

Insights

May 14, 2008

A biweekly audit and accounting publication

Accounting

Financial Reporting Alert Released

The American Institute of Certified Public Accountants recently issued a Financial Reporting Alert, *Current Accounting Issues and Risks—2008*. This Alert is intended to be used by members of an entity's financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity's financial reporting. Among other information, this Alert summarizes recently issued accounting standards, including:

- FASB Statement No. 141 (revised 2007), *Business Combinations*;
- FASB Statement No. 157, *Fair Value Measurements*;
- FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*;
- FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115*;
- FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*; and
- FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*.

The Alert is available for purchase at http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Accounting/PRDOVR~PC-029203/PC-029203.jsp.

Determination of the Useful Life of Intangible Assets

As originally drafted, FASB Statement No. 142, *Goodwill and Other Intangible Assets*, allowed for limited renewal and extension assumptions that could be used to determine the useful life of a recognized intangible asset. This limitation often resulted in the useful life of a recognized intangible asset as measured under Statement No. 142 being shorter than the period of expected cash flows used to measure the fair value of the asset under Statement No. 141, *Business Combinations*, (and other applicable accounting literature) when the underlying arrangement included renewal or extension terms. Paragraph 11(d) of Statement No. 142 stated that the estimate of the useful life of a recognized intangible asset must include consideration of any legal, regulatory, or contractual provisions that enable renewal or extension of the asset's legal or contractual life without substantial cost (provided there is evidence to support renewal or extension and renewal or extension can be accomplished without material modifications of the existing terms and conditions). Statement No. 142 therefore precluded an entity from using its own assumptions about renewal or extension of an arrangement when there was likely to be substantial cost or material modifications.

To improve the consistency between the useful life of a recognized intangible asset under Statement No. 142 and the period of expected cash flows used to measure the fair value of the asset under Statement No. 141 and other applicable accounting literature, the Financial Accounting Standards Board (FASB) has issued FASB Staff Position (FSP) No. FAS 142-3, *Determination of the Useful Life of Intangible Assets*. This FSP removes the constraints imposed in paragraph 11(d) of Statement No. 142, as mentioned in the preceding paragraph, and amends paragraph

11(d) to require an entity to consider its own historical experience in making assumptions about renewing or extending similar arrangements. These assumptions must be adjusted for certain entity-specific factors, however. In the absence of historical experience, an entity must consider the assumptions that market participants would use about renewal or extension, adjusted for certain entity-specific factors, such as expected use of the asset. The FSP requires disclosure of certain information that would enable users of financial statements to assess the extent to which the expected future cash flows associated with the recognized intangible asset are affected by the entity's intent and/or ability to renew or extend the arrangement.

The FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The guidance in the FSP for determining the useful life of a recognized intangible asset is to be applied prospectively to intangible assets acquired after the effective date; however, the disclosure requirements must be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. Early adoption of the FSP is prohibited.

The FSP is available in full at http://www.fasb.org/pdf/fsp_fas142-3.pdf.

FSP Amends SOP 90-7

AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*, was issued in 1990 to provide guidance on financial reporting by entities that file petitions with a bankruptcy court and expect to reorganize as a going concern under Chapter 11 of Title 11 of the United States Code. Under SOP 90-7, entities meeting certain criteria are required to adopt fresh-start reporting. Paragraph 38 of SOP 90-7 required changes in accounting principles that will be required in the financial statements of the emerging entity within the twelve months following the adoption of fresh-start reporting to be adopted at the time fresh-start reporting is adopted.

At the time SOP 90-7 was published, new accounting standards were being issued with effective dates that encouraged early adoption. However, in several recent standards, the Financial Accounting Standards Board (FASB) has prohibited early adoption. Questions have been raised as to whether an emerging entity that is applying fresh-start reporting should follow the provisions of SOP 90-7 in early adopting new accounting standards that will be effective within 12 months from the date of emergence from bankruptcy or whether the emerging entity should follow the effective date guidance of a new accounting standard when the new accounting standard prohibits early adoption.

The FASB has issued FASB Staff Position (FSP) No. SOP 90-7-1, *An Amendment of AICPA Statement of Position 90-7*, which amends SOP 90-7 to nullify the requirement in paragraph 38 of SOP 90-7 regarding changes in accounting principles. The amendment requires an entity emerging from bankruptcy that applies fresh-start reporting to only follow the accounting standards in effect at the date fresh-start reporting is adopted, which include those standards eligible for early adoption if an election is made to adopt such standards early. The FSP is effective for financial statements issued subsequent to April 24, 2008.

The FSP is available in full at http://www.fasb.org/pdf/fsp_sop90-7-1.pdf.

