

# Insights

A biweekly publication from the National Office of Audit and Accounting

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## *Season's Greetings!*

*As this year draws to a close, the National Office of Audit and Accounting extends season's greetings to you. May this holiday time bring you the happiest of moments and the warmest of memories. We wish you and your family all the best in the new year!*

## Accounting

### **Many Warrants Now Expected to Be Liabilities in 2009**

As previously announced, EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock", was ratified in June 2008 and generally is effective beginning January 1, 2009 for warrants outstanding at that time. Issue 07-5 **will** change the classification and related accounting for many warrants outstanding at that date. The warrants covered by this Issue will be considered liabilities and therefore be adjusted to their fair value every reporting period with the change in fair value shown in earnings. All warrants outstanding and previously classified in equity should be analyzed again using this new consensus to determine whether the accounting will change.

Issue 07-5 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2008 (January 1, 2009, for calendar year-end companies). Issue 07-5 applies to any outstanding instruments as of the beginning of the fiscal year in which the Issue is initially applied. Because the transition guidance under Issue 07-5 only requires entities to evaluate those instruments (and the related terms and provisions) in existence at the effective date, an entity could modify those instruments to eliminate features, such as a strike price adjustment, that fail the Issue 07-5 analysis, before the Issue's effective date and thus potentially retain equity classification.

Issue No. 07-5 provides the guidance for determining whether an equity-linked financial instrument (or an embedded feature) is indexed to an entity's own stock using a two-step approach. First, the instrument's contingent exercise provisions, if any, must be evaluated, followed by an evaluation of the instrument's settlement provisions. Example 8 in Issue 07-5 illustrates one specific term that is common in warrants. This term is prevalent in private entity situations, although it is also becoming more common in public entities. As explained in Example 8, the existence of this term will change the classification of the warrant. Due to its significant impact, Example 8 is included below. However, the other examples in this Issue could also impact the accounting for currently outstanding warrants classified in equity; therefore if a warrant does not have the term discussed in Example 8, it is important that companies further consider any other impacts of Issue 07-5.

#### Example 8

Company A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that (a) if the entity sells shares of its common stock for an amount less than \$10 per

share, the strike price of the warrants is reduced to equal the issuance price of those shares, and (b) if the entity issues an equity-linked financial instrument with a strike price below \$10 per share, the strike price of the warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument.

*Analysis:* The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The strike price would be adjusted if Company A (a) sells shares of its common stock for an amount less than \$10 per share or (b) issues an equity-linked financial instrument with a strike price below \$10 per share. Consequently, the settlement amount of the warrants can be affected by (a) future equity offerings undertaken by Company A at the then-current market price of the related shares or (b) the contractual terms of other equity-linked financial instruments issued in a subsequent period. The occurrence of a sale of common stock by the entity at market is not an input to the fair value of a fixed-for-fixed option on equity shares. Similarly, the occurrence of a sale of an equity-linked financial instrument is not an input to the fair value of a fixed-for-fixed option on equity shares, if the transaction was priced at market.

Any warrant with this feature (*i.e.*, its settlement amount does not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price) cannot be classified in equity and will be recorded as a liability. It also must be marked to fair value at every reporting period. The change in the fair value of the liability will be recorded in the income statement.

Prior to the effective date of Issue 07-5, it was often concluded that such a feature was "under the control of the company" and therefore would not preclude equity treatment for the warrant. Issue 07-5's assessment model doesn't allow for the consideration of whether the feature is "under the control of the company" in order to obtain equity treatment which results in the change in classification.

### **Disclosures about Transfers of Financial Assets and VIEs**

The Financial Accounting Standards Board (FASB) recently issued FASB Staff Position (FSP) No. FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*. This FSP amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to require public entities to provide additional disclosures about transferors' continuing involvements with transferred financial assets. It also amends FASB Interpretation (FIN) No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, to require public enterprises, including sponsors that have a variable interest in a variable interest entity (VIE), to provide additional disclosures about their involvement with VIEs. Further, this FSP requires disclosures by a public enterprise that is (a) a sponsor of a qualifying special-purpose entity (SPE) that holds a variable interest in the qualifying SPE but was not the transferor of financial assets to the qualifying SPE and (b) a servicer of a qualifying SPE that holds a significant variable interest in the qualifying SPE but was not the transferor of financial assets to the qualifying SPE. The FSP does not change the existing disclosure requirements for nonpublic entities.

