

Insights

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Accounting

Hart Joins FASB Resource Group to Assist with Valuation Guidance Issues

The Financial Accounting Standards Board (FASB) has recently named Jolene Hart, a partner in the National Office of Audit & Accounting of McGladrey & Pullen, to a resource group that will provide input on potential clarifying guidance for issues relating to the application of FASB Statement No. 157, *Fair Value Measurements*, to fair value information required or permitted under U.S. generally accepted accounting principles. Ms. Hart, along with other members of the group, will contribute information regarding the diversity in practice that impacts valuations performed for financial reporting purposes.

Ms. Hart serves McGladrey & Pullen as a firmwide resource for assistance in developing, applying and teaching the firm's interpretation of accounting principles. In addition, she is the firm's expert in issues related to FASB Statement No. 133, *Accounting for Derivative Instruments and Related Hedging Activities*. Ms. Hart is a member of the American Institute of Certified Public Accountants and the Minnesota Society of Certified Public Accountants. She graduated with a degree in accounting from Loras College in Dubuque, Iowa.

Guidance Proposed for Consistent Application of Shortcut Method

One technique for computing hedge effectiveness in hedge accounting under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities, as amended*, is the shortcut method. This method prescribes a set of conditions that must be met in order for a reporting entity to assume that certain hedging relationships of interest rate swaps result in no ineffectiveness. Using the shortcut method vastly simplifies the necessary calculations involved in hedge accounting, as it assumes that the change in value of the swap is a "perfect proxy" for the change in value of the hedged item, thereby resulting in no income statement volatility (or "ineffectiveness"). Currently, however, there is diversity in the way the shortcut method is applied by preparers of financial statements.

In response to this diversity, the Financial Accounting Standards Board has proposed Statement 133 Implementation Issue No. E23, "Issues Involving the Application of the Shortcut Method under Paragraph 68." The proposal is designed to promote consistency and reduce complexity in the practice of determining when an entity qualifies for the shortcut method. Specifically, the proposal expands the guidance for the conditions in paragraph 68 of Statement No. 133 that must be met for a reporting entity to use the shortcut method.

The proposal is available for comment until September 21, 2007 at http://www.fasb.org/derivatives/07-23-07_E23.pdf.

Proposed Accounting for Transfers of Financial Assets and Repurchase Financing Transactions

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides accounting and reporting standards for transfers of financial assets. Recently, questions have arisen about whether there are circumstances that would permit a transferor and a transferee to evaluate the accounting for a transfer of a financial asset separately from a repurchase agreement that relates to a previously transferred financial asset (a repurchase financing) when the counterparties to the two transactions are the same under Statement No. 140. Consequently, the Financial Accounting Standards Board has proposed FASB Staff Position (FSP) No. FAS 140-d, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*, to address this issue.

The proposed FSP concludes that a transferor and transferee should separately account for a transfer of a financial asset and a related repurchase financing, either entered into at the same time or subsequently, if (a) the transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor's regaining control over the financial asset. The proposed FSP specifies that if the transactions meet all of the following criteria, the repurchase financing should be accounted for separately from the initial transfer, and the transferor and transferee should analyze the repurchase financing as a repurchase agreement under Statement No. 140:

- The initial transfer and the repurchase financing are not contractually contingent on one another. There are no implied commitments that are entered into at or near the same time with the same counterparty (or an affiliate or agent of the counterparty) that depend on or affect either of the transactions.
- The repurchase financing provides the initial transferor with full recourse to the initial transferee upon default, and the initial transferee's agreement to repurchase the previously transferred financial asset (or substantially the same asset) is for a fixed price and not fair value.
- The financial asset subject to the initial transfer and repurchase financing has a quoted price in an active market. In addition, the initial transfer of a financial asset and the repurchase financing are executed at market rates.
- The initial transferee (the borrower) maintains rights to the collateral (is able to take control of the transferred financial asset and substitute it with a different financial asset). In addition, the initial transferor (the lender) cannot sell or repledge the collateral at any point prior to the settlement of the repurchase financing, unless the asset is readily obtainable.
- The financial asset and repurchase agreement are not coterminous (the maturity of the repurchase financing is before the maturity of the financial asset).

If the transactions do not meet all of the above criteria, the initial transfer and repurchase financing should be evaluated as a linked transaction. The linked transaction should then be evaluated to determine if it meets the requirements for sale accounting under Statement No. 140. If the linked transaction does not meet the requirements for sale accounting, the linked transaction should be accounted for based on the economics of the combined transactions, which generally represent a forward contract that should be evaluated under Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

If finalized, the FSP would be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application would not be permitted. In the year of initial application, the FSP would be applied as a cumulative effect adjustment to repurchase financings existing as of the beginning of the year.

The proposed FSP is available for comment until September 14, 2007 at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas140-d.pdf.

PCFRC

In June 2006, the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) issued a joint Invitation to Comment (IC), "Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies". The purpose of the initiative is to evaluate and improve the standard-setting process for generally accepted accounting principles (GAAP) for private company financial reporting. The June 21, 2006 issue of *Insights* has further information about the IC.

