

Insights

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Accounting

Accounting for Uncertainty in Income Taxes

When a position is taken in a tax return that reduces the amount of income taxes paid to a taxing authority, a company realizes an immediate economic benefit. However, whether a position taken in an income tax return will ultimately be sustained may be uncertain. Because FASB Statement No. 109, *Accounting for Income Taxes*, contains no specific guidance on how to address uncertainty in accounting for income tax assets and liabilities, the Financial Accounting Standards Board (FASB) has issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109*.

FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The evaluation of a tax position in accordance with this Interpretation is a two-step process:

- **Recognition:** The company must first determine whether it is more likely than not (a likelihood of more than 50 percent) that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit of that position is not recognized in the financial statements.
- **Measurement:** A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Interest and penalties that would be required to be paid on an underpayment of income taxes must be accrued beginning in the first period as required by the relevant tax law.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in Statement No. 109 is not an appropriate substitute for the recognition or derecognition (reversal) of a liability for a tax position, and the liability cannot be classified with deferred income tax liabilities.

FIN 48 also requires expanded disclosure with respect to the uncertainty in income taxes at the end of each annual reporting period presented:

- A tabular reconciliation and rollforward of the total amounts of unrecognized tax benefits at the beginning and end of the period;

- The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate;
- The total amounts of interest and penalties recognized in the income statement and in the balance sheet;
- Certain additional disclosures for positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date; and
- A description of tax years that remain subject to examination by major tax jurisdictions.

FIN 48 is effective for fiscal years beginning after December 15, 2006 and will require management to evaluate every open tax position that exists on the date of initial adoption in every jurisdiction. This evaluation must include management's decision not to file tax returns in certain states. However, when past administrative practices of the taxing authority in its dealings with the company or similar companies are widely understood, those practices may be taken into account.

The effect of this new Interpretation on companies' financial statements may be a net increase or decrease in net assets, depending on the number of aggressive positions taken on past income tax issues, as well as what accounting was previously followed for such uncertain tax positions. The process of investigating all open positions and assessing them using the new guidelines may be a time-consuming process, especially for companies with a significant number of jurisdictions and complex issues.

The Interpretation is available in full at www.fasb.org/pdf/fin%2048.pdf.

Accounting for Cash Flows Generated by Leveraged Leases

Leveraged leases can provide significant tax benefits to the lessor. The timing of the cash flows relating to income taxes generated by a leveraged lease is an important assumption that affects the periodic income recognized by the lessor for that lease. Recently, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction*, which will require companies to recalculate their leveraged leases if there is a change or projected change in the timing of cash flows relating to income taxes generated by the leveraged lease. The FSP amends FASB Statement No. 13, *Accounting for Leases*.

Per the FSP, the projected timing of income tax cash flows generated by a leveraged lease transaction must be reviewed annually or more frequently if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. If, during the lease term, the projected timing of the income tax cash flows generated by a leveraged lease is revised, the rate of return and the allocation of income to positive investment years must be recalculated from the inception of the lease. The lessor must update all assumptions used to calculate total and periodic income when the lessor is performing a recalculation of the leveraged lease. The recalculation must include actual cash flows up to the date of the recalculation and projected cash flows following the date of recalculation.

The guidance in this FSP applies only to changes or projected changes in the timing of income taxes that are directly related to the leveraged lease transaction. The FSP must be applied to fiscal years beginning after December 15, 2006, and certain disclosures are required in the fiscal year of adoption. The FSP is available in full at www.fasb.org/fasb_staff_positions/fsp_fas13-2.pdf.

FASB Posts Changes to the Green Book

On July 10, 2006, the staff of the Financial Accounting Standards Board posted a compilation of all changes that have been made to the guidance in the February 10, 2004 edition of *Accounting for Derivative Instruments and Hedging Activities*, commonly referred to as the Green Book. The compilation of changes to the Green Book is available at http://www.fasb.org/derivatives/07-10-06_green_book_changes.pdf.