The purpose of this FSP is to promptly improve disclosures by public entities and enterprises until the pending proposed amendments to Statement No. 140 and FIN 46(R) are finalized; therefore the FSP is effective for reporting periods (interim and annual) ending after December 15, 2008. The FSP is available in full at [http://www.fasb.org/pdf/fsp\\_fas140-4andfin46r-8.pdf](http://www.fasb.org/pdf/fsp_fas140-4andfin46r-8.pdf).

### **Codification Expected to Officially Launch July 1, 2009**

In January, 2008, the Financial Accounting Standards Board (FASB) released for verification the *FASB Accounting Standards Codification*<sup>™</sup>. Although the Codification content is not yet approved as authoritative, it is expected that prior to July 1, 2009, the Codification will be approved as the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP). Then on July 1, 2009, the Codification will supersede existing FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force, and related literature. After that date, only one level of authoritative GAAP will exist, and all other literature will be considered non-authoritative.

The Codification reorganizes thousands of U.S. GAAP pronouncements into approximately 90 accounting topics and displays all topics using a consistent structure. Also included is relevant SEC guidance that will follow the same topical structure in separate sections in the Codification. The Codification does not change GAAP; instead, it introduces a new structure - one that is organized in an easily accessible, user-friendly online research system.

Financial statement preparers and auditors are encouraged to familiarize themselves with the Codification. Users who register at <http://asc.fasb.org/register> are able to review the Codification free of charge. The FASB has recorded a webcast that discusses and demonstrates the use of the Codification. The one-hour webcast, *The Move to Codification of U.S. GAAP*, is archived for free access by the public. [Click here](#) to register for the archived webcast.

### **EITF Final Consensuses Issued**

At its November 24, 2008 meeting, the Financial Accounting Standards Board ratified the final consensuses for the following Emerging Issues Task Force (EITF) Issues:

- *Issue No. 08-6, "Equity Method Investment Accounting Considerations"*  
This Issue addresses the following equity-method investment accounting considerations:
  - How the initial carrying value of an equity-method investment should be determined
  - How an impairment assessment of an underlying indefinite-lived intangible asset of an equity-method investment should be performed
  - How an equity-method investee's issuance of shares should be accounted for
  - How to account for a change in an investment from the equity method to the cost method

This Issue is effective in fiscal years beginning on or after December 15, 2008, and interim periods within those fiscal years.

- *Issue No. 08-7, "Accounting for Defensive Intangible Assets"*  
This Issue applies to all acquired intangible assets in situations in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset (a defensive intangible asset), except for intangible assets that are used in research and development activities. The EITF reached a consensus that a defensive intangible

asset should be accounted for as a separate unit of accounting and should be assigned a useful life that reflects the entity's consumption of the expected benefits related to the asset, noting that it would be rare for a defensive intangible asset to have an indefinite life. This Issue is effective for intangible assets acquired on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

- *Issue No. 08-8, "Accounting for an Instrument (or an Embedded Feature) with a Settlement Amount That Is Based on the Stock of an Entity's Consolidated Subsidiary"*  
This Issue applies to a freestanding financial instrument (and an embedded feature) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary for purposes of determining whether such an instrument (or an embedded feature) is precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent. The EITF reached a consensus that, provided that the subsidiary is a substantive entity, a freestanding financial instrument (or an embedded feature) within the scope of this Issue is not precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent. This Issue is effective for fiscal years beginning on or after December 15, 2008, and interim periods within those fiscal years.

The minutes of the November 13, 2008 EITF meeting are available at [http://www.fasb.org/eitf/11-13-08\\_mtg\\_minutes.pdf](http://www.fasb.org/eitf/11-13-08_mtg_minutes.pdf).