Based on responses to the IC, the Private Company Financial Reporting Committee (PCFRC) was formed. Its membership consists of a chairperson plus four members representing preparers, four members representing accountants and auditors in public practice, and four members representing users of private company financial statements. The PCFRC is staffed by the AICPA and funded by the FASB. The PCFRC meetings are open to the public, and it expects to meet approximately every two months at various locations throughout the United States.

The PCFRC held its inaugural meeting in Chicago on May 10-11, 2007. At this meeting, the PCFRC established three objectives. The first objective is to have its members serve as individual resources to the FASB, Emerging Issues Task Force and FASB staff during FASB staff research on accounting projects. The second objective is for the PCFRC to make formal recommendations to the FASB on prospective standard-setting activities. For certain projects, such as liabilities and equity, financial statement presentation, leases and subsequent events, separate task forces or working groups were formed. The third objective is for the PCFRC to address certain existing GAAP topics that have a broad impact on private companies. The topics chosen for initial consideration consist of FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, FIN 46(R), *Consolidation of Variable Interest Entities*, and FASB Statement No. 123(R), *Share-Based Payment*. At this meeting, the PCFRC agreed to submit a recommendation to the FASB in connection with its subsequent events project that a private company should disclose in a note to the financial statements its policy as to the cut-off date for which subsequent events were considered by management for purposes of subsequent events analysis and disclosures.

The second meeting of the PCFRC was held in Denver on July 26-27, 2007. This meeting focused principally on a discussion about FIN 48 and FIN 46(R) and difficulties faced by private companies in complying with the related accounting requirements. The PCFRC will recommend a further delay to the effective date for nonpublic companies to initially apply FIN 48. Also, the PCFRC will recommend a scope exception for nonpublic companies in the application of FIN 46(R) to certain specified variable interest entities. The PCFRC also agreed to recommend the FASB issue guidance on how a primary beneficiary should deconsolidate a variable interest entity after a reconsideration event occurs.

The next meeting of the PCFRC is tentatively scheduled for September 20-21 in Dallas. The agenda for that meeting is expected to include a discussion of the following FASB projects: financial statement presentation; liabilities and equity; and leases.

As part of its outreach to private company constituents, the PCFRC encourages interested persons to join the Committee's resource group. To date, approximately 100 individuals have joined the resource group. Resource group members periodically receive requests for input on various projects which are considered by the PCFRC in making its recommendations to the FASB. Information about the PCFRC, including how to join the resource group, recommendations submitted to the FASB on various projects, and meeting agenda material and meeting highlights are available on its website at <http://pcfrc.org/>.

Public Sector

Revision of Government Auditing Standards

The U.S. Government Accountability Office has issued the 2007 revision of *Government Auditing Standards*. These standards, which are commonly referred to as the “Yellow Book,” cover federal entities and those organizations receiving federal funds. Various laws require compliance with the comptroller general’s auditing standards in connection with audits of federal entities and funds. Furthermore, many states and local governments and other entities have voluntarily adopted these standards.

The 2007 revision contains the January 2007 revision plus updated quality control and peer review sections in chapter 3, which were exposed in January 2007. The 2007 revision supersedes the 2003 revision and contains fundamental changes that:

- Heighten the emphasis on ethical principles as the foundation, discipline, and structure behind the implementation of the standards, including a description of five key ethical principles that should guide the work of those who audit government programs and operations;
- Clarify and streamline the discussion of the impact of nonaudit services and their impact on auditor independence;
- Update the financial auditing standards based on recent developments in financial auditing and internal control, increased transparency surrounding restatements and significant concerns, uncertainties, or other unusual events that could have a significant impact on the financial condition or operations of a government entity or program;
- Enhance performance-auditing standards that elaborate on the overall framework for high-quality performance auditing, including the concepts of reasonable assurance and its relationship to audit risk, significance, and the levels of evidence used to support audit findings and conclusions;
- Clarify the standards through standardized language to define the auditor’s level of responsibility and distinguish between auditor requirements and additional guidance; and
- Reinforce the key role of auditing in maintaining accountability and providing information for making improvements in government operations.

The July 2007 revision of *Government Auditing Standards* is effective for financial audits and attestation engagements for periods beginning on or after January 1, 2008, and for performance audits beginning on or after January 1, 2008.

This revision of the standards went through an extensive deliberative process, including public comments and input from the Comptroller General’s Advisory Council on Government Auditing Standards. Brian Schebler, director of services to the public sector for McGladrey & Pullen, LLP, is a member of the 25-member Advisory Council.

The 2007 revision of *Government Auditing Standards* is available in full at <http://www.gao.gov/govaud/d07731g.pdf>.

SEC

SEC Approves Auditing Standard on Internal Control Over Financial Reporting

The SEC has approved the Public Company Accounting Oversight Board’s (PCAOB) 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 definitions of a material weakness and a significant deficiency;
- 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 approving the new auditing standard, the SEC noted that it:

- Is less prescriptive than the prior standard;
- Makes the audit scalable to the size and complexity of the issuer;
- Directs auditors to focus on what is important and to eliminate unnecessary procedures; and
- Includes a principles-based approach to determining when and to what extent the auditor can use the work of others.

