

# Insights

A biweekly publication from the National Office of Audit and Accounting

February 28, 2006

By clicking on a heading in the Bookmark section on the left, you will go directly to that subject.

## Accounting

### Presentation of Certain Items in the Cash Flow Statement

As the world places more and more emphasis on fair value accounting and cash flow information, it is natural that financial statement users will be taking a closer look at the cash flow statement. The statement of cash flows enables investors, creditors and others to assess future cash flows, evaluate the availability of cash for dividends and investment, and to judge a company's ability to finance growth from internal sources. Those who seek cash flow information are not only concerned about the amounts of cash flow, but also about the classification of such amounts among operating, investing and financing cash flows.

The SEC is among those who are taking a closer look at the cash flow statement. In doing so, the SEC has identified three areas for which they believe cash flow presentation is frequently inconsistent with the requirements of FASB Statement No. 95, *Statement of Cash Flows*:

- Discontinued operations
- Floor-plan financing
- Insurance settlements and proceeds

Although these matters were noticed by the SEC, they are applicable and important to all companies, whether registered with the SEC or not. It is incumbent upon all companies to follow the Statement No. 95 guidance with respect to the proper presentation and classification of these accounting issues in the statement of cash flows. Generally, companies using incorrect cash flow statement formats should revise their presentation by restating prior periods as a correction of an error. SEC registrants, however, are encouraged to read the "Presentation of Discontinued Operations in the Cash Flow Statement" article below to learn more about the temporary error-correction provisions adopted by the SEC to address this issue.

### Accounting for Certain Hybrid Financial Instruments

The Financial Accounting Standards Board (FASB) has issued a new standard, FASB Statement No. 155, *Accounting for Certain Hybrid Instruments*. This Statement amends FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Statement No. 155 resolves issues related to the financial reporting of certain hybrid financial instruments that are addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets."

This new Standard allows financial instruments that have embedded derivatives to be accounted for as a whole at fair value (with changes in fair value recognized in earnings), if the holder elects this option. This accounting eliminates the need to bifurcate the derivative from its host. Statement No. 155 also:

- Significantly narrows which interest-only strips and principal-only strips are scoped out of Statement No. 133;
- Establishes a requirement for holders of securitized financial assets to evaluate whether the interest is a freestanding derivative or a hybrid financial instrument that contains an embedded derivative requiring bifurcation;
- Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and
- Eliminates the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

This Statement is effective for all financial instruments acquired, issued or subject to a re-measurement event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. Earlier adoption is permitted in certain circumstances. The Standard is available in full at <http://www.fasb.org/pdf/fas155.pdf>.

### **FASB Responds to SEC Study**

The Sarbanes-Oxley Act of 2002 mandated that the SEC conduct a study of filings by issuers, and prepare a report that addresses the extent of off-balance sheet arrangements and whether current financial statements of issuers transparently reflect the economics of off-balance sheet arrangements. The SEC's report identified several key initiatives aimed at improving the transparency of financial reports and made several recommendations to accounting standard setters. The Financial Accounting Standards Board (FASB) responded to the report by stating that it sees reducing complexity and improving transparency and overall usefulness of financial statements as key challenges facing the financial reporting system.

Specifically, the FASB has affirmed that it agrees with the standard-setting recommendations in the study, which are consistent with its current and planned activities:

- The FASB has on its agenda a long-term project to develop comprehensive accounting guidance on accounting for affiliations between entities, including reconsideration of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*.
- The accounting guidance for defined-benefit pension plans and other postretirement benefit plans is being reconsidered in a comprehensive project that is on the FASB's technical agenda and is being conducted in two phases. The first phase is expected to be completed later in 2006, and it seeks to improve financial statement transparency by requiring the funded or unfunded status of such plans to be recognized in the balance sheet. The second phase is expected to take several years and will be conducted jointly with the International Accounting Standards Board.
- The FASB has instructed its staff to perform research and recommend potential alternatives for improving the current accounting guidance on leases.
- The feasibility of reporting all financial instruments at fair value will continue to be explored through a number of projects on the FASB's agenda. For example, the FASB has issued an Exposure Draft of a proposed Statement of Financial Accounting Standards that would permit entities to report certain financial assets and financial liabilities at their fair value.

Although not discussed in the SEC's report, the FASB believes that intangible assets is another area where current reporting generally does not adequately capture or provide sufficient information on what, for many companies and industries, are very significant economic assets. The FASB has also undertaken several

initiatives aimed at improving the understandability, consistency, and overall usability of existing accounting literature, through codification, by attempting to stem the proliferation of new pronouncements emanating from multiple sources and by developing new standards in a “principles-based” or “objectives-oriented” approach. The FASB also agrees that transparency in financial reporting would be improved by discouraging transactions and transaction structures primarily motivated by achieving accounting and reporting objectives rather than their economics.

The SEC’s study is available in full at <http://www.sec.gov/news/studies/soxoffbalancerpt.pdf>, and the FASB’s response is available at [http://www.fasb.org/fasb\\_response\\_sec\\_study\\_obs.pdf](http://www.fasb.org/fasb_response_sec_study_obs.pdf).

## Financial Institutions

### Compliance with Applicable Servicing Criteria under Regulation AB

As of January 1, 2006 Regulation AB provides the disclosure and periodic reporting requirements related to asset-backed securities that are registered with the SEC. Item 1122 of Regulation AB is of particular interest to public accountants and their clients. Item 1122, *Compliance with Applicable Servicing Criteria*, potentially impacts the ongoing periodic reporting of almost every entity (servicers, issuers, master servicers, bond administrators, trustees, underwriters) involved with publicly registered mortgage-backed or asset-backed securities that are the subject of registered offerings beginning after December 31, 2005.

Item 1122 provides details of four categories of servicing criteria to be used in assessing servicing compliance - general servicing considerations, cash collection and administration, investor remittances, and reporting and pool asset administration. Servicers must now formally make an assertion regarding their compliance with these new minimum servicing criteria for mortgage and asset-backed securities. For publicly registered offerings, this new performance reporting will replace the prior reporting under the Mortgage Banker’s Association Uniform Single Attestation Program (USAP). Regulation AB, however, broadens the definition of a servicer to include any person responsible for the management or collection of the pool assets or making allocations or distributions to holders of the asset-backed securities.

The registered public accounting firm for each assessing party is required to attest to the assessment of compliance made by such assessing party. The attestation will need to state the opinion of the accountant as to whether the servicer’s assessment of compliance with the applicable servicing criteria was fairly stated in all material respects, or must include a statement that such an opinion cannot be provided. In addition, the attestation must not include any restricted-use language. The substitution of another type of accountant’s report, such as a USAP report or an agreed-upon procedures report, will not be acceptable.

The issuer’s Form 10-K must include, among other things, the assessment of compliance with the SEC’s minimum servicing criteria from each party participating in the servicing function and the accountant’s attestation report evaluating each servicer’s assertion regarding compliance with the minimum servicing criteria. Each assessing party is required to report any material instance of noncompliance with the servicing criteria in Form 10-K. Disclosure of noncompliance would be required if noncompliance occurred during the relevant period of the report, regardless of any correction that occurred before the end of the period.

## Public Sector

### Proposed Technical Bulletin to Clarify Reporting of Medicare Part D Payments

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 provides for a prescription drug benefit under Medicare Part D as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D.<sup>1</sup> Recently, the Governmental

Accounting Standards Board published a proposed staff Technical Bulletin to clarify the reporting of payments that an employer or a defined benefit other postemployment benefit (OPEB) plan receives from the federal government under Medicare Part D. The Technical Bulletin analyzes the following four questions:

- How should an employer account for and report a Medicare Part D payment from the federal government to the employer?
- How does a Medicare Part D payment from the federal government to an employer affect the accounting for the transaction and financial reporting by a defined benefit OPEB plan?
- How should an employer account for and report a Medicare Part D payment from the federal government to the plan?
- How should a defined benefit OPEB plan account for and report a Medicare Part D payment from the federal government to the plan?

The proposed Technical Bulletin is expected to be effective for financial statements issued after June 30, 2006, except for portions of answers pertaining to the measurement, recognition, or required supplementary information requirements of GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. Those provisions should be applied simultaneously with the implementation of Statement Nos. 43 and 45.

The proposed Technical Bulletin is available for comment until April 17, 2006 at [http://www.gasb.org/exp/prop\\_tb\\_2006-a.pdf](http://www.gasb.org/exp/prop_tb_2006-a.pdf).

## SEC

### Presentation of Discontinued Operations in the Cash Flow Statement

The SEC staff has stated that the presentation of discontinued operations in the statement of cash flows is one area that is the subject of scrutiny in their reviews of filings. The reason for this scrutiny is that the SEC staff has identified certain presentation formats that they consider to be inconsistent with FASB Statement No. 95, *Statement of Cash Flows*, such as:

- Aggregating operating, investing, and financing cash flows from discontinued operations into a single line item; and
- Presenting operating, investing, and financing cash flows from discontinued operations all within the operating cash flows category.

Statement No. 95 does not require separate disclosure of cash flows pertaining to discontinued operations reflected in the operating, investing, and financing categories of the cash flow statement. However, a company that chooses to report separately operating cash flows of discontinued operations must do so consistently for all periods affected. Further, all cash flows must be reported as either an operating, investing, or financing activity. For proper cash flow statement presentation, cash flows from discontinued operations can be:

- Combined with cash flows from continuing operations within each category;
- Identified within each category; or
- Identified for each category and presented separately.

If an issuer presents on its balance sheet a single line for assets of the discontinued operations, which includes cash and cash equivalents, the issuer should consider additional disclosures that may be necessary with respect to cash flows from discontinued operations depicted on the statement of cash flows.

The SEC Staff further advises that the "Liquidity and Capital Resources" section of Management's Discussion and Analysis (MD&A) should describe how cash flows from discontinued operations are reported in the cash flows statement and should quantify cash flows from discontinued operations if that amount is not disclosed separately in the cash flow statement. MD&A also should describe how the absence of cash flows from discontinued operations is expected to affect future liquidity and capital resources.

The SEC staff believes issuers using any incorrect cash flow statement formats should revise their presentation by restating prior periods as a correction of an error. However, the SEC staff has advised the AICPA Center for Public Company Audit Firms (CPCAF) that they will not object to issuers retrospectively modifying their presentation similar to a change in accounting method, without referring to the correction of an error. Issuers who choose to retrospectively modify their presentation must inform readers that the cash flow presentation has been modified. Even though the alternative disclosure is similar to a change in accounting method, no preferability letter is required in this circumstance.

Registrants would need to make these changes in the next periodic report filed subsequent to February 15, 2006. If the issue is discovered and corrected in a later interim or annual period, the SEC staff would expect the modification to be treated as a correction of an error, and would expect the prior filing(s) to be amended.

If a previous presentation had a single line at the bottom of the statement of cash flows containing the combined operating, investing and financing cash flows of discontinued operations, and the registrant now chooses to disclose such cash flows by expanding the previous one caption display, then the footnotes would need to clearly disclose the change, and the face of the cash flow statement should indicate the change by labeling either the column or the marginal heading as "revised" or "restated." Characterizing the modification as "reclassified" in the column or marginal heading would not be acceptable. If a registrant chooses to provide the disclosures of the cash flows pertaining to the discontinued operations by adding an additional line to each of the three categories of cash flows, that method would have the effect of changing the total for each such category. In that case, the marginal caption revision cannot be used, and the column heading of each year must be labeled "Revised - See Note X" or "Restated - See Note X."

Per the CPCAF, the SEC staff believes that the footnote disclosure of the change must be specific, and that it is not acceptable to assert that this change is already encompassed by a general footnote, such as, "Certain prior year amounts have been reclassified for comparative purposes to conform to current year presentation." The SEC staff expects the disclosure to be more complete, such as, "In 2005 the Company has separately disclosed the operating, investing and financing portions of the cash flows attributable to its discontinued operations, which in prior periods were reported on a combined basis as a single amount."

### Standing Advisory Group Meeting

The Public Company Accounting Oversight Board (PCAOB) held a Standing Advisory Group (SAG) meeting on February 9, 2006. The SAG is composed of approximately 30 people representing the auditing profession, public companies, investors and others. At this meeting, the PCAOB sought advice from its SAG members on the following topics:

- **Appropriate auditor responsibilities related to the use of specialists.** Discussions were held regarding what the auditor's competencies should be when relying on a specialist. There also was conversation about the education of those entering the auditing profession. It was mentioned that future auditors will need much more knowledge about fraud, internal control, contracts, foreign

business practices, information technology, and fair value. SAG members also discussed whether the auditor should have responsibility to directly evaluate the reasonableness of the methods and assumptions of the specialist.

- **Risk assessment.** Much discussion was held about the evolving and popular topic, risk assessment. Among many issues discussed, SAG members talked about the use of financial benchmarks in determining planning materiality and the flexibility that auditors have in determining sample sizes. There was dialogue concerning whether the auditing standards should provide more guidance regarding the precision of the auditor's judgments about accounting estimates. There also was conversation about whether more direction should be provided for evaluating the possibility of management bias in accounting estimates.
- **Indemnification and limitation of liability clauses in audit arrangement letters.** Generally, members thought that indemnification clauses in engagement letters are not appropriate. Some SAG members indicated that the auditor should discuss the details of litigation-related clauses in the arrangement letter with the audit committee. Members believe there is a need to look at these clauses separately because some may compromise independence and objectivity, while others may not.

The PCAOB will consider the advice of the SAG when establishing auditing standards for public companies. Joseph (Leroy) Dennis, Executive Partner Assurance Services for McGladrey & Pullen, LLP, is a member of the Standing Advisory Group.

### Roundtable to Discuss SOX 404 Experiences

The Public Company Accounting Oversight Board (PCAOB) and the SEC will sponsor a roundtable on May 10, 2006 to discuss second-year experiences with the internal control reporting requirements under Section 404 of the Sarbanes-Oxley Act of 2002. The roundtable discussion will include issuers, auditors, investors and other interested parties. Prior to the roundtable discussions, the PCAOB and SEC are seeking written feedback from auditors, investors, issuers and others on lessons learned from the first two years of applying the internal control reporting requirements and how the efficiency and effectiveness of those assessments and audits could be improved. Comments should be submitted by May 1, 2006 to [comments@pcaobus.org](mailto:comments@pcaobus.org) or:

Internal Control Roundtable  
Public Company Accounting Oversight Board  
Attention: Office of the Secretary  
1666 K Street N.W.  
Washington, D.C. 20006-2803

---

*Insights* is a biweekly publication of McGladrey & Pullen, LLP and should not be construed as accounting, auditing, consulting, or legal advice on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult your McGladrey & Pullen, LLP service provider concerning your situation and any specific questions you may have. You may call 1.888.214.1416 for a contact person in your area.

For further information about McGladrey & Pullen or to retrieve archived issues of *Insights*, visit our Web site: <http://www.mcgladrey.com/>. If you do not wish to continue receiving *Insights*, or if you wish to place another person on the distribution list, please contact [mpinsights@rsmi.com](mailto:mpinsights@rsmi.com).