### **EITF Consensuses-for-Exposure**

At its November 13, 2008 meeting, the Emerging Issues Task Force (EITF) reached tentative conclusions on the following Issues:

- *Issue No. 08-1, "Revenue Arrangements with Multiple Deliverables"*  
Entities often enter into revenue arrangements that provide for multiple payment streams.  
  
If delivery of a single unit of accounting spans multiple accounting periods or deliverables, an entity needs to determine how to allocate the multiple payment streams attributable to that unit of accounting to those accounting periods. The EITF reached a consensus-for-exposure that an entity is required to use the residual method of allocating arrangement consideration when the selling price of the undelivered unit(s) of accounting is based on the vendor's best estimate of what the undelivered element would sell for if sold separately. However, the amount allocated to the delivered unit(s) of accounting as a result of applying this methodology cannot exceed the selling price of the delivered unit(s) of accounting based on vendor-specific objective evidence of fair value or third-party evidence of fair value, if known. The Task Force also reached a consensus-for-exposure that requires vendors to make certain disclosures, among others, regarding the estimated selling price and individually significant arrangements.  
  
If finalized, vendors must apply the measurement and allocation guidance in this Issue to revenue arrangements entered into or materially modified in fiscal years beginning on or after December 15, 2009. The draft abstract is available for comment until January 30, 2009.
- *Issue No. 08-10, "Selected Statement 160 Implementation Questions"*  
While FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, provides general guidance on accounting for the deconsolidation of a subsidiary, some have raised concerns that other authoritative guidance exists that may conflict with Statement No. 160 for the recognition of a gain or loss upon deconsolidation of subsidiaries when the subsidiary is in-

substance real estate or the transaction involves an equity-method investee or joint venture. The EITF reached a consensus-for-exposure that an entity should not apply Statement No. 160 to transfers of interests in a subsidiary that are in substance real estate, but should account for the transfers as sales of real estate in accordance with Statement No. 66, *Accounting for Sales of Real Estate*, and related literature. The Task Force also reached a consensus-for-exposure that Statement No. 160 should be applied when accounting for transfers of interests of subsidiaries to an equity-method investee, including exchanges of a subsidiary for an interest in a joint venture.

If finalized, this Issue will be effective for fiscal years beginning on or after December 15, 2008, and interim periods within those fiscal years. The draft abstract is available for comment until December 26, 2008.

The draft abstracts are available in full at <http://www.fasb.org/draft/index.shtml>.

### **Proposed Accounting for Assets and Liabilities Arising from Contingencies**

Currently, FASB Statement No. 141 (revised 2007), *Business Combinations*, requires that all contractual contingencies and all noncontractual contingencies that are more likely than not to give rise to an asset or liability as defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*, be recognized at their acquisition-date fair value. All noncontractual contingencies that do not meet the more-likely-than-not criterion as of the acquisition date are accounted for in accordance with other generally accepted accounting principles, such as FASB Statement No. 5, *Accounting for Contingencies*. Recently, preparers, auditors, and members of the legal profession have expressed concerns about the application of Statement No. 141(R) to assets and liabilities arising from contingencies in a business combination. The Financial Accounting Standards Board (FASB) therefore has issued proposed FASB Staff Position (FSP) No. FAS 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*, to amend Statement No. 141 (R) related to the accounting for assets and liabilities arising from contingencies in a business combination.

The proposed FSP would require that assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value in accordance with FASB Statement No. 157, *Fair Value Measurements*, if the acquisition-date fair value can be reasonably determined. It also would provide guidance for assessing when fair value can be reasonably determined during the measurement period. If the acquisition-date fair value of such an asset or liability cannot be reasonably determined, the asset or liability would be measured at the amount that would be recognized for liabilities in accordance with FASB Statement No. 5 and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and an amount using similar criteria for assets (the future settlement amount). An asset or liability measured at its future settlement amount would only be recognized as of the acquisition date if (1) information available prior to the end of the measurement period indicates that it is probable that an asset existed or a liability had been incurred at the acquisition date and (2) the future settlement amount of the asset or liability can be reasonably estimated. The proposed FSP also would amend the subsequent measurement and accounting guidance and the disclosure requirements for assets and liabilities arising from contingencies in a business combination.

