regarding the plan document, Form 5500 filing, and compliance testing. The session is scheduled to last for 75 minutes. To register for this free session, please click [here](#).

SEC

Regulation S-K Interpretations

The SEC has issued Compliance and Disclosure Interpretations (C&DIs), which comprise interpretations of Regulation S-K. The new interpretations replace the interpretations of Regulation S-K and Regulation S-B that are published in the July 1997 *Manual of Publicly Available Telephone Interpretations*, the March 1999 *Interim Supplement to the Manual of Publicly Available Telephone Interpretations*, the November 2000 *Current Issues and Rulemaking Projects Outline*, the 2007 *C&DIs on Items 201, 402, 403, 404 and 407*, and the March 2008 *C&DIs on Smaller Reporting Companies*. The Regulation S-K interpretations are available in full at <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm>.

International

Accounting for Agreements for the Construction of Real Estate

On July 3, 2008, the International Financial Reporting Interpretations Committee (IFRIC) issued IFRIC 15, *Agreements for the Construction of Real Estate*. The Interpretation addresses the accounting for revenue and associated expenses by entities that engage in the construction of real estate directly or through subcontractors. The Interpretation provides guidance on how to determine whether an agreement for the construction of real estate is within the scope of IAS 11, *Construction Contracts* or IAS 18, *Revenue* and when revenue from the construction should be recognized.

Agreements for the construction of real estate vary significantly and may relate to residential, commercial or industrial developments. Construction often spans more than one accounting period, may take place on land the buyer owns or leases before construction begins and agreements may require progress payments. In addition, some agreements are for the provision of construction services, while others are in substance for the delivery of goods (e.g. housing units) that have yet to be completed at the date of the agreement. The underlying issue is that the percentage of completion method is appropriate for some agreements, while for others revenue should be recognized only at the point that the constructed real estate is delivered to the customer. The Interpretation provides guidance as to how to determine which approach is appropriate in which circumstances. IFRIC 15 concludes that IAS 11 should be applied only when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether or not the buyer exercises that ability).

The main expected change in practice is a shift for some entities from recognizing revenue using the percentage of completion method (i.e., as construction progresses, by reference to the stage of completion of the development) to recognizing revenue at a single time (i.e., at completion upon or after delivery). Agreements that will be affected will be mainly those currently accounted for in accordance with IAS 11 that do not meet the definition of a construction contract as interpreted by the IFRIC and do not transfer to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses.

IFRIC 15 is effective for annual periods beginning on or after January 1, 2009 and is to be applied retrospectively. Earlier application is permitted.

Hedges of a Net Investment in a Foreign Operation

In certain companies, the currency that is used to present financial statements (the presentation currency) differs from the currency that the company or its foreign subsidiaries use daily and in which they generate net cash flows (the functional currency). Currently, some of those companies use hedge accounting when "translating" that functional currency into the presentation currency. The International Financial Reporting Interpretations Committee (IFRIC) takes the view that this translation of currency for presentational use does not represent a hedgeable economic risk.

To clarify what qualifies as a risk in the hedge of a net investment in a foreign operation, the IFRIC has released an Interpretation, IFRIC 16, *Hedges of a Net Investment in a Foreign Operation*. IFRIC 16 concludes that the hedged risk is the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any parent entity within the group structure. Consequently, it does not allow the use of hedge accounting when translating a functional currency into a presentation currency.

The Interpretation also considers which individual entity within a group structure can hold a hedging instrument. The Interpretation states that the hedging instrument can be held by any subsidiary or parent entity within a group regardless of the entity's functional currency. IFRIC 16 further states that while International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, must be applied to determine the amount that needs to be reclassified to profit or loss from the foreign currency translation reserve in respect of the hedging instrument, IAS 21, *The Effects of Changes in Foreign Exchange Rates*, must be applied in respect of the hedged item.

The IFRIC recognizes the difficulty that entities would face in preparing adequate documentation from the inception of the hedge relationship. It therefore states that the guidance should be applied prospectively, i.e. for all future transactions. The Interpretation is effective for annual periods beginning on or after October 1, 2008, with earlier application permitted. IFRIC 16 applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with IAS 39. It does not apply to other types of hedge accounting.

Standard Clarifies Auditor's Responsibilities with Respect to Related Parties

The International Auditing and Assurance Standards Board (IAASB) recently released International Standard on Auditing (ISA) 550 (Revised and Redrafted), *Related Parties*. This Standard clarifies the meaning of "related party" for purposes of an audit. It also makes clear the auditor's responsibility to obtain sufficient evidence about the required accounting and disclosures of related-party relationships and transactions. The Standard emphasizes the need for the auditor to understand related-party relationships and transactions in order to identify the risks of material misstatement to which these may give rise.

In addition to ISA 550 (Revised and Redrafted), the IAASB has also recently released the following redrafted ISAs:

- ISA 250 (Redrafted), *Consideration of Laws and Regulations in an Audit of Financial Statements*;
- ISA 510 (Redrafted), *Initial Audit Engagements – Opening Balances*; and
- ISA 570 (Redrafted), *Going Concern*.

These standards result from the IAASB's program of redrafting existing standards following its clarity drafting conventions. To date, the IAASB has released 15 redrafted ISAs, and is on track to finalize its complete set of clarified ISAs by the end of this year. The clarified ISAs, including newly revised standards

such as ISA 550 (Revised and Redrafted), will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The ISAs are available in full at <http://www.ifac.org/store/Category.tmpl?Category=Auditing%2C%20Assurance%20%26%20Related%20Services&Cart=1216130830334511>.

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