DIG Implementation Issues Revised for Issuance of Statement No. 161

In March, 2008, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, to require enhanced disclosures about derivative instruments and hedging activities. Recently, the following Derivatives Implementation Group (DIG) Implementation Issues for FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, were revised to reflect the issuance of Statement No. 161:

- No. I1, *Disclosures: Interaction of the Disclosure Requirements of Statement 133 and Statement 47*, and
- No. K4, *Miscellaneous: Income Statement Classification of Hedge Ineffectiveness and the Component of a Derivative's Gain or Loss Excluded from the Assessment of Hedge Effectiveness*.

These DIG Implementation Issues are available at http://www.fasb.org/derivatives/04-21-08_I1&K4.pdf.

PCFRC Meets

The Private Company Financial Reporting Committee (PCFRC) held its regularly scheduled meeting in San Diego, California on April 24 and 25, 2008. A wide range of topics were discussed including new and emerging accounting issues affecting, or that may affect, private companies. An update was also provided on the PCFRC's liaison activities with other organizations, including the Institute of Management Accountants, Small Business Advisory Council, and the Financial Executives International.

Considerable discussion focused on developments of the International Accounting Standards Board (IASB) and its International Financial Reporting Standards (IFRS). The SEC has issued a Rule that no longer requires foreign registrants that prepare their financial statements in accordance with IFRS as issued by the IASB to reconcile their financial statements to United States generally accepted accounting principles (U.S. GAAP). The SEC is also expected to soon issue a Rule proposal whereby all U.S. companies will be required to adopt IFRS as issued by the IASB beginning in 2013. A one- or two-year deferral may be included in the Rule proposal for smaller public companies. It is further anticipated the final Rule will be issued by the end of 2008. The final Rule may also permit U.S. public companies to early adopt IFRS beginning with 2008 year-end financial statements. These developments concern the PCFRC as to what effect, if any, this will have on nonpublic companies.

If nonpublic companies will be required, or permitted, to adopt IFRS the PCFRC discussed whether the U.S. should modify IFRS for the specific needs of users of nonpublic company financial statements. That discussion was based on the assumption that U.S. public companies will be required to adopt IFRS by 2013, and that pressure will mount to require nonpublic companies to move to IFRS or IFRS-based accounting. Alternatives discussed included the proposed IFRS for Small and Medium-sized Entities (the SME standard), a modification of the SME standard to meet the needs of users of nonpublic companies' financial statements, or a modification of the full IFRS to meet the needs of those users. No decisions were reached as to the desired approach, but the PCFRC will continue to monitor these developments and consider how best to proceed. It was also observed that an uncertainty surrounding U.S. companies' ability to adopt IFRS relates to the Internal Revenue Service (IRS). The IRS is reported to have approximately 1000 references to U.S. GAAP in the Internal Revenue Code and related Regulations and Interpretations. One of those references relates to the use of the Last-in, First-out inventory valuation method and the conformity rule.

As a result of the deferral of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, the PCFRC conducted a survey of preparers, users, and accountants in public practice as to the cost to apply FIN 48 and the benefit of that information to users of financial statements of nonpublic companies. Not unexpectedly, a large percentage of respondents to the survey observed the costs and difficulty of applying FIN 48 was high, and the usefulness was low. As a result, the PCFRC will send a letter to the Financial Accounting Standards Board (FASB) asking for an exemption for private companies from making the disclosures specified in FIN 48. The PCFRC observed that disclosures already required by AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, would be sufficient for the needs of users of nonpublic company financial statements.

Due to cost/benefit considerations of applying FASB Interpretation No. 46(R) (FIN 46), *Consolidation of Variable Interest Entities*, by nonpublic companies, the PCFRC agreed to send a letter to the FASB that will request the FASB to consider allowing those entities to issue parent-company-only financial statements, which would be considered to be presented in accordance with generally accepted accounting principles. The PCFRC believes this would solve the concerns about the cost/benefit of applying FIN 46 to the preparers and users of nonpublic company financial statements.

The PCFRC also discussed the Preliminary Views (PV) document, *Financial Instruments with Characteristics of Equity*, issued by the FASB in November 2007. The PV discusses the preliminary decisions reached by the FASB on distinguishing between liabilities and equity. The PCFRC agreed to submit a comment letter to the FASB that supports the ownership settlement approach. The FASB has preliminarily agreed to require the use of the basic ownership approach.

The next meeting of the PCFRC is scheduled to be held in Atlanta, Georgia on June 19 and 20, 2008.

Proposed Amendment to Accounting for Inventories Included in Trading Activities

Currently, Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins, Chapter 4, "Inventory Pricing,"* defines inventory as "the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale." Chapter 4 generally requires that inventory be accounted for at the lower of cost or market. Only in exceptional cases could inventory be stated above cost (e.g., where the inventory had a ready market at a fixed price and was fungible, such as might be the case for precious metals). AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, requires that a reporting entity account for inventories at fair value. The AICPA Audit and Accounting Guide, *Investment Companies*, requires that a reporting entity report all investment assets at fair value. To address this inconsistency in generally accepted accounting principles, the Financial Accounting Standards Board (FASB) has issued proposed FASB Staff Position (FSP) No. ARB 43-a, *Amendment of the Inventory Provisions of Chapter 4 of ARB No. 43*.