If finalized, the FSP would be effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The proposed FSP is available for comment until January 15, 2009 at [http://www.fasb.org/fasb\\_staff\\_positions/prop\\_fsp\\_fas141r-a.pdf](http://www.fasb.org/fasb_staff_positions/prop_fsp_fas141r-a.pdf).

## Public Sector

### Service Efforts and Accomplishments Reporting

An important component of public sector financial reporting is information about service efforts and accomplishments (SEA). Such information provides insight into how effectively and efficiently state and local governments utilize resources to achieve their missions on behalf of their citizens. To bring its conceptual framework up to date on advances made by governments in reporting SEA information, the Governmental Accounting Standards Board (GASB) has issued Concepts Statement No. 5, *Service Efforts and Accomplishments Reporting (an amendment of GASB Concepts Statement No. 2)*. The new Statement also clarifies the role of the GASB in SEA reporting.

To enhance a common understanding of the elements, characteristics, limitations, and methods of communicating SEA performance information, the GASB modified four sections of Concepts Statement No. 2 (*Purpose and Scope, The Elements of SEA Reporting, Limitations of SEA Information, and Enhancing the Usefulness of SEA Information*). The changes to the *Purpose and Scope* section clarify that it is beyond the scope of the GASB to establish the goals and objectives of state and local government services, develop specific nonfinancial measures or indicators of service performance, or set standards for service performance. Some provisions of the *Developing Reporting Standards for SEA Information* section have been interpreted in ways that cause confusion, and therefore the GASB eliminated that section from the Concepts Statement entirely.

### Determining the Annual Required Contribution for Postemployment Benefits

In circumstances in which an employer has one or more past contribution deficiencies or excess contributions to a pension or other postemployment benefits (OPEB) plan in relation to the annual required contribution (ARC), GASB Statements No. 27, *Accounting for Pensions by State and Local Governmental Employers*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, require the use of two adjustments to the ARC in the calculation of annual pension or OPEB cost - an interest adjustment and an ARC adjustment. Each Statement assumes that the ARC adjustment amount is not known and therefore specifies an estimation methodology for calculating the ARC adjustment.

It has come to the attention of the Governmental Accounting Standards Board (GASB) that some actuaries do track actual known amounts for purposes of calculating the ARC adjustment relating to pensions and OPEB. The GASB therefore has issued GASB Technical Bulletin No. 2008-1, *Determining the Annual Required Contribution for Postemployment Benefits*, to clarify that governments may base the ARC adjustment on the actual amount when it is known. The Technical Bulletin further clarifies that use of the known amount in place of the estimation procedure in Statements No. 27 and 45 is encouraged.

With regard to pensions, the provisions of this Technical Bulletin are effective for financial statements for periods ending after December 15, 2008. With regard to OPEB, the provisions of the Technical Bulletin are effective for financial statements for periods ending after December 15, 2008, or simultaneously with the initial implementation of Statement No. 45, whichever is later. Earlier application is encouraged.

### Audit Committee Guide Available for Not-for-Profit Organizations

McGladrey & Pullen, LLP announces the publication of an updated guide to help not-for-profit organizations develop effective and efficient audit committees. The *Audit Committee Guide for Not-for-Profit Organizations* discusses the audit committee charter, audit committee responsibilities, and its role in

oversight of the control environment, financial reporting, and the audit process. The Guide also contains a section on selecting an independent audit firm, together with additional resources. The appendices include examples of an audit committee charter, questions to ask in carrying out audit committee responsibilities, and an in-depth questionnaire for use in assessing the effectiveness of the audit committee.

