

# Insights

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## Accounting

### Accounting for Certain Loan Modifications

On July 18, 2007 Conrad W. Hewitt, Chief Accountant for the SEC, issued a memorandum discussing the accounting for certain loan modifications. The memorandum was drafted in response to questions raised regarding modification of the terms of securitized mortgage loans in light of the rising numbers of mortgage foreclosures. The accounting for such loan modifications is governed by Financial Accounting Standards Board (FASB) Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Per the memorandum, Statement No. 140 is sometimes cited as being a potential impediment to loan modifications because it is the accounting standard that sets forth the requirements for when securitized assets are to be recorded on the balance sheet versus off balance sheet. For many financial institutions, it is important for them to receive off-balance sheet treatment for securitized assets because of regulatory capital requirements. Statement No. 140 is a detailed accounting standard with many specific requirements, and its application can be a complicated process. However, a basic underlying principle in the standard is that transferred assets should only be recorded off balance sheet when the entity that transferred those assets (known as a transferor) has given up control, including decision-making ability, over those assets.

In the treatment of securitized residential mortgage loans, the issue in practice is whether an entity's having or exercising the ability to modify the terms of a securitized mortgage loan is an activity that demonstrates that the entity has not given up control over the loan, thereby precluding off-balance sheet accounting for that loan. Statement No. 140 does not directly address the impact on off-balance sheet treatment for modifications to the terms of a loan when default is reasonably foreseeable (but prior to delinquency or actual default). Per the memorandum, the decision-making ability (or discretion) that is required in working out a loan where default is reasonably foreseeable is similar to the discretion required when a loan becomes delinquent or default has occurred. When a loan is delinquent or when default has occurred, Statement No. 140 implementation guidance provides that a servicer may have discretion in restructuring or working out a loan, subject to certain limitations, without calling into question off-balance sheet treatment for the loan. In Mr. Hewitt's view, entering into loan restructuring or modification activities (consistent with the nature of activities permitted when a default has occurred) when default is reasonably foreseeable does not preclude continued off-balance sheet treatment under Statement No. 140. Since Mr. Hewitt's view is consistent with predominant practice, the SEC staff does not believe that any additional interpretive guidance is necessary in order to clarify the application of Statement No. 140 to the contemplated types of securitized mortgage loan work-out activities. Because this is the predominant practice, it should be followed by both public and nonpublic entities.

Mr. Hewitt's memorandum is available in full at [http://www.house.gov/apps/list/press/financialsvcs\\_dem/sec\\_response072507.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/sec_response072507.pdf).

## Invitation to Comment on Proposed FASB Project

The Financial Accounting Standards Board (FASB) has issued an Invitation to Comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, including the IASB Discussion Paper, "Preliminary Views on Insurance Contracts."* The Invitation to Comment discusses a proposed FASB project to develop a comprehensive standard on accounting for insurance and reinsurance contracts. If undertaken, the proposed project would be a joint project with the International Accounting Standards Board (IASB). The objective of the proposed joint project would be to develop a common, high-quality standard that addresses recognition, measurement, presentation, and disclosure requirements for insurance contracts. That standard would provide accounting and reporting guidance for both the issuer and the holder of the insurance contract. It would replace all existing U.S. generally accepted accounting principles and International Financial Reporting Standards for insurance contracts.

In issuing the Invitation to Comment, the FASB seeks to gather information from its constituents to help decide whether:

- There is a need for a project on accounting for insurance contracts;
- The scope of the proposed project should include accounting by policyholders;
- The FASB should undertake this project jointly with the IASB;
- The IASB's May 2007 Discussion Paper, *Preliminary Views on Insurance Contracts*, which describes the main components of a proposed accounting model for insurance contracts, would be a suitable starting point for a joint project; and
- The proposed project should interact with other major FASB/IASB joint projects that address similar issues, for example, the conceptual framework and revenue recognition projects.

The Invitation to Comment is available in full at [http://www.fasb.org/draft/ITC\\_Insurance\\_Contracts.pdf](http://www.fasb.org/draft/ITC_Insurance_Contracts.pdf). The FASB is seeking to obtain written comments on the proposal by November 16, 2007.