Auditing

A Practice Aid for Auditing Alternative Investments

Pension plans, not-for-profit organizations, healthcare entities, and investment companies sometimes invest in financial instruments that do not have a readily determinable market value (commonly referred to as alternative investments). These alternative investments include private investment funds meeting the definition of an *investment company* under the provisions of the AICPA Audit and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds. Such alternative investments can present challenges with respect to obtaining sufficient appropriate audit evidence in support of the existence and valuation assertions because of the lack of a readily determinable fair value for these investments and the limited investment information generally provided by fund managers.

Due to the risk of misstatement inherent with these investments, the Alternative Investments Task Force of the Auditing Standards Board has issued a practice aid for auditors, "Alternative Investments – Audit Considerations". This Practice Aid addresses challenges associated with auditing investments for which a readily determinable fair value does not exist (that is, investments not listed on national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System). The Practice Aid focuses on the existence and valuation assertions associated with alternative investments, providing guidance on:

- General considerations pertaining to auditing alternative investments;
- Addressing management's financial statement existence assertion;
- Addressing management's financial statement valuation assertion;
- Management representations;
- Disclosure of certain significant risks and uncertainties; and
- Reporting.

The Practice Aid also includes example confirmations for alternative investments and examples of due diligence, ongoing monitoring and financial reporting controls. The Practice Aid is available at http://www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf.

Also, authoritative guidance for auditing alternative investments can be found in:

- AU section 332, *Auditing Derivative Investments, Hedging Activities, and Investments in Securities*;
- Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332 at

http://www.aicpa.org/download/auditstd/announce/Audit_Interpretations_Auditing_Fair_Value.pdf;
and

- AU section 328, *Auditing Fair Value Measurements and Disclosures*.

Exposure Draft of Omnibus SAS

The Auditing Standards Board of the American Institute of Certified Public Accountants has issued an exposure draft of a proposed Statement on Auditing Standards (SAS) entitled *Omnibus 2006*. An Omnibus SAS is issued when proposed revisions to existing Standards do not in and of themselves warrant the issuance of separate standards. This Exposure Draft proposes the following revisions to existing Standards:

- SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards*, was issued to define the terms used in establishing professional requirements that impose an obligation on the auditor. SAS No. 105, *Amendment to Statement on Auditing Standards No. 95, "Generally Accepted Auditing Standards"* then revised certain auditing standards to clarify the terminology used in describing the professional requirements imposed on auditors. The proposed SAS would amend the general and reporting Standards that were not amended by SAS No. 105. The proposed SAS would also amend any Standards that quote the 10 general, fieldwork, and reporting standards to conform them to these changes and to the changes in SAS No. 105.
- SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to identify and assess the risk of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. SAS No. 110, *Performing Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, requires the auditor to determine overall responses and design and perform further audit procedures to respond to the assessed risks of material misstatement at the financial statement and relevant assertion levels in a financial statement audit. The proposed SAS would amend SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, by adding a footnote to SAS No. 99 that provides a clear link between the auditor's consideration of fraud, the auditor's assessment of risk, and the auditor's procedures in response to those assessed risks.
- SAS No. 103, *Audit Documentation*, changed the date of the auditor's report from the date of completion of fieldwork to no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence. The amendments in this Exposure Draft would remove references to the *completion of fieldwork* throughout the codification of Statements on Auditing Standards.
- This Exposure Draft also would change the date of management's representation letter to align it with the requirement that the auditor's report not be dated prior to the date on which the auditor has obtained sufficient appropriate audit evidence.

The amendments related to SAS No. 102 and SAS No. 109 would be effective for audits of financial statements for periods beginning on or after December 15, 2006. The amendments related to SAS No. 103 (as summarized in the last two bullet points above) would be effective for audits of financial statements for periods ending on or after December 15, 2006. The Exposure Draft is available for comment until September 15, 2006 at

http://www.aicpa.org/download/members/div/auditstd/final_ED_SAS_Omnibus_2006.pdf.

Proposed SSAE Hierarchy

The Auditing Standards Board of the American Institute of Certified Public Accountants has issued an exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) entitled *SSAE Hierarchy*. The proposed SSAE:

- Identifies the body of attest literature;
- Clarifies the authority of attest publications issued by the AICPA and others;
- Specifies which attest publications the practitioner must comply with and those he or she should be aware of when conducting an attest engagement; and
- Amends the 11 attestation standards to conform them with the use of terms established in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*.

