

Insights

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Accounting

McGladrey & Pullen Responds to Proposed FSP

McGladrey & Pullen, LLP has submitted a comment letter to the Financial Accounting Standards Board (FASB) on proposed FASB Staff Position (FSP) No. FAS 142-d, *Amortization and Impairment of Acquired Renewable Intangible Assets*. The proposed FSP would amend FASB Statement No. 142, *Goodwill and Other Intangible Assets*. The principal objective of the proposed FSP is to connect the amortization period for certain intangible assets to the period used in FASB Statement No. 141, *Business Combinations*, in initially measuring the fair value of those assets. In achieving that objective, the proposed FSP creates a new class of intangible assets (called renewable intangible assets) which would be amortized over future periods based on the discounted cash flow of each period (that is, the initial contractual period and each expected future renewal period) compared with the total discounted cash flows, and subjecting the carrying value of those intangible assets to an annual impairment test based on the then fair value of those intangible assets.

In its comment letter, our Firm agrees with the proposed FSP's principal objective but expresses disagreement with the amortization methodology and the need for an annual impairment test. We also disagree with the proposed FSP's requirement to capitalize incremental and direct renewal costs and the method of initial application. Our Firm's comment letter may be found at http://www.mcgladrey.com/FSP_142d_Comment_Letter.html.

FASB Proposes Major Change in Employers' Reporting Defined Benefit Postretirement Plans

The accounting guidance for defined-benefit pension plans and other postretirement benefit plans is being reconsidered by the Financial Accounting Standards Board (FASB) in a comprehensive project that is being conducted in two phases. The second phase, which will be conducted jointly with the International Accounting Standards Board, is expected to take several years. However, the first phase of the project recently resulted in the issuance of an Exposure Draft (ED) of a proposed Statement, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. This ED applies to plan sponsors that are public and private companies and to nongovernmental not-for-profit organizations. The objective of the ED is to respond to criticisms that the current reporting by employers lacks transparency and understandability about the costs and obligations of providing postretirement benefits.

The ED would require employers to recognize the overfunded or underfunded positions (the difference between the fair value of plan assets and the benefit obligation) of defined benefit postretirement plans, including pension plans, in their balance sheets. For a pension plan, the benefit obligation would be the projected benefit obligation; for any other postretirement benefit plan, the benefit obligation would be the

accumulated postretirement benefit obligation. Current accounting standards require information about the current funded status of such plans to be reported in the notes to financial statements.

FASB Statements No. 87, *Employers' Accounting for Pensions*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, currently require that plan assets and benefit obligations be measured as of the date of the employer's balance sheet or, if used consistently from year to year, as of a date not more than three months prior to that date. In this ED, the FASB has proposed to eliminate the choice of a measurement date and would require that employers measure plan assets and obligations as of the balance sheet date.

The ED also would require employers to:

- Recognize as a component of other comprehensive income, net of tax, the actuarial gains and losses and the prior service costs and credits that arise during the period but pursuant to current standards are not recognized as components of current net periodic benefit cost;
- Recognize as an adjustment to the opening balance of retained earnings, net of tax, any transition asset or transition obligation remaining from the initial application of Statement No. 87 or 106; and
- Disclose additional information in the notes to financial statements about certain effects on net periodic benefit cost in the upcoming fiscal year that arise from delayed recognition of the actuarial gains and losses and the prior service costs and credits.

The proposed changes, other than the requirement to measure plan assets and obligations as of the balance sheet date, would be effective for fiscal years ending after December 15, 2006, with earlier application encouraged. Except for the measurement date change, the requirements of the ED are to be applied retrospectively. Public companies would be required to apply the proposed changes to the measurement date for fiscal years beginning after December 15, 2006 and nonpublic entities, including not-for-profit organizations, would become subject to that requirement one year later.

The ED is available for comment until May 31, 2006 at http://www.fasb.org/draft/ed_pension&postretirement_plans.pdf.

A summary of the principal effects the ED will have on employers' current reporting is as follows:

- Recognize the underfunded (overfunded) status of defined benefit postretirement plans as a liability (asset) on the balance sheet;
- Recognize actuarial gains and losses, net of tax, as a component of other comprehensive income;
- Recognize unrecognized prior service cost or credit, net of tax, as a component of other comprehensive income;
- Eliminate the requirement to recognize an additional minimum liability for certain defined benefit pension plans;
- Recognize any remaining unamortized transition obligation or asset as an adjustment to retained earnings (unlike the other changes, this change will affect the measure of periodic benefit cost by eliminating amortization of the transition obligation or asset as a component of benefit cost);
- Require the measurement of plan obligations and assets as of the employer's balance sheet date, except for certain consolidated subsidiaries;

- Require additional components of items of other comprehensive income to be recognized by investors in equity-method investees; and
- As a result of the foregoing, certain disclosures currently required will be eliminated.

Since this ED can affect employers' assets, liabilities and net worth, employers will need to consider their ability to meet certain financial statement requirements of contractual agreements (for example, debt-to-equity ratio of a loan covenant). Accordingly, these indirect effects must be considered when planning the initial application of the requirements of the ED.