This proposed FSP would amend Chapter 4 of ARB No. 43 to require that inventories included in an entity's trading activities be initially and subsequently measured at fair value with changes in fair value recognized in earnings. The proposed FSP does not define a trading activity. That determination would be made by an entity based on its specific facts and circumstances and guidance in other generally accepted accounting principles that describe or define trading activities. When reclassifying inventory from trading to nontrading activities (or vice versa), the transfer would be recorded at fair value at the date of reclassification. The FSP would require financial statement disclosures that enable users to understand management's conclusion that inventory is included in an entity's trading activities, including a description of those activities and the typical holding period. Those disclosures also would include the effect of inventory transfers between nontrading and trading categories on the entity's financial performance. The FSP would not change current practice for inventories included in production, retail, wholesale, or other nontrading activities.

This proposed FSP would be effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. Early adoption would not be permitted. The FSP would be applied as a cumulative effect of the change in accounting principle. An offsetting adjustment would be made to the opening balance of retained earnings (or other appropriate components of equity or net assets) at the date of initial adoption and would be presented separately.

The proposed FSP is available for comment until June 16, 2008 at http://www.fasb.org/fasb_staff_positions/prop_fsp_arb43-a.pdf.

Auditing

Auditing Standards Board Begins Redrafting Standards

To address concerns over the clarity, length, and complexity of its standards, the Auditing Standards Board (ASB) is beginning a project to redraft its Statements on Auditing Standards (SAS). While clarifying its Standards, the ASB will also attempt to achieve convergence with the Standards of the International Auditing and Assurance Standards Board (IAASB).

The redrafted standards will be revised in accordance with the following ASB clarity drafting conventions:

- Establishing objectives for each of the standards
- Including a definitions section, where relevant, in each standard
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an A- prefix, and presenting them in a separate section that follows the requirements section
- Using formatting techniques, such as bullet lists, to enhance readability
- Including, where appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standard

- Including, where appropriate, special considerations relevant to audits of governmental entities within the text of the standard

Bob Dohrer, ASB member and practice leader for our International Assurance Services Group, commented on the redrafting project, “The IAASB recently completed the first phase of its program to redraft existing International Standards on Auditing, so it is appropriate for the ASB to strive for convergence with those standards. In today’s global economy, U.S. auditors need to understand the work required to audit a foreign entity, and foreign auditors will need to understand the requirements of U.S. auditing standards. Also, separating the requirements of the standards from guidance on their application will enhance the overall readability and understandability of the standards.”

The first standards to be redrafted are proposed SAS No. 103 (Redrafted), *Audit Documentation*, and SAS No. 114 (Redrafted), *The Auditor’s Communication With Those Charged with Governance*. Proposed SAS No. 103 (Redrafted) has been drafted using International Standard on Auditing (ISA) 230 (Redrafted), *Audit Documentation*, as a base. Most notably, the language in SAS No. 103 defining the experienced auditor has been redrafted to align with the definition used in ISA 230. Proposed SAS No. 114 (Redrafted) has been drafted using ISA 260 (Revised and Redrafted), *The Auditor’s Communication with Those Charged with Governance*, as a base. Also, SAS No. 114 has been revised so that the communication of issues of risk and materiality is a required part of the communication of the planned scope and timing of the audit with those charged with governance.

If finalized, the proposed standards will not become effective for audits of financial statements for periods beginning earlier than December 15, 2010. The proposed standards are available for comment until June 30, 2008 at http://www.aicpa.org/download/auditstd/ED_Audit_Documentation.pdf and http://www.aicpa.org/download/auditstd/ED_Communication.pdf.

SEC

PCAOB Adopts and Amends Independence Rules

The Public Company Accounting Oversight Board (PCAOB) recently adopted Rule 3526, *Communication with Audit Committees Concerning Independence*. Rule 3526 will require a registered public accounting firm, before accepting an initial engagement pursuant to the standards of the PCAOB, to describe in writing to the audit committee all relationships between the firm or any of its affiliates and the issuer or persons in a financial reporting oversight role at the issuer that may reasonably be thought to bear on the firm’s independence. Registered firms will also be required to discuss with the audit committee the potential effects of any such relationships on the firm’s independence. Further, the Rule will require firms to make a similar communication annually for continuing engagements. If approved by the SEC, Rule 3526 will become effective on the later of September 30, 2008, or 30 days after SEC approval, and will supersede Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees, and two related interpretations*.

The PCAOB also recently adopted an amendment to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*. As originally adopted, Rule 3523 provided that a registered public accounting firm is not independent if it or any of its affiliates provides any tax service to a person in a financial reporting oversight role or an immediate family member of such a person during the audit and professional engagement period. The term “audit and professional engagement period” includes both the audit period (the period covered by any financial statements being audited or reviewed) and the engagement period (the period from the time the initial arrangement letter is signed or our procedures begