

Insights

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Accounting

Guidance on Accounting for Interests in Securitized Financial Assets

FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, amended FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to, among other things, establish a requirement to evaluate interests in securitized financial assets to determine whether (a) the interest itself is a freestanding derivative or (b) the underlying securitized financial assets contain embedded derivatives that require bifurcation.

This amendment results in certain interests in securitized financial assets being required to be analyzed in accordance with Statement No. 133 for the first time. Interests in securitized financial assets can have many types of embedded derivatives. The most common types are those whose value is tied to changes in interest rates. Paragraph 13 of Statement No. 133 provides the guidance for embedded features whose underlying is an interest rate or interest rate index. This paragraph requires separate accounting of such an embedded derivative if:

- a. The interest in securitized financial assets can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment;
OR
- b. The embedded derivative meets both of the following conditions:
 - (1) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the interest in securitized financial assets.
 - (2) For each of the possible interest rate scenarios under which the investor's initial rate of return on the interest in securitized financial assets would be doubled, the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under each of those future interest rate scenarios) for a contract that has the same terms as the interest in securitized financial assets and that involves a debtor with a credit quality similar to the issuer's credit quality at inception.

Because prepayment risk is tied to interest rate (i.e. as interest rates increase, prepayment risk also increases), this paragraph would be analyzed to determine if a prepayment feature within the interest in securitized financial assets must be bifurcated. If subparagraph 13.b. is met, then the prepayment feature would be bifurcated.

The FASB has provided a narrow scope exception for interests in securitized financial assets whose only embedded derivative is one tied to the prepayment risk of the underlying prepayable financial assets. This guidance is provided in recently issued Derivatives Implementation Group Statement 133 Implementation Issue No. B40 (DIG Issue No. B40), *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets*.

Specifically, DIG Issue No. B40 states that a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13.b. of Statement No. 133 if the securitized financial instrument meets both of the following criteria:

- a. The right to accelerate the settlement of the securitized interest cannot be controlled by the investor; and
- b. The securitized interest itself does not contain an embedded derivative (including an interest-rate-related derivative) for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets.

Consider the following example:

A mortgage-backed security (MBS) is issued, whereby the cash flows associated with the principal payments (including full or partial prepayments and related penalties) received on the related mortgage loans are passed through to the MBS investors. The MBS did not give the investor the right to accelerate the settlement of the securitized interest. However the underlying mortgages are prepayable, and therefore each loan contains a separate embedded call option.

With the change to Statement No. 133 by Statement No. 155, the investor would have had to evaluate the call options embedded in the loans themselves to determine if bifurcation was necessary. However this DIG Issue states that since (a) the settlement of the MBS itself cannot be accelerated by the investor and (b) the only embedded feature in the underlying loans is the call option (prepayment feature), the MBS is not subject to paragraph 13(b) of Statement No. 133.

Keep in mind that DIG Issue No. B40 does not exempt an entity from analyzing the interest in securitized financial assets under Statement No. 133 if there are any other embedded derivatives that may exist in the interest in securitized financial assets. Therefore the first step in the analysis is to determine which features may be considered an embedded derivative.

The effective date for the guidance in this Issue is generally upon initial adoption of Statement No. 155. An entity that adopted Statement No. 155 prior to December 31, 2006 must apply the guidance in this Issue in the first reporting period beginning before December 31, 2006 for which financial statements have not yet been issued.

DIG Issue No. B40 is available in full at http://www.fasb.org/derivatives/01-17-07_B40.pdf.

Guidance Proposed on Computing Diluted Earnings per Share

FASB Statement No. 128, *Earnings per Share*, requires the use of the two-class method of computing basic earnings per share (EPS) for those enterprises with participating securities or multiple classes of common stock. Participating securities are defined in Statement No. 128 as securities that may participate in dividends with common stocks according to a predetermined formula with, at times, an upper limit on the extent of participation. This definition was expanded in Emerging Issues Task Force (EITF) Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128," to include a security

that may participate in undistributed earnings with common stock in its current form, whether that participation is conditioned upon the occurrence of a specified event or not. Proposed FASB Staff Position (FSP) EITF 03-6-a, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities," addresses whether unvested instruments granted as share-based compensation are participating securities and, therefore, need to be included in basic EPS using the two-class method.

This existing and proposed literature provides guidance on the application of the two-class method in computing *basic* EPS, but does not specifically address or illustrate the application of the two-class method in computing *diluted* EPS. As a result, the Financial Accounting Standards Board (FASB) has issued proposed FSP No. FAS 128-a, *Computational Guidance for Computing Diluted EPS under the Two-Class Method*, to provide guidance for, and illustrative scenarios of, the computation of diluted EPS under the two-class method as follows:

1. Compute basic EPS using the two-class method.
2. Using total earnings allocated to the common stock under Step 1, compute diluted EPS (with earnings available/allocated to common shareholders as the numerator). The FSP prescribes two different methods of determining the dilutive effect depending on whether the participating security is also a potential common share.
3. Determine whether diluted EPS is required to be presented. If so, determine the incremental effect of reallocating undistributed earnings to the second class of common stock. For a second class of common stock convertible into the first class of common stock, disclose the fact that (a) diluted EPS for the second class of common stock does not assume conversion into the first class of common stock and (b) diluted EPS for the first class of common stock assumes conversion of the second class of common stock into the first class of common stock, if dilutive.