## Auditing

### Independence Impact of Providing FIN 48 Services to an Attest Client

Recently, the staff of the AICPA's Professional Ethics Division was asked whether assisting a client in applying FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, such as by identifying potential uncertain tax positions, advising the client whether those tax positions meet the more-likely than not (MLTN) threshold, and calculating the related unrecognized tax benefits, would impair independence. At its July 2007 meeting, the Professional Ethics Executive Committee decided that the provision of such services would not impair independence provided the client can make an informed judgment on the results of the member's services and the other requirements of AICPA Ethics Interpretation 101-3, *Performance of Nonattest Services*, are met. In meeting the requirements of Interpretation 101-3, the member may assist the client in understanding why the tax positions do or do not meet the MLTN threshold and the basis for any unrecognized tax benefit so that the client can accept responsibility for the amounts reported and disclosed in the financial statements.

For tax services to be permitted, the auditor must enter into a written engagement letter with the client describing the scope of the services and the fee structure, and the client must:

- Designate an individual who possesses suitable skill, knowledge and/or experience, preferably within senior management, to oversee the services;

- Make all management decisions with respect to the services;
- Evaluate the adequacy of the services and accept responsibility for the results.

Tax services provided to an SEC audit client, whether they constitute compliance, consulting or controversy services, are also subject to Rule 2-01(c)(4) of Regulation S-X and Public Company Accounting Oversight Board Rules 3521, 3522 and 3524. If the audit client is subject to the SEC's independence rules, the auditor must also obtain audit committee pre-approval of the services, discuss the potential effect of the services on independence and document the substance of those discussions. In addition, an auditor is prohibited from providing any of the following tax services:

- Preparing the tax computations that underlie the client's provisions for current and deferred income taxes;
- Performing any service for a contingent fee;
- Any legal service (including representing a client in tax court, district court or a federal court of claims) or any expert service that is unrelated to the audit; or
- Marketing, planning or opining in favor of the tax treatment of a transaction (a) that is a confidential transaction or (b) that was initially recommended by the auditor and a significant purpose of which was tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.

### **SSARS No. 15 Issued**

The Accounting and Review Services Committee of the American Institute of Certified Public Accountants has issued Statement on Standards for Accounting and Review Services (SSARS) No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance into Statements on Standards for Accounting and Review Services*. Many SSARSs reference the practitioner to Statements on Auditing Standards; however, many practitioners may be unfamiliar with the auditing literature because compilations and reviews represent the highest level of service they perform. Statement No. 15 therefore eliminates references to auditing literature from the SSARSs and, where appropriate, incorporates guidance similar to that originally referenced.

Specifically, SSARS No. 15 provides:

- A definition of other comprehensive basis of accounting (OCBOA), examples of appropriate OCBOA financial statement titles, and reporting examples for compilations and reviews of OCBOA financial statements;
- Guidance on emphasizing a matter when reporting on compiled or reviewed financial statements;
- Clarifying guidance regarding the accountant's responsibility with respect to facts discovered subsequent to the date of the accountant's compilation or review report;
- Additional illustrative representations that may be appropriate for inclusion in the management representation letter; and
- An appendix entitled "Sources of Generally Accepted Accounting Principles".

The Statement is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2007.

## SEC

### Independence FAQ Updated

On August 6, 2007, the SEC's Office of the Chief Accountant updated its frequently asked questions (FAQ) regarding the SEC's auditor independence rules. The FAQ provides assistances in several areas, including:

- Partner rotation;
- Financial relationships;
- Performance of nonaudit services;
- Audit committee pre-approval requirements;
- Auditor communications with audit committees;
- "Cooling off" period rules; and
- Applicability of the rules to auditors of non-issuer brokers and dealers and investment advisers that are non-issuers.

The updated FAQ can be found in its entirety at <http://www.sec.gov/info/accountants/ocafaqaudind080607.htm>.

### July SEC Regulations Committee Meeting

On July 10, 2007, the AICPA's SEC Regulations Committee met with the SEC staff to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. The following summarizes some of the issues discussed at the meeting:

#### *Risk Factors Related to the Financial Reporting Process*

Sometimes registrants disclose risk factors identifying potential risks that the registrant might be required to restate or make other changes to financial statements. These risk factors discuss the complexities of the accounting standards, explain that they can be interpreted or applied differently, either by the SEC staff or by successor auditors (when there has been a change in auditors), and communicate that such differences in interpretation or application could cause a restatement of the registrant's financial statements. The SEC staff expressed concern that such disclosures could be an attempt to dilute the responsibility that the registrant takes for its financial statements. The SEC staff also stated that a risk factor would not satisfy the specificity required by Item 503(c) of Regulation S-K if the registrant merely identifies the complexity of financial reporting and the generic risk of a subsequent financial restatement. When reviewing filings, the SEC staff will evaluate specific risk factors based on a registrant's specific facts and circumstances.

