

Insights

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Accounting

FASB Seeks Comments on the Bifurcation of Insurance and Reinsurance Contracts

The Financial Accounting Standards Board (FASB) is seeking comment on the potential bifurcation of insurance and reinsurance contracts into two main components for financial reporting purposes – insurance components and financing components. Insurance components of such contracts (i.e., those that transfer significant insurance risk) would be accounted for under existing insurance accounting guidance and generally provide an income statement benefit (recovery) in the period of an insured loss. Financing components that are accounted for as deposits would be recorded as an asset by the policyholder; any recovery from an insured event would reduce the deposit and not have a significant income statement benefit.

Of particular concern to the FASB is the depiction in the policyholder's financial statements of insurance or reinsurance contracts that transfer only limited insurance risk—often referred to as finite risk contracts. These finite risk contracts likely have both insurance components and deposit components, but they generally are accounted for in their entirety as insurance contracts. The Invitation to Comment, however, is not exclusive to finite risk contracts.

Bifurcation could have a significant impact on the way some insurance contracts are accounted for by policyholders, insurers and reinsurers. Substantially all entities that buy insurance could be affected by these issues. The Invitation to Comment does not reach any tentative conclusions about these issues, but rather, it requests specific information from buyers and sellers of insurance and reinsurance contracts, and the users of their financial statements, about whether bifurcation would improve financial reporting. The Invitation to Comment is available in full at http://www.fasb.org/draft/ITC_Bifurcation_Insurance.pdf. The comment deadline is August 24, 2006.

Proposed FSP Addresses Accounting for Planned Major Maintenance Activities

The term “planned major maintenance activities” is not defined in the authoritative literature. However, it encompasses situations where items of property or equipment are required by regulatory or operational requirements to undergo major overhaul or refurbishment to return them to a pre-used condition. For example, diesel engines of over-the-road tractors of a trucking company are required to be overhauled after so many miles to return them to an appropriate roadworthy condition. Similarly, the engines and airframe of commercial aircraft are required to be overhauled at specific periodic intervals so as to recertify the engines and airframe to be airworthy.

The principal source of guidance on the accounting for planned major maintenance activities is the AICPA Industry Audit Guide, *Audits of Airlines*. The Guide describes four methods of accounting for planned major maintenance activities that are most frequently used. Those methods are: direct expense, built-in overhaul, deferral, and accrual (accrue-in-advance). Those methods are widely used by other industries as well as the airline industry.

The direct expense method recognizes the cost of overhauls as expenses as they are incurred. The built-in overhaul method is based on segregating the aircraft costs into those that should be depreciated over the useful life of the aircraft and those that require overhaul at periodic intervals with the latter being depreciated to the date of initial overhaul. The cost of the initial overhaul is then capitalized and depreciated to the next overhaul after which

the process is repeated. With the deferral method, the cost of each overhaul is capitalized and depreciated to the next overhaul. The accrue-in-advance method provides for estimating the cost of the initial overhaul and accruing the cost, based on an hourly rate, to the overhaul. At that time, the actual cost of overhaul is charged to the accrual, with any deficiency or excess charged or credited to expense. The cost of the next overhaul is then estimated, based on the new rate, and accrued to that overhaul, at which time the process is repeated.

The Financial Accounting Standards Board (FASB) believes that the accrue-in-advance method of accounting for planned major maintenance activities results in the recognition of liabilities that do not meet the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Therefore, proposed FASB Staff Position (FSP) No. AUG AIR-a, *Accounting for Planned Major Maintenance Activities*, prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities.

If finalized, the guidance in this FSP would be applicable to entities in all industries and must be applied in the first fiscal year beginning after December 15, 2006. The guidance in this FSP should be applied retrospectively for all financial statements presented, unless it is impracticable to do so. The FSP also requires certain disclosures as of the date of its adoption. The FSP is available for comment until July 31, 2006 at http://www.fasb.org/fasb_staff_positions/prop_fsp_aug_air-a.pdf.

Auditing

Communicating Internal Control Related Matters Identified in an Audit

The American Institute of Certified Public Accountants Auditing Standards Board has issued Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*. This Statement supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements.

The new Statement:

- Uses the term *those charged with governance* to refer to the persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the financial reporting and disclosure process;
- Incorporates the definitions of the terms *control deficiency* and *material weakness* used in Public Company Accounting Oversight Board Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, (AS 2) and replaces the term *reportable condition* with the term *significant deficiency* and its related definition in AS 2;
- Identifies specified control deficiencies that ordinarily would be considered at least significant deficiencies;
- Identifies specified circumstances that should be regarded as at least a significant deficiency and a strong indicator of a material weakness;
- Requires the auditor to communicate, in writing, to management and those charged with governance significant deficiencies and material weaknesses in internal control - even if these matters were communicated in previous audits;
- Requires the auditor to communicate internal control matters to management and those charged with governance no later than 60 days following the report release date; and
- Includes revised illustrative written communications.

This Statement is effective for audits of financial statements for periods ending on or after December 15, 2006.

SEC

More Reporting Proposed for Registered Accounting Firms

The Public Company Accounting Oversight Board (PCAOB) has proposed new rules for annual and special reporting of information and events by accounting firms that are registered with the PCAOB. The proposed new annual reporting would require each registered firm to make disclosures about the firm and its SEC practice over the most recent 12-month period, beginning with years ended March 31, 2007. Information to be reported annually includes the names of SEC audit clients, the percentage of billings attributable to SEC audit clients, resources used in the performance of such audits, and new employment of individuals with certain disciplinary histories.

The proposed new rules also require special reporting by registered firms within 14 days after the occurrence of certain reportable events, including the following:

- The firm has withdrawn an audit report on financial statements, and the issuer failed to comply with the reporting requirements in Item 4.01 of Form 8-K. (This illegal act also triggers the reporting obligations of Section 10A(b) of the Securities Exchange Act of 1934.)
- The firm has learned that an issuer, in a report containing the issuer's financial statements, has made use of the Firm's name without obtaining a consent from the Firm when required or when the issuer indicates that such consent was provided. (This illegal act also triggers the reporting obligations of Section 10A(b) of the Securities Exchange Act of 1934.)
- The firm, or a partner, shareholder, principal, owner, member or manager of the firm, has become a defendant in a government-initiated civil or alternative dispute resolution proceeding, an administrative or disciplinary proceeding, or certain types of criminal proceedings (and at the time such proceedings have concluded).
- The firm has entered into an arrangement to receive consulting or other professional services from individuals or entities with certain disciplinary histories.

These proposed rules are available for comment until July 24, 2006 at http://www.pcaobus.org/Rules/Docket_019/2006-05-23_Release_No._2006-004.pdf. Final rules adopted by the PCAOB must be submitted to the SEC for approval and would be effective 21 days after SEC approval.

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