In addition to the internal control standard, the SEC also approved PCAOB Rule 3525, *Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting*, which requires auditors to take certain steps as part of seeking audit committee pre-approval for internal control related non-audit services. Further, the SEC approved conforming amendments that update other affected PCAOB auditing standards.

The SEC also adopted a definition of significant deficiency: "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." This definition is the same as that used by the PCAOB and will be used by the SEC in evaluating the required communications under Sections 302 and 404 of the Sarbanes-Oxley Act of 2002.

Auditing Standard No. 5, PCAOB Rule 3525, and the conforming amendments are effective for integrated audits conducted for fiscal years ending on or after November 15, 2007. However, early adoption is permitted.

Auditing Standard No. 5 is available in full at

http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf.

Proposed New and Amended Independence Rules

The Public Company Accounting Oversight Board (PCAOB) has proposed new Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence*, which would supersede the Board's interim independence requirement, Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*, and two related interpretations. The proposed Rule would require a registered public accounting firm to communicate to an issuer's audit committee about any relationships between the firm and the issuer that may reasonably be thought to bear on the firm's independence. The

communications would be required both before the firm accepts a new engagement pursuant to the standards of the PCAOB and annually for continuing engagements.

In addition, the PCAOB has proposed an amendment to Ethics and Independence Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*. Under this Rule, a registered public accounting firm is not independent of its audit client if it provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member (spouse, spousal equivalent or dependent) of such person during the audit and professional engagement period. The term "audit and professional engagement period" includes both the audit period (the period covered by any financial statements being audited or reviewed) and the engagement period (the period from the time the initial arrangement letter is signed or our procedures begin until the firm resigns or is terminated). The recently proposed amendment would exclude from the scope of the rule the portion of the audit period that precedes the beginning of the engagement period. In addition, the amendment would provide that in the context of an initial public offering, the provision of tax services to a person in a financial reporting oversight role before the accounting firm is engaged to perform an audit under PCAOB standards or begins to do so would not impair the accounting firm's independence. In its proposal the PCAOB declined to provide a transition period to complete tax services in process at the beginning of the professional engagement period, but is seeking additional comments on the practical implications of failing to do so.

To allow sufficient time for consideration of comments on the proposed amendment, the PCAOB has adjusted the implementation schedule for Rule 3523 as it applies to tax services provided during the audit period. The PCAOB will not apply Rule 3523 to tax services provided on or before April 30, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins.

The PCAOB's proposals are available for comment until September 7, 2007 at http://www.pcaobus.org/Rules/Docket_017/2007-07-23_Release_2007-008.pdf.

Employee Benefit Plans

SAS 112 and EBP Audits

Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, provides guidance regarding the identification and evaluation of control deficiencies during an audit. It also provides guidance regarding communication of those deficiencies that are significant deficiencies or material weaknesses to management and those charged with governance. The written communications required by SAS No. 112 apply to audits of employee benefit plans. Situations requiring written communication could include, for example, the auditor needing to propose significant adjusting accounting entries, a lack of segregation of accounting duties, an inability of plan management to properly value plan investments, and inadequate oversight over plan recordkeeping and reporting by a third-party administrator.

To assist plan administrators, sponsors and trustees in understanding the importance and benefits of establishing an effective monitoring program over third-party service providers that provide plan recordkeeping and reporting services, the Employee Benefit Plan Audit Quality Center of the American Institute of Certified Public Accountants has developed a Plan Advisory, *Effective Monitoring of Outsourced Plan Recordkeeping and Reporting Functions*. This Advisory contains useful information for selecting service providers and addresses monitoring of third-party administrator controls over plan accounting information. In addition, this Advisory includes suggestions for conducting on-site reviews of third-party service providers and examples of controls that help ensure complete and accurate plan accounting information and reporting. The Plan Advisory is available in full at <http://ebpaqc.aicpa.org/Resources/Plan+Advisory>.

It should also be noted that The United States Department of Labor (DOL) publication, *Meeting Your Fiduciary Responsibilities*, provides an overview of the basic fiduciary responsibilities applicable to retirement plans under the Employee Retirement Income Security Act. The DOL publication is available in full at <http://www.dol.gov/ebsa/pdf/fiduciaryresponsibility.pdf>.

International

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 a draft Interpretation, IFRIC D22, *Hedges of a Net Investment in a Foreign Operation*. Draft IFRIC D22 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 proposes not to allow the use of hedge accounting when translating a functional currency into a presentation currency.

The IFRIC proposal also considers which individual entity within a group structure can hold a hedging instrument. The IFRIC proposes that the hedging instrument can be held by any subsidiary or parent entity within a group regardless of the entity’s functional currency. To assess how effective the hedging instrument is in offsetting the risk from the foreign operation, the company must calculate the change in value of the hedging instrument in the functional currency of the parent hedging its risk and not the functional currency of the subsidiary holding the instrument. The IFRIC recognizes the difficulty that entities would face in preparing adequate documentation from the inception of the hedge relationship. It therefore proposes that, if finalized, the guidance should be applied prospectively, i.e. for all future transactions. The proposal is open for public comment until October 19, 2007.

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