

# Insights

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## Accounting

### Guidance Published on Applying APB 25

Several companies have recently issued press releases announcing the restatement of their financial statements due to errors in their accounting for grants of stock options. Many other companies have announced that they are currently looking into their past practices related to the granting of stock options. In response to these announcements, on September 19, 2006 the Office of the Chief Accountant of the Securities and Exchange Commission (SEC) issued a letter summarizing the staff's views regarding the application of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB 25) to grants of stock options. (Most of the issues addressed in the letter relate to stock options which were granted prior to the effective date of FASB Statement No. 123R (revised 2004), *Share-Based Payment*.)

APB 25 defines the measurement date as "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any". Thus, the determination of the measurement date is based on the finality of the terms and recipients of stock option awards. The topics addressed in the letter largely relate to questions about whether a company's determination of the measurement date of past stock option awards was appropriate. The letter discusses the accounting consequences under APB 25 under the following sections:

- Dating an option award to predate the actual award date;
- Option grants with administrative delays;
- Uncertainty as to the validity of prior grants;
- Uncertainty as to individual award recipients;
- An exercise price set by reference to a future market price;
- Grants prior to the commencement of employment;
- Documentation of option granting activities that is incomplete or cannot be located;

- Timing of option grants;
- Changes to option grants due to the release of new information; and
- Income tax benefits related to options.

The letter provides several illustrations of the appropriate application of APB 25. While the letter is directed toward public entities filing with the SEC, our Firm believes the letter provides useful guidance that should be followed by non-SEC entities as well.

The letter can be accessed in full at [http://www.sec.gov/info/accountants/staffletters/fei\\_aicpa091906.htm](http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm).

## **FASB Issues Statement on Fair Value Measurements**

Current guidance for measuring fair value has evolved over time and is dispersed among many existing accounting pronouncements that require fair value measurements. Having considered the need for increased consistency in estimates of fair value and enhanced disclosures about the estimates, the Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. This Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value.

The changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to estimate fair value, and the requirement for expanded disclosures about estimates of fair value. Among other provisions, this Statement:

- Clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability (i.e., an exit price) in an orderly transaction between market participants in the market in which the reporting entity transacts. In the absence of a transaction involving the entity, the estimate of fair value is determined by reference to a hypothetical transaction for the asset or liability at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability.
- Uses a fair value hierarchy, which gives the highest priority to quoted prices in active markets and the lowest priority to unobservable inputs (e.g., the reporting entity's own data). The notion of unobservable inputs is intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date.
- Affirms that the fair value of a position in a financial instrument (including a block) that trades in an active market should be measured as the product of the quoted price for the individual instrument times the quantity held. The quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor). This Statement extends that requirement to broker-dealers and investment companies within the scope of the *AICPA Audit and Accounting Guides* for those industries.
- Establishes that the fair value measurement for a restricted asset (an asset for which sale is legally restricted by governmental or contractual requirement for a specified period, whether the restriction limits sale or prohibits sale) should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset.
- Expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures focus on the inputs used to measure fair value and for recurring fair value measurements using significant unobservable inputs, the effect of the measurements on earnings (or changes in net assets) for the period.

This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. With certain exceptions, the Statement should be applied prospectively. Early adoption is permitted.

The Statement is available at <http://www.fasb.org/pdf/fas157.pdf>.

### **FSP Addresses Accounting for Planned Major Maintenance Activities**

The term “planned major maintenance activities” is not defined in the authoritative literature. However, it encompasses situations where items of property or equipment are required by regulatory or operational requirements to undergo major overhaul or refurbishment to return them to a pre-used condition. For example, diesel engines of over-the-road tractors of a trucking company are required to be overhauled after so many miles to return them to an appropriate roadworthy condition. Similarly, the engines and airframe of commercial aircraft are required to be overhauled at specific periodic intervals so as to recertify the engines and airframe to be airworthy.

The principal source of guidance on the accounting for planned major maintenance activities is the AICPA Industry Audit Guide, *Audits of Airlines*. The Guide describes four methods of accounting for planned major maintenance activities that are most frequently used. Those methods are: direct expense, built-in overhaul, deferral, and accrual (accrue-in-advance). Those methods are widely used by other industries as well as the airline industry.

