

Insights

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Accounting

Cash Flow Statement Presentation of Inventory Sales

Recently the staff of the SEC's Division of Corporation Finance sent letters to certain registrants regarding their incorrect presentation of cash receipts from inventory sales as investment activities in their statements of cash flows. The presentation issues involved situations in which a company financed the sale of its inventory in various ways, such as on account or with a long- or short-term note or sales-type lease receivable, and with various entities in a consolidated group. FASB Statement No.95, *Statement of Cash Flows*, requires classifying cash receipts from the sale of inventory as operating activities regardless of whether those cash flows stem from the collection of the customer receivable or the sale of the customer receivable to others, whether those receivables are on account or stem from the issuance of a note, or whether they are collected in the short-term or the long-term. The SEC also noted that presenting cash flows between a company and its consolidated subsidiaries as an investing cash outflow and an operating cash inflow when there has not been a cash inflow to the company on a consolidated basis from the sale of inventory is not in accordance with generally accepted accounting principles.

The importance of appropriate classification and presentation of items in the statement of cash flows cannot be overstated. This statement enables investors, creditors and others to analyze cash flows, the availability of cash for dividends and investment, and the company's ability to finance growth from internal sources. The cash flow statement also identifies the reasons for differences between net income or loss and net cash flows.

Proposed Practice Aid for Derivative Loan Commitment Disclosures

The AICPA Derivative Loan Commitments Task Force has published a proposed practice aid, which provides examples of financial statement disclosures related to derivative loan commitments. The disclosures are required by SEC Staff Accounting Bulletin (SAB) No. 105, *Application of Accounting Principles to Loan Commitments*. SAB 105 is applicable to all SEC registrants that issue derivative loan commitments related to the origination of fixed- and variable-rate mortgage loans that will be held for sale. The practice aid is intended for entities engaged in mortgage banking activities and therefore the GAAP-related portions of the disclosure examples also are available for use by non-registrants.

For loan commitments (often referred to as interest rate locks) that are required to be accounted for as derivatives under FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, the proposed practice aid illustrates substantial accounting policy disclosures required in accordance with Accounting Principles Board Opinion No. 22, *Disclosure of Accounting Policies*. These disclosures include methods and assumptions used to estimate fair value and any associated hedging strategies as required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*,

and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The practice aid also includes examples of disclosures required by Regulation S-K Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, and Item 305, *Quantitative and Qualitative Disclosures about Market Risk*. The extent of information to disclose will depend upon management's conclusions as to the materiality of the derivative loan commitments in relation to the financial statements taken as a whole.

Disclosures about derivative loan commitments should be as thorough and transparent as possible. Entities engaged in mortgage-banking activities should consider disclosing changes in a derivative loan commitment's fair value for each period presented, along with information that is necessary to understand how the fair values are computed. Also, entities should consider disclosing the name of the asset or liability related to the subsequent changes in interest rates that an entity reports in its financial statements each period.

There are differing views about how to estimate the fair value of derivative loan commitments. The example disclosures are intended to show a methodology that a company might use to estimate the fair value of its derivative loan commitments and are not intended to provide valuation guidance. Management should evaluate whether the entity's valuation methodology is in accordance with GAAP.

The provisions of SAB 105 must be applied to loan commitments accounted for as derivatives that are entered into subsequent to March 31, 2004. Comments regarding this proposed practice aid will be accepted until March 14. The proposed practice aid and SAB 105 are available at http://www.aicpa.org/download/members/div/acctstd/Illustrative_Disclosure_on_Derivative_Loan_Commitments.pdf.

More information about interest rate locks can be found on our Web site in the following previously published articles at http://www.mcgladrey.com/Resource_Center/insights_2004Archive.html:

Jan. 7, 2004 - "SEC's Position on Loan Commitments"

March 26, 2004 - "SEC Issues Staff Accounting Bulletin No. 105"

May 26, 2004 - "SEC's View on Loan Commitments"

Public Sector

International Accounting Pronouncements

The International Federation of Accountants has released its *2005 Handbook of International Public Sector Accounting Pronouncements*, which is available for purchase at <http://www.ifac.org/Store/Category.tmpl?Category=Public%20Sector%20Accounting>. The new edition of the handbook features all International Public Sector Accounting Standards issued as of December 31, 2004, including two standards issued in 2004 - - the Cash Basis IPSAS, *Financial Reporting Under The Cash Basis of Accounting*, and IPSAS 21, *Impairment of Non-Cash-Generating Assets*.