If finalized, proposed FSP No. FAS 128-a will have the same effective date as proposed FSP EITF 03-6-a. All prior-period EPS data presented must be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform to the provisions of proposed FSP No. FAS 128-a.

The comment deadline on proposed FSP No. FAS 128-a is March 27, 2007. The complete text of this proposed FSP, which includes several illustrations on its application, is available on the FASB Web site at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas128-a.pdf.

Auditing

Center for Audit Quality

McGladrey & Pullen, LLP has been working with the other members of the public company auditing profession and the American Institute of CPAs to create a public policy and information forum to help serve investors, public company auditors and the markets. We are pleased to announce the creation of the Center for Audit Quality—an autonomous, nonpartisan, nonprofit organization that aims to become an expert resource and catalyst for public education and discussion on public company auditing. Membership is open to all U.S. CPA firms that are registered with the Public Company Accounting Oversight Board.

The Center for Audit Quality's mission is to make the audit process more reliable and useful for investors in this time of growing financial complexity and market globalization. The Center for Audit Quality represents the first time that public company auditors, as a group, have joined with public leaders in the investor and corporate communities to discuss the issues facing the capital markets, conduct research on these topics

and ultimately make recommendations that will foster confidence in the capital markets. All stakeholders have an interest in how the public company auditing profession adapts to a changing reality, and our unique perspective on these changes creates an obligation to lead the dialogue on how to meet them.

The Center for Audit Quality will be led by a Governing Board representing the public company auditing profession and the investor and issuer communities. McGladrey & Pullen, LLP will be represented by David Scudder, the Firm's managing partner. Cindy Fornelli will serve as the Center's executive director. She was previously with Bank of America, and, before that, the SEC and the law firms of Dechert and of Fried, Frank.

More information about the Center for Audit Quality, its genesis, structure and activities is available at <http://thecaq.org/>.

Financial Institutions

Application of PCAOB Independence Rules to Audits of Non-Issuers Required by FDICIA

Auditors of financial institutions required to have a financial statement audit by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) must be independent under the independence rules of the SEC. The Federal Deposit Insurance Corporation recently announced that, in all cases where financial statement audits are required by FDICIA, the SEC's independence rules encompass the Public Company Accounting Oversight Board's (PCAOB) ethics and independence rules approved by the SEC. This position means, among other things, that:

- Under PCAOB Rule 3522, which applies to tax services performed after June 18, 2006, McGladrey and Pullen, LLP and RSM McGladrey, Inc. cannot provide any tax services to such a client related to marketing, planning or opining in favor of a confidential transaction or an aggressive tax position.
- Under PCAOB Rule 3523, which applies to services that were not in process as of April 19, 2006, and not completed by October 31, 2006, McGladrey and Pullen, LLP, RSM McGladrey, Inc. and H&R Block, Inc. are prohibited from providing tax services to persons in a financial reporting oversight role at the audit client (except those persons who are in such a role only because they serve on the board of directors), or an immediate family member of such person.
- Under PCAOB Rule 3524, which applies to all services approved on an engagement-by-engagement basis after June 18, 2006, in connection with obtaining audit committee pre-approval of all permitted tax services performed by McGladrey & Pullen, LLP or RSM McGladrey, Inc., we must describe, in writing, the scope of the service and the fee structure, discuss with the audit committee the potential effects of the services on independence, and document the substance of those discussions. Rule 3524 does not apply to engagements approved subject to pre-approval policies and procedures that are begun by April 20, 2007.

International

Proposed Exception for Parent Companies when Adopting IFRS

Currently, International Financial Reporting Standards (IFRS) require a parent company to measure an investment in a subsidiary either at its cost or at fair value. In some circumstances a parent is unable to determine cost in accordance with IFRS and is deterred from using fair value to account for the investment by the subsequent need to measure the investment at each reporting date. In response to concerns about difficulties encountered by parent companies in measuring the cost of an investment in a subsidiary upon

adopting IFRS, the International Accounting Standards Board has proposed to amend IFRS 1, *First-time Adoption of International Financial Reporting Standards*. The proposal would allow a parent to use a deemed cost to measure its investment in subsidiaries when it first adopts IFRS. This deemed cost can be determined by reference to the parent's investment in the net assets of the subsidiary or the fair value of the parent's investment. The proposal also would alleviate the need to restate the pre-acquisition accumulated profits of a subsidiary for purposes of classifying dividends. Comments on the proposal are due by April 27, 2007.

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