Accounting for Life Settlement Contracts

The Financial Accounting Standards Board (FASB) has issued FASB Staff Position (FSP) No. FTB 85-4-1, *Accounting for Life Settlement Contracts by Third-Party Investors*, to provide measurement and financial statement presentation and disclosure guidance for investments in life settlement contracts within the scope of the FSP. This FSP amends certain provisions of FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This FSP addresses transactions in which a broker facilitates settlement transactions between the policy owner and the investor, as well as transactions that do not involve a broker. A life settlement contract for purposes of this FSP is a contract between the owner of a life insurance policy and a third party investor that has the following characteristics:

- The investor does not have an insurable interest;
- The investor provides consideration to the policy owner of an amount in excess of the current cash surrender value of the life insurance policy; and
- The contract pays the face value of the life insurance policy to the investor when the insured dies.

Prior to the issuance of this FSP, an investor in a life settlement contract accounted for the investment in accordance with Technical Bulletin No. 85-4, which requires the investor to expense, on the date of purchase, the difference between the purchase price of life settlement contract and its cash surrender value. FSP No. FTB 85-4-1 now states that an investor may elect to account for its investments in life settlement contracts using either the investment method or the fair value method. The election must be made on an instrument-by-instrument basis and is irrevocable and must be supported by contemporaneous documentation.

Under the investment method, the initial investment is recorded at the transaction price plus initial direct external costs, and continuing costs (that is, premiums and direct external costs) are capitalized. No income is recognized until the insured dies, at which time the difference between the carrying cost of a life settlement contract and the life insurance proceeds of the underlying life insurance policy is recognized. An investor must recognize an impairment loss if the expected undiscounted cash inflows (typically, the insurance proceeds) are less than the carrying amount of the investment plus anticipated undiscounted future premiums and capitalizable direct external costs, if any.

Under the fair value method, an investor recognizes the initial investment at the transaction price. In subsequent periods, the investor remeasures the investment at fair value in its entirety at each reporting period and recognizes changes in fair value in earnings in the period in which the changes occur. The investor should account for premiums paid and life insurance proceeds received on the same financial reporting line as the changes in fair value are reported.

The FSP prescribes the financial statement presentation and disclosures required by investors in life settlement contracts.

The guidance in this FSP must be applied to fiscal years beginning after June 15, 2006. At the date of adoption, an investor must make a one-time irrevocable election to account for its currently held life settlement contracts on an instrument-by-instrument basis using either the fair value method or the investment method and recognize a cumulative-effect adjustment to beginning retained earnings. The FSP is available in full at http://www.fasb.org/fasb_staff_positions/fsp_ftb85-4-1.pdf.

EITF Changes Rules of Practice and Tentative Conclusions Ratified

Effective with the March 16, 2006 meeting, the Emerging Issues Task Force (EITF) agreed to a change in its rules of practice. The change requires the following steps before a consensus is deemed to be final:

1. Any initial conclusion reached on an Issue at an EITF meeting will first be characterized as a tentative conclusion.
2. A tentative conclusion is then to be discussed at a public meeting of the Financial Accounting Standards Board (FASB) at which the Board will decide whether to ratify a tentative conclusion.
3. Any tentative conclusion ratified by the FASB will be posted to its Web site for a 30-day comment period.
4. Comments received on an Issue, if any, will be considered by the EITF at its next regularly scheduled meeting at which the EITF will consider whether to agree to a consensus, subject to FASB ratification.
5. A consensus agreed to by the EITF is to be discussed at a public meeting of the FASB to determine whether to ratify the consensus.
6. An EITF consensus ratified by the FASB will become final as described in the minutes of the EITF.

Consistent with the above rules of practice, on March 28, 2006 the FASB ratified tentative conclusions reached by the EITF at its March 16, 2006 meeting on the following Issues:

- *EITF Issue No. 05-1, "Accounting for the Conversion of an Instrument That Became Convertible upon the Issuer's Exercise of a Call Option"*

The accounting question being addressed in this Issue is how to account for the issuance of equity securities to settle a debt instrument that was not otherwise convertible but became convertible upon the issuer's exercise of a call option when the issuance of equity securities is pursuant to the instrument's original conversion terms. A tentative conclusion was reached that the issuance of equity securities to settle a debt instrument pursuant to its original conversion terms that became convertible upon the issuer's exercise of a call option should be accounted for as a conversion if the debt instrument contained a substantive conversion feature as of its issuance date. If the instrument did not contain a substantive conversion feature as of its issuance date, the equity securities issued to settle the debt instrument should be accounted for as a debt extinguishment.