The *Audit Committee Guide for Not-for-Profit Organizations* is available on the McGladrey & Pullen Web site at [http://www.mcgladrey.com/Resource\\_Center/Audit/Audit%20Committe%20Guide%20Not-for-profit%20%202008.pdf](http://www.mcgladrey.com/Resource_Center/Audit/Audit%20Committe%20Guide%20Not-for-profit%20%202008.pdf).

## SEC

### Financial Reporting Manual Available

The SEC's Division of Corporation Finance recently has made its *Financial Reporting Manual* available online. Although the Manual is intended only to provide general guidance to Division staff, it contains helpful information to auditors and preparers of issuer financial statements. Topics discussed in the Manual include the following, among others:

- Registrant's financial statements
- Other financial statements required
- Pro forma financial information
- Smaller reporting companies
- Related-party matters
- Non-GAAP measures of financial performance, liquidity, and net worth
- Management's discussion and analysis of financial position and results of operations
- Reverse acquisitions and reverse recapitalizations
- Effects of subsequent events on financial statements required in filings
- Employee stock benefit plans

The *Financial Reporting Manual* is available in full at <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf>.

## Financial Institutions

### TARP and Related Accounting Issues

The Emergency Economic Stabilization Act of 2008 allocated up to \$700 billion for the U.S. Treasury to buy mortgages and other troubled assets owned by financial institutions under a new Troubled Asset Relief Program (TARP). Under this program, the U.S. Treasury established a voluntary Capital Purchase Program (CPP) to encourage U.S. financial institutions to build their capital base, which in turn is expected to increase the capacity of those institutions to lend to U.S. businesses and consumers and to support the U.S. economy. The CPP is available to qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies engaged solely or predominately in financial activities permitted under the relevant law. As of October 28, 2008, the U.S. Treasury had signed final agreements with nine financial institutions holding 50 percent of all U.S. deposits, and had completed capital purchase

transactions with eight of those institutions for a total of \$115 billion. Applications for publicly traded institutions wishing to participate in the CPP were due November 14, 2008. The Treasury will establish an application deadline for privately held eligible institutions at a later date.

Pursuant to the CPP, the U.S. Treasury will purchase up to \$250 billion of senior preferred shares on standardized terms, which will include warrants for future Treasury purchases of common or preferred stock. The senior preferred shares will qualify as Tier 1 capital and will rank senior to common stock and at an equal level in the capital structure with existing preferred shares, other than preferred shares which by their terms rank junior to any other existing preferred shares. The senior preferred shares will pay a cumulative dividend rate of five percent per annum for the first five years and will reset to a rate of nine percent per annum after year five. The senior preferred shares will be callable at par after three years. Prior to the end of three years, the senior preferred may be redeemed with the proceeds from a qualifying equity offering of any Tier 1 perpetual preferred or common stock. In conjunction with the purchase of senior preferred shares, the U.S. Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15 percent of the senior preferred investment. The exercise price on the warrants will be the market price of the participating institution's common stock at the time of issuance, calculated on a 20-trading day trailing average.

When warrants are issued in conjunction with preferred stock, the financial institution must determine the proper classification of all instruments issued in the transactions, how to account for those instruments based on their classification, and how to allocate the proceeds accordingly. How this allocation is computed is affected by the nature of the instrument issued. Having analyzed the terms and conditions of the warrants described above, the SEC staff and the staff of the Financial Accounting Standards Board (FASB) have concluded that they would not object if the warrants were to be classified as permanent equity under applicable U.S. generally accepted accounting principles, provided that the issuer of the warrants has sufficient authorized but unissued shares of the class of stock that may be required upon settlement and any other necessary shareholder approvals have been obtained. If an issuer does not have required shareholder approval, including shareholder approval for sufficient authorized but unissued shares of the class of stock that may be required for settlement, the SEC and FASB would also not object to classification of the warrants as permanent equity provided that the issuer takes the necessary action to secure sufficient approvals prior to the end of the fiscal quarter in which the warrants are issued. These conclusions solely apply to the warrants described above and should not be applied by analogy to other warrants or capital transactions.

More guidance regarding these and other related issues is forthcoming.