SEC

SOX 404 Is Here to Stay

If you were wondering whether maybe, just maybe, the SOX 404 requirements would somehow vanish for small business filers, wonder no more. Informal comments by the Public Company Accounting Oversight Board suggest that small businesses will not be totally exempt from the requirement to report on internal controls. It appears that Sarbanes-Oxley Section 404 and related SEC rules will continue to require all entities that file annual reports with the SEC to report on management's assessment of the effectiveness of internal controls over financial reporting, and the accounting firm that audits the company's financial statements must report on both management's assessment and the effectiveness of internal control.

Bill Travis, McGladrey & Pullen's managing partner, recently attended a meeting of representatives from the SEC, PCAOB, NYSE, NASDAQ, and public accounting firms to exchange comments about the implementation of the new SOX 404 reporting requirements. The meeting was an excellent dialog among regulators, capital markets and the accounting profession to help identify what is working and where the issues are. All attendees agreed on the importance of strengthening corporate governance, internal controls and auditor effectiveness. Travis summarized the meeting stating, "The SEC believes that the objective of SOX 404 is to ensure that the financial information is right, and the PCAOB is adamant that SOX 404 is here to stay. Although there was general agreement among the attendees that implementation progress is being made and that a lot of learning is going on, there is concern about how far and how fast to implement the one-size-fits-all internal control requirements. There also is genuine concern over the cost to implement and the related timing requirements, especially for smaller companies."

Generally, representatives of the Big Four accounting firms believe that most Fortune 500 companies are just trying to get through the current SOX 404 requirements, but will need to do significant enhancements over time to build the necessary controls into more efficient business processes to ensure cost effectiveness. Also, highly regulated companies, such as banks that are subject to FIDICIA, generally are doing better with implementation than most businesses, but there is still a lot of work to be done to achieve the SOX requirements.

There is widespread concern about the high financial and opportunity costs of implementation, especially for small and mid-sized registrants and for organizations with subsidiaries scattered across the United States and throughout the world that use different accounting systems. The chief executive officer of the New York Stock Exchange also expressed concern about the potentially adverse impact on litigation, and stated that tort reform is the major issue for U.S. public companies. This leads to significant concerns about the potentially unfavorable effect on the U.S. capital markets if companies go elsewhere (i.e. use foreign markets) for capital, and foreign businesses stop coming to the United States for capital. The NYSE CEO stated that the number of European companies listed on the New York Stock Exchange already has decreased.

Small companies should not expect total relief from the SOX 404 requirements. Enforcement action will ensue for a registrant that does not comply with the 404 requirements. NASDAQ and NYSE have said that a non-compliant registrant would be delisted.

The SEC will host a roundtable discussion in April regarding registrants' and accounting firms' experiences implementing the new reporting requirements under Section 404. The roundtable will include representatives of the PCAOB, issuers, auditors, investors and other interested parties. Also, the SEC will seek written feedback from registrants, auditors and others on their experiences in implementing the Section 404 internal control reporting requirements. Further, a task force of the Committee of Sponsoring Organizations (COSO) has been established and anticipates publishing this summer additional guidance in applying COSO's framework to smaller companies.

McGladrey & Pullen Responds to PCAOB Proposed Rules

McGladrey & Pullen, LLP has submitted to the Public Company Accounting Oversight Board a letter of comment on PCAOB Rulemaking Docket Matter No. 017, "Proposed Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees". The proposed rules are available at http://www.pcaobus.org/Rules_of_the_Board/Documents/Docket_017/Release2004-015.pdf and our comments are available at http://www.mcgladrey.com/Resource_Center/pcaob.html.

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