This Statement would be effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006. The Exposure Draft is available for comment until September 15, 2006 at <http://www.aicpa.org/download/members/div/auditstd/finalEDSSAEHierarchy.pdf>.

Public Sector

One More Question Regarding Implementation of GASB Statements No. 43 and 45

In August of 2005, the Governmental Accounting Standard Board (GASB) published a *Guide to Implementation of GASB Statements 43 and 45 on Other Postemployment Benefits* to assist preparers and auditors of governmental financial statements as they implement the GASB's recently issued standards on accounting and reporting for healthcare and other non-pension benefits provided to retirees (OPEB). The Implementation Guide provided answers to over 250 questions. In July of 2006, the GASB cleared an additional question and answer intended to provide implementation guidance regarding qualifying OPEB plan trusts, and the responsibilities of those who play a significant role in the functions of an OPEB plan that includes such a trust, for purposes of accounting and financial reporting in accordance with the requirements of Statements No. 43 and 45. The additional question and answer is available at http://www.gasb.org/project_pages/opeb_staff_guidance.pdf.

GASB Statement No. 43, *Reporting for Postemployment Benefit Plans Other Than Pension Plans*, addresses accounting by plans that administer OPEB and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, establishes accounting and reporting requirements for state and local government employers that provide OPEB. Implementation of Statement No. 43 for plans will take place in three phases, based on the revenues of the plan's largest participating employer, starting with fiscal years beginning after December 15, 2005. Employer implementation of Statement No. 45 also will proceed in three phases, starting one year later.

SEC

Conrad Hewitt Selected as Chief Accountant

Conrad Hewitt has been selected to be the next Chief Accountant of the Securities and Exchange Commission, effective August 18, 2006. As Chief Accountant, Mr. Hewitt will oversee accounting interpretations, international accounting matters, and professional practice issues. He will lead the SEC's work in implementing the internal control provisions of the Sarbanes-Oxley Act of 2002, reducing

complexity in accounting, enforcing compliance with accounting standards, and promoting the convergence of U.S. accounting standards and international standards.

Mr. Hewitt currently is chairman of the audit committees of Varian, Inc. and North Bay Bancorp. He also chairs both the compensation committees and the audit committees of S&P Co. and Pabst Brewing Co. From 1995 to 1998, he was California Superintendent of Banking and Commissioner of the California Department of Financial Institutions. From 1972 to 1995, Mr. Hewitt was the Managing Partner of Ernst & Young, and its predecessor firm, Ernst & Ernst, in the firm's Northern California (1986-95), Seattle (1979-86), and Honolulu (1972-79) regions. He began his career as an auditor in the U.S. Air Force at Strategic Air Command Headquarters.

International

Interim Financial Reporting and Impairment

The International Financial Reporting Interpretations Committee (IFRIC) has issued an Interpretation, which states that any impairment losses recognized in an interim financial statement must not be reversed in subsequent interim or annual financial statements. IFRIC 10, *Interim Financial Reporting and Impairment*, addresses the conflict of International Accounting Standard (IAS) No. 34, *Interim Financial Reporting*, with the impairment provisions relating to goodwill included in IAS No. 36, *Impairment of Assets*, and the impairment provisions relating to investments in equity instruments and in financial assets carried at cost included in IAS No. 39, *Financial Instruments: Recognition and Measurement*. The extension of the consensus in IFRIC 10 by analogy to potential conflicts between IAS No. 34 and other standards is prohibited.

No New IFRS Effective until 2009

The International Accounting Standards Board (IASB) recently announced that it intends to allow a minimum of one year between the date of publication of wholly new International Financial Reporting Standards (IFRS) or major amendments to existing IFRS and the date when implementation is required. Consistent with this announcement, the IASB stated that it will not require the application of new IFRS under development (or major amendments to existing standards) before January 1, 2009. The establishment of this approach does not preclude the publication of new standards before that date, and companies would be permitted to adopt a new standard on a voluntary basis before its effective date. Interpretations and minor amendments to deal with potential issues identified during implementation would not be subject to this approach. These steps are intended to accommodate the time required for translations and implementation of new standards into practice and, where IFRS are legally binding, into law.

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