### **Deduction of Goodwill Net of Associated Deferred Tax Liability for Tier 1 Capital**

Under existing risk-based and leverage capital rules of the federal banking agencies, a banking organization must deduct certain assets from tier 1 capital. A banking organization is permitted to net any associated deferred tax liability against some of those assets prior to making the deduction from tier 1 capital. Included among the assets eligible for this netting treatment are certain intangible assets arising from a nontaxable business combination. Such netting generally is not permitted for goodwill and other intangible assets arising from a taxable business combination. In these cases, the full or gross carrying amount of the asset is deducted.

Recently, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision amended their regulatory capital rules to permit banks, bank holding companies, and savings associations to reduce the

amount of goodwill that a banking organization must deduct from tier 1 capital by the amount of any deferred tax liability associated with that goodwill. For a banking organization that elects to apply this final rule, the amount of goodwill the banking organization must deduct from tier 1 capital would reflect the maximum exposure to loss in the event that such goodwill is impaired or derecognized for financial reporting purposes. This rule will be effective 30 days after its publication in the *Federal Register*. Banking organizations, however, may elect to apply this final rule for purposes of the regulatory reporting period ending on December 31, 2008. It should be noted that the federal banking agencies decided not to extend similar treatment to other intangible assets currently required to be deducted fully from Tier 1 capital.

The final rule is available in full at <http://www.fdic.gov/news/board/08DEC15rule4.pdf>.

## International

### IAASB Issues Eight Clarified Standards

The International Auditing and Assurance Standards Board (IAASB) recently released the following clarified International Standards on Auditing (ISAs) as a result of its Clarity Project:

- ISA 220 (Redrafted), *Quality Control for an Audit of Financial Statements*
- ISA 500 (Redrafted), *Audit Evidence*
- ISA 501 (Redrafted), *Audit Evidence—Specific Considerations for Selected Items*
- ISA 505 (Revised and Redrafted), *External Confirmations*
- ISA 520 (Redrafted), *Analytical Procedures*
- ISA 620 (Redrafted), *Using the Work of an Auditor's Expert*
- ISA 710 (Redrafted), *Comparative Information—Corresponding Figures and Comparative Financial Statements*

The IAASB also released clarified International Standard on Quality Control (ISQC) (Redrafted), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*. To date, the IAASB has released 29 final redrafted ISAs and one final redrafted ISQC in the new clarity style.

Further, in finalizing ISA 210 (Redrafted), *Agreeing the Terms of Audit Engagements*, the IAASB approved conforming amendments to the following four reporting standards, which are expected to be issued in February 2009:

- ISA 700 (Redrafted), *Forming an Opinion and Reporting on Financial Statements*;
- ISA 800 (Revised and Redrafted), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*;
- ISA 805 (Revised and Redrafted), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*; and
- ISA 810 (Revised and Redrafted), *Engagements to Report on Summary Financial Statements*.

In addition to ISA 210 (Redrafted), the IAASB approved new ISA 265, *Communicating Deficiencies to Those Charged with Governance and Management*, and ISA 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Service Organization*, which are expected to be released in

March 2009. The IAASB believes that, with its approval of these final three ISAs and its review of consistency, its work in redrafting its international standards under the Clarity Project is now complete. The complete set of clarified ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The ISAs are available in full at

<http://www.ifac.org/store/Category.tpl?Category=Auditing%2C%20Assurance%20%26%20Related%20Services&Cart=1229391697620760>.

### **IASB Proposes to Eliminate Certain Related-party Disclosures for State-controlled Entities**

International Accounting Standard (IAS) 24, *Related Party Disclosures*, requires entities to provide disclosures about transactions with related parties. However, entities controlled, jointly controlled or significantly influenced by a state (state-controlled entities) may find it difficult and costly to provide all the required details for transactions with other state-controlled entities. The International Accounting Standards Board (IASB) believes that it is possible to omit some of the required details while still providing sufficient information to users of financial statements. As a result, in 2007 the IASB published an Exposure Draft, *State-controlled Entities and the Definition of a Related Party*, to exempt state-controlled entities from providing disclosures about transactions with other state-controlled entities if specified conditions were met. However, respondents were concerned about the complexity of the proposals, particularly the proposed requirement to assess whether state influence actually existed.