The direct expense method recognizes the cost of overhauls as expenses as they are incurred. The built-in overhaul method is based on segregating the aircraft costs into those that should be depreciated over the useful life of the aircraft and those that require overhaul at periodic intervals with the latter being depreciated to the date of initial overhaul. The cost of the initial overhaul is then capitalized and depreciated to the next overhaul after which the process is repeated. With the deferral method, the cost of each overhaul is capitalized and depreciated to the next overhaul. The accrue-in-advance method provides for estimating the cost of the initial overhaul and accruing the cost, based on an hourly rate, to the overhaul. At that time, the actual cost of overhaul is charged to the accrual, with any deficiency or excess charged or credited to expense. The cost of the next overhaul is then estimated, based on the new rate, and accrued to that overhaul, at which time the process is repeated.

The Financial Accounting Standards Board (FASB) believes that the accrue-in-advance method of accounting for planned major maintenance activities results in the recognition of liabilities that do not meet the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*, because it causes the recognition of a liability in a period prior to the occurrence of the transaction or event obligating the entity. Therefore, the FASB has issued FASB Staff Position (FSP) No. AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, which prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting periods. Further, the FSP states that an entity must apply the same method of accounting for planned major maintenance activities in annual and interim financial reporting periods.

The guidance in this FSP is applicable to entities in all industries and must be applied to the first fiscal year beginning after December 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year. The guidance in this FSP should be applied retrospectively for all financial statements presented, unless it is impracticable to do so. The FSP also requires certain disclosures as of the date of its adoption. The FSP is available in full at [http://www.fasb.org/fasb\\_staff\\_positions/fsp\\_augair-1.pdf](http://www.fasb.org/fasb_staff_positions/fsp_augair-1.pdf).

## Auditing

### Proposed Ethics Interpretations

On September 15, 2005, the American Institute of Certified Public Accountant's Professional Ethics Executive Committee (PEEC) issued an exposure draft containing proposed guidance regarding the use of indemnification and limitation of liability provisions and the performance of forensic accounting services. Based on comments received on that exposure draft, the PEEC recently revised some of that guidance and decided to also provide guidance about the performance of tax compliance services in an exposure draft released September 8, 2006. The latest exposure draft is summarized as follows:

#### *Indemnifications and Limitations of Liability Provisions*

The proposal provides new guidance to members on the impact that certain indemnification and limitation of liability provisions may have on a member's independence when included in engagement letters or other agreements entered into with a client. Under the proposal, any indemnification or limitation of liability provision that limits or eliminates a member's liability for actual damages arising from the member's failure to perform the attest services, in all material respects, in accordance with professional standards would impair independence. The proposed interpretation also provides guidance on arrangements whereby a member and client agree to use arbitration, mediation or other alternative dispute resolution methods to resolve a dispute between them, or agree to waive a jury trial.

#### *Forensic Accounting Services*

The second proposal would revise Ethics Interpretation 101-3, *Performance of Nonattest Services*, to incorporate guidance on how the provision of forensic accounting services would affect a member's independence. Under the proposal, certain litigation services (expert witness services, court-appointed expert, special master, trier of fact, or arbitrator) create the appearance that a member is not independent, and therefore independence would be impaired if a member agreed to perform such services. However, investigative services not involving litigation and litigation consulting services (where a member provides advice about facts, issues and strategy of a matter) would not impair independence as long as the member complies with the general requirements of Interpretation 101-3.

#### *Tax Compliance Services*

The proposed interpretation also provides guidance on the provision of tax compliance services. Under the proposal, preparation of a tax return and transmittal of a tax return/related tax payment to a taxing authority would not impair a member's independence provided the member does not have control over the client's funds, and the individual designated by the client to oversee the tax services signs the tax return prior to the member transmitting the return to the taxing authority. In addition, the proposed interpretation would permit a member to sign and file a tax return on behalf of an attest client provided the member has the legal authority to do so and the taxing authority has prescribed procedures in place that meet, at a minimum, the requirements of IRS Form 8879 or, if no such procedures exist, an individual who is authorized to sign and file the return makes similar representations to the member. Authorized representation of a client in administrative proceedings before a taxing authority would not impair a member's independence provided the member does not commit a client to a specific arrangement with the taxing authority without first obtaining client approval. Filing a petition or otherwise representing a client in a court to resolve a tax dispute would impair a member's independence.

The proposal is available for comment until November 8, 2006 at [http://www.aicpa.org/download/ethics/Final\\_ED\\_September\\_2006.pdf](http://www.aicpa.org/download/ethics/Final_ED_September_2006.pdf)

Bruce Webb, McGladrey & Pullen's National Director of Auditing, is chair of the PEEC.