- *EITF Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, 'Accounting for Compensated Absences'"*

The accounting question being addressed in this Issue is whether to accrue compensation cost related to a sabbatical leave, or similar benefit arrangement. A tentative conclusion was reached

that an employee's right to a compensated absence under a sabbatical or other similar benefit arrangement that requires the completion of a minimum service period and in which the benefit does not increase with additional years of service, accumulates pursuant to paragraph 6(b) of Statement No. 43 for arrangements in which the individual continues to be a compensated employee and is not required to perform duties for the entity during the absence. Therefore, assuming all of the other conditions of paragraph 6 of Statement No. 43 are met, the compensation cost associated with a sabbatical or other similar benefit arrangement should be accrued over the requisite service period.

- *EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)"*

The accounting question being addressed in this Issue is how to report nondiscretionary amounts assessed by governmental authorities in connection with transactions with customers in the entity's income statement. A tentative conclusion was reached that the presentation on either a gross (included in revenues and costs) or a net (excluded from revenues) basis of any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer (such as sales, use, value-added, and some excise taxes) is an accounting policy decision that should be disclosed pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*. For any such taxes that are reported on a gross basis, a company should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant.

Draft abstracts on these conclusions are available for comment until May 4, 2006 at <http://www.fasb.org/eitf/agenda.shtml>.

Also, at the March 16, 2006 EITF meeting, the Task Force clarified that the consensus in Issue 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues", also applies to a modification of a debt instrument that either adds or eliminates an embedded conversion option that is not bifurcated from its host contract pursuant to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Further, at the March 16, 2006 meeting, the SEC Observer clarified the SEC staff's position on the application of Topic D-98, "Classification and Measurement of Redeemable Securities", to certain share-based payment arrangements with employees. The SEC staff believes that for options or similar instruments granted in conjunction with share-based payment arrangements with employees for which the terms may permit redemption of the option or underlying share, the initial amount classified outside of permanent equity should be based on the redemption provisions of the instrument. Registrants should also consider the guidance in FASB Staff Position 123(R)-4, *Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event*, when evaluating the classification of options or similar instruments whose terms may permit redemption of the option or underlying share.

The minutes of the March 16, 2006 EITF meeting are available at http://www.fasb.org/eitf/03-16-06_mtg_minutes.pdf.

Auditing

IRS to Examine More EB Plans

Beginning in 2006, the IRS is changing its employee benefit plan examination philosophy. Instead of looking at all aspects of a company's plan, the IRS will now employ a more limited process that concentrates on four to five key issues. Under the new system, IRS agents will perform an initial review of the plan documents. Then, the agents will focus only on the records necessary to resolve the issues initially identified. This new focused philosophy will increase examination productivity, which means that the IRS will be able to examine more plans this year than in prior years. The focus of IRS examinations is likely to include the following key issues:

- Compliance with eligibility rules;
- Timing of remittance of contributions;
- Failure to use proper compensation amounts in calculations;
- Abusive tax transactions; and
- Pension funding.

Non-compliant plan sponsors could be subject to fines or other penalties. The IRS has developed the *EP Examination Process Guide* to clarify the various steps in the examination process. This guide is available at <http://www.irs.gov/retirement/article/0,,id=135076,00.html>. Also, sponsors can assess their compliance risk using tools that are available at <http://www.irs.gov/retirement/article/0,,id=147167,00.html>.

Reporting Pursuant to the Global Investment Performance Standards

In 1987, the Association for Investment Management and Research (AIMR) first introduced the AIMR Performance Presentation Standards (AIMR-PPS) to promote greater comparability in investment performance presentations among investment managers. In 1999, AIMR issued the Global Investment Performance Standards (GIPS) to provide a basis for readily accepted and comparable presentations of an investment firm's past investment performance without regard to geographic location. As of January 1, 2006, the AIMR-PPS standards converged with the GIPS standards, and the AIMR-PPS standards no longer exist as a separate set of standards.

As a result of the above standards convergence, the American Institute of Certified Public Accountants has released Statement of Position (SOP) 06-1, *Reporting Pursuant to the Global Investment Performance Standards*, which supersedes SOP 01-4, *Reporting Pursuant to the Association for Investment Managing and Research Performance Presentation Standards*. SOP 06-1 provides guidance for engagements to examine and report on aspects of an investment firm's compliance with GIPS. In addition, this SOP provides guidance for engagements to examine and report on the performance results of specific composites in conformity with GIPS. The SOP also provides guidance on engagements to examine and report, for periods ending no later than December 31, 2005, under both AIMR-PPS and GIPS.

International

Standard Proposed for Auditing Group Financial Statements

The International Auditing and Assurance Standards Board is re-exposing a draft of proposed International Standard on Auditing 600 (Revised and Redrafted), *The Audit of Group Financial Statements*. The Exposure Draft is different from the prior draft in two areas:

- Previous proposals distinguished between the work that the group auditor needed to do, depending upon whether other auditors were related or not. While this may be a relevant factor, the strength of relationships varies. The proposal, therefore, eliminates the distinction.
- Because current group audit practices vary, the proposal is reasonably specific about the steps to be taken, and the work effort required, by the group auditor who takes sole responsibility for the audit opinion on the group financial statements.

The Exposure Draft is available for comment until July 31, 2006 at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0055>.

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