The IASB therefore recently modified its proposed exemption for state-controlled entities. Unlike the original proposal, the revised exemption would not require state-controlled entities to assess the extent of state influence. It would exempt such entities from providing full details about transactions with other state-controlled entities and the state. Instead, unlike the 2007 exposure draft, the revised proposal would require general disclosures about the types and extent of significant transactions.

The revised Exposure Draft, *Relationships with the State (Proposed amendments to IAS 24)*, is available for comments until March 13, 2009 at [http://www.iasb.org/NR/rdonlyres/601CCCB0-4C4F-4DEB-8F0C-C539A0A4F3C7/0/EDIAS24\\_1208.pdf](http://www.iasb.org/NR/rdonlyres/601CCCB0-4C4F-4DEB-8F0C-C539A0A4F3C7/0/EDIAS24_1208.pdf).

### **Property, Plant and Equipment and Investment Property: IFRS vs. U.S. GAAP**

*This article is the ninth in a series of articles that takes our readers on a journey through International Financial Reporting Standards (IFRS) with a special focus on the standards' quintessential feature: they are principles-based. In this article, we provide an overview of some of the most significant differences between IFRS and U.S. generally accepted accounting principles (GAAP) with regard to property, plant and equipment (PP&E) and investment property. Actual differences in the accounting treatment between the two frameworks depend on specific circumstances.*

International Accounting Standard (IAS) 16, *Property, Plant and Equipment*, allows an entity to select its accounting policy for PP&E from two alternate subsequent measurement attributes: the cost model and the revaluation model. The cost model approach is based on the historical cost model as adjusted for depreciation and impairment. Although this overall approach is similar to U.S. GAAP, the way in which depreciation and impairment are calculated differs significantly as discussed below. The revaluation model allows entities to carry PP&E at fair value. Changes in fair value are recognized in equity (to the extent not previously recognized in the income statement), and subsequent depreciation is charged to the income statement. If an item of PP&E is revalued, the entire class of assets to which that asset belongs should also be revalued. The revaluation model is clearly prohibited by U.S. GAAP.

U.S. GAAP does not provide specific provisions regarding investment property. On the other hand, IFRS have a standard dedicated to investment property, IAS 41, *Investment Property*. This Standard allows IFRS preparers to use the “full fair value model”, with all changes in fair value entirely recognized in the income statement.

Under IFRS the general principle that is valid for initial measurement and recognition of PP&E and investment property is applicable to subsequent expenditures as well. In particular, if under the general recognition principle an entity recognizes in the carrying amount of an item of PP&E the cost of a replacement for part of the item (e.g., replacing the interior walls of a building), it should derecognize the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. Under U.S. GAAP, three alternative methods of accounting for planned major maintenance activities generally are permitted: the direct expensing method, the built-in overhaul method, and the deferral method. Under both U.S. GAAP and IFRS, the costs of day-to-day servicing of the item are expensed as incurred.

The concept of useful life is similar between IFRS and U.S. GAAP. However, IFRS poses more emphasis on the concept of “componentization”. In fact, under IFRS each part of an item of PP&E with a cost that is significant in relation to the total cost of the item must be depreciated separately. A change in amortization method (i.e., straight-line method, diminishing-balance method, unit-of-production method, etc.) is recognized as a change in accounting estimate under IFRS. Adjustments are recognized in the current and prospective periods. Under U.S. GAAP a change in amortization method is regarded as a change in accounting policy. The cumulative effect is recognized in the income statement in the current year.

Obviously IAS 16 and IAS 41 interact with many other standards. This can lead to a series of other differences that are indirectly triggered by those standards. In particular, application of IAS 36, *Impairment of Assets*, and IFRS 5, *Non-Current Assets Held for sale and Discontinued Operations*, might further significantly increase the gap between IFRS and U.S. GAAP in accounting for PP&E and investment property.

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