

Insights

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Accounting

More TPAs Released for SOP 03-3

The Accounting Standards Team of the American Institute of Certified Public Accountants (AICPA) has released two new Technical Practice Aids (TPAs) relating to AICPA Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. SOP 03-3 provides guidance on accounting for *acquired* loans (not loans originated by the entity) when there has been deterioration in credit quality since the loan was originated. The SOP applies to all nongovernmental entities, including not-for-profit organizations, which acquire loans.

SOP 03-3 states that investors may aggregate loans acquired in the same fiscal quarter that have common risk characteristics and thereby use a composite interest rate and expectation of cash flows expected to be collected for the pool. The SOP also states that once the pool is assembled, the integrity of the pool should be maintained. TPA #2130.36 provides an example of the impact on the accounting for a pool of loans if there is a confirming event and one loan is removed as expected. TPA #2130.37 provides an example of the impact on the accounting for a group of loans accounted for as a pool if there is a confirming event, one loan is removed from the pool, and the investor decreases its estimate of expected cash flows.

These two TPAs are available at http://www.aicpa.org/download/acctstd/TPA_03-3A.pdf. Late last year the AICPA released a series of 27 TPAs (# 2130.09 through #2130.35) to address a variety of other topics related to SOP 03-3; these TPAs are available at http://www.aicpa.org/download/acctstd/TPA_03-3.pdf.

Financial Institutions

Interagency Statement Proposed Concerning Complex Structured Finance Activities

The Office of the Comptroller of the Currency, Office of Thrift Supervision, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and SEC have collectively requested public comment on a revised proposed statement on the complex structured finance activities of financial institutions. These agencies have reorganized, streamlined and modified the original proposed statement, which was issued for comment in May, 2004, to make the document more principles based and focused on those complex structured finance transactions that may pose heightened levels of legal or reputational risk to a financial institution. The revised statement describes the types of internal controls and risk-management procedures that should help financial institutions identify, manage and address the heightened legal and reputational risks that may arise from certain complex structured finance transactions.

The revised statement would represent supervisory guidance for institutions supervised by the four banking agencies and a policy statement for institutions supervised by the SEC. The revised statement will not affect or apply to the vast majority of small financial institutions. The proposed revised statement is available for comment at <http://www.sec.gov/rules/policy/2006/34-53773.pdf>.

Public Sector

Circular A-133 Supplement Released

The Office of Management and Budget has released a March 2006 supplement to Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Circular A-133 sets forth standards for auditing states, local governments, and non-profit organizations that administer Federal financial assistance programs. The Compliance Supplement provides guidance regarding Federal programs' objectives, procedures, and compliance requirements. This Supplement also provides guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for Federal programs. For single audits, the Supplement replaces agency audit guides and other audit requirement documents for individual Federal programs. The March 2006 Supplement, which is effective for audit of periods ending on or after June 30, 2006, is available at http://www.whitehouse.gov/omb/circulars/a133_compliance/06/06toc.html.

SEC

PCAOB and SEC Announce Actions to Improve SOX 404

The Public Company Accounting Oversight Board (PCAOB) and the SEC have announced a series of actions they intend to take to improve the implementation of the Section 404 internal control requirements of the Sarbanes-Oxley Act of 2002 (SOX 404). Based on extensive analysis and commentary received from investors, companies, auditors, and the SEC Advisory Committee on Smaller Public Companies, the following actions are expected to be taken:

- The SEC intends to issue a short postponement of the SOX 404 implementation date for non-accelerated filers, which is currently effective for audits of periods ending on or after July 15, 2007. It is anticipated that any such postponement would nonetheless require all filers to comply with the management assessment required by SOX 404 for fiscal years beginning on or after December 16, 2006.
- The SEC intends to issue additional guidance for management on how to complete its assessment of internal control over financial reporting as required by SOX 404, and this guidance is expected to be responsive to the circumstances of smaller public companies. To prepare for the release of such guidance, the SEC intends to first issue a Concept Release soliciting views on the management assessment process and on the appropriate role of outside auditors in connection with management's assessment. Also, the SEC will consider the extent to which additional guidance provided by the Committee of Sponsoring Organizations of the Treadway Commission is useful to smaller public companies in completing their SOX 404 assessments.
- The PCAOB intends to propose revisions to its Auditing Standard (AS) No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. The proposed revisions would clarify what role the auditor should play in evaluating the company's process of assessing internal control effectiveness and would seek to ensure that during integrated

audits auditors focus on areas that pose higher risk of fraud or material error. The proposal also would clarify some of the existing AS 2 provisions and would reinforce the expectation that the integrated audit be conducted in the most efficient manner, while achieving the objectives of the Standard.

- The PCAOB's 2006 inspections will focus on whether auditors have achieved cost-saving efficiencies in audits performed under AS 2. Upon completion of the PCAOB's 2006 inspections, the SEC will examine whether the PCAOB inspections of audit firms have been effective in encouraging such efficiencies.
- The PCAOB plans to develop implementation guidance for auditors of smaller public companies and to explore various means of facilitating opportunities for such auditors to obtain effective training on auditing internal control over financial reporting. The PCAOB will hold a total of eight forums during 2006 for the auditors, directors and financial officers of smaller public companies to monitor reaction to the internal control-related implementation changes that are announced throughout the year.

These expected actions will not change current rules or regulations unless formally adopted by the SEC. Therefore, you should continue to plan that the adoption of Section 404 will occur as currently scheduled in the law. You should also monitor the SEC's Web site or McGladrey & Pullen's Web site for updates and current events.

The Relationship between Internal Control and the Cost of Equity Capital

A recent study on the relationship between internal control and the cost of equity capital showed that companies with effective internal controls, as demonstrated by an unqualified Section 404 audit opinion, can be rewarded with a significantly lower cost of capital. The study, "The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital," was conducted by Hollis Ashbaugh-Skaife, University of Wisconsin, Madison; Daniel W. Collins, University of Iowa; William R. Kinney, Jr., University of Texas – at Austin; and Ryan LaFond, MIT-Sloan School of Management. The study found evidence that both companies reporting strong internal controls and companies that corrected prior internal control problems benefited from reduced equity capital costs. In fact, the study showed that companies that remediated previously announced internal control weaknesses benefited from an average reduction in equity capital costs of 151 basis points. Conversely, the study found that the first disclosure of an internal control deficiency raised the cost of equity capital by an average of 93 basis points.

The study is available in full at

http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID896760_code328250.pdf?abstractid=896760&mirid=1.

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