## SEC

### Quantifying Financial Statement Misstatements

Recently, the SEC released Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, to clarify how the effects of the carryover or reversal of prior-year misstatements should be considered in quantifying a current year misstatement. In current practice, registrants are diverse as to how they quantify such misstatements. There have been two common approaches used to quantify the effects of prior-year misstatements in current-year financial statements:

- Under the rollover (income statement) approach, the error is quantified as the amount by which the current-year income statement is misstated. This approach allows errors to accumulate in the balance sheet that, while immaterial to the balance sheet, would be material to the income statement if corrected in the current year.
- The iron curtain (balance sheet) approach quantifies the error as the cumulative amount by which the current-year balance sheet is misstated. Implicitly, this approach assumes that because the prior-year financial statements were not materially misstated, correcting any immaterial errors that existed in those statements through the current-year income statement is the "correct" accounting and therefore is not a misstatement in the current year.

SAB 108 states that registrants should not rely exclusively on either the rollover or the iron curtain approach to appropriately quantify misstatements. The SEC staff believes that registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior-year misstatements, on the current-year financial statements. The staff believes that this can be accomplished by quantifying an error under both the rollover and iron curtain approaches as described above and by evaluating the error measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors, to any of the financial statements or financial statement disclosures. If correcting a prior-year misstatement is material to the current year, after all of the relevant quantitative and qualitative factors are considered, the prior-year financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior-year financial statements.

SAB 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. To assist registrants in adopting the requirements of SAB 108, the SEC staff has decided to allow registrants to elect not to restate prior-period financial statements or amend prior filings, assuming management properly applied its prior approach (either rollover or iron curtain), including properly evaluating all qualitative materiality considerations. In adopting the SAB, registrants may report the cumulative effect of the initial application of the SAB in the carrying amounts of assets and liabilities as of the beginning of the first fiscal year ending after November 15, 2006, with the offsetting adjustment being made to the opening balance of retained earnings for that year. Registrants must disclose the nature and amount of each individual error being corrected in the cumulative adjustment. The disclosure also should include when and how each error being corrected arose and the fact that the errors had previously been considered immaterial.

The SEC staff also has included guidance for the early application of SAB 108, which is encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006. In the event that the cumulative effect adjustment is reported in an interim period other than the first interim period, previously filed reports need not be amended. However, the quarterly information required by Item 302 of Regulation S-K included in the annual financial statements and the comparative information included in subsequent

interim reports should be adjusted to reflect the cumulative effect adjustment as of the beginning of the year of initial application.

While SAB 108 only applies to public companies, private companies are advised that the Auditing Standards Board will be considering whether those requirements are also appropriate for auditors of private companies.

SAB 108 is available in full at <http://www.sec.gov/interps/account/sab108.pdf>.

## International

### IFRIC Proposes Guidance on Accounting for Customer Loyalty Programs

Customer loyalty programs are widespread in a range of businesses that grant “points”, “miles” or other award credits when customers buy goods or services. Such award credits can then be redeemed in the future for free or discounted goods or services. Currently, International Financial Reporting Standards lack detailed guidance on how businesses should account for their obligations related to the customer loyalty award credits. Therefore, the International Financial Reporting Interpretations Committee released draft Interpretation IFRIC D20, *Customer Loyalty Programmes*, to address the accounting for such programs.

The draft Interpretation proposes that entities should recognize their obligations to provide free or discounted goods or services as a separately identifiable component of the initial sales transaction in which the award credits are granted. The fair value of the consideration received or receivable in the initial sale should be allocated between its components (i.e., the goods/services sold and the award credits granted) based upon the relative fair values for which each component could be sold separately. Entities should then defer recognition of the revenue in respect of the award credits until they have fulfilled their obligations to supply the free or discounted goods or services or until such time as the obligation is assumed by a third party. The draft Interpretation should be applied by means of retrospective application for annual periods beginning on or after three months after the Interpretation is finalized. Earlier application of the draft Interpretation will be encouraged.

The Draft Interpretation is available for comment until November 6, 2006 at [http://www.iasb.org/uploaded\\_files/documents/8\\_39\\_IFRICD20.pdf](http://www.iasb.org/uploaded_files/documents/8_39_IFRICD20.pdf).

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