#### *Reporting on Internal Controls in a Reverse Merger*

In light of the December 2006 amendments that provide an "IPO accommodation" by deferring Sarbanes-Oxley Act Section 404 reporting requirements for a new public company until its second SEC annual report, the Committee asked the SEC staff for its views on whether this accommodation would apply in a reverse merger when the accounting acquirer was not a public company. The SEC staff continues to address the reporting requirements of a reverse merger on a facts and circumstances basis. Accordingly, a registrant with this fact pattern is encouraged to consult with the legal staff in the Division of Corporation Finance's Office of the Chief Counsel to determine its Section 404 reporting requirements.

### *Executive Compensation Disclosures*

In its review of 2007 transactional filings for compliance with the new executive compensation disclosure rules, the SEC staff noted the following recurring observations in comment letters:

- The Compensation Discussion and Analysis could provide better analysis of executive compensation decisions.
- If registrants have an adequate basis for omitting incentive plan performance targets, they should provide the alternate disclosure regarding the relative likelihood that those performance targets will be met.
- Descriptions of incentive plan performance targets should be specific.
- "Benchmarking" executive compensation should be accompanied by an identification of the other companies that were used for benchmarking purposes.
- In disclosing executive compensation decisions, registrants should provide a clear description about the respective roles and responsibilities of the chief executive officer, compensation consultants and the compensation committee in the decision making process.

Scott Pohlman, SEC Coordinator for McGladrey & Pullen, LLP, is a member of the AICPA's SEC Regulations Committee.

## Employee Benefit Plans

### Notification Required for Plans that Offer Company Stock

Publicly traded companies that offer their own stock as an investment option in their 401(k) plans have been put on warning by the Department of Labor under recently issued guidance, which is effective on October 9, 2007. In the event that such companies fail to advise workers when they are eligible to diversify any company stock holdings in the 401(k) plan, the employer could be fined as much as \$100 per day.

These new regulations interpret a provision from last year's Pension Protection Act (PPA), which made it easier for workers to move their retirement savings out of company stock holdings and into other investments in the 401(k) plan. PPA requires that employees who invest in company stock with their own contribution to the plan can switch out of it at any time; company stock acquired from the company's contribution must be eligible to be diversified once the employee attains three years of service. There are some transition rules.

Employers are required to give workers 30 days notice of the point at which they are eligible to diversify out of company stock. Failure to provide such notice could trigger a fine of up to \$100 a day.

## International

### Exposure Drafts of Nine Redrafted Standards

In striving to improve the clarity of its standards, the International Auditing and Assurance Standards Board (IAASB) is continuing to redraft some of its existing standards. Key elements of the new drafting conventions include: basing each standard on the objective of the auditor with respect to the subject matter of the standard; separating the requirements that the auditor is required to follow from guidance on their application; eliminating the present tense to describe actions by the auditor, which raised ambiguity about whether such actions were required; and other structural and drafting improvements to enhance the overall readability and understandability of the standards. Standards redrafted in this way are described as "redrafted." If further revision has been undertaken, a standard is described as "revised and redrafted."

Recently, the IAASB approved for comment exposure drafts of nine proposed standards:

- International Standard on Quality Control (ISQC) 1 (Redrafted), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*
- International Standard on Auditing (ISA) 220 (Redrafted), *Quality Control for an Audit of Financial Statements*
- ISA 700 (Redrafted), *The Independent Auditor's Report on General Purpose Financial Statements*
- ISA 705 (Revised and Redrafted), *Modifications to the Opinion in the Independent Auditor's Report*
- ISA 706 (Revised and Redrafted), *Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report*
- ISA 800 (Revised and Redrafted), *Special Considerations - Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*
- ISA 805 (Revised and Redrafted), *Engagements to Report on Summary Financial Statements*
- ISA 510 (Redrafted), *Initial Audit Engagements - Opening Balances*
- ISA 530 (Redrafted), *Audit Sampling*

The complete set of redrafted ISAs is currently expected to be effective for audits of financial statements for periods beginning on or after December 15, 2008.

Comments on proposed redrafted ISQC 1 and ISA 220 are requested by December 31, 2007. Comments on proposed ISAs 700 (Redrafted), 705 (Revised and Redrafted), 706 (Revised and Redrafted), 800 (Revised and Redrafted) and 805 (Revised and Redrafted) are requested by November 30, 2007. Comments on proposed redrafted ISAs 510 and 530 are requested by October 31, 2007. The exposure drafts are available in full at <http://www.ifac.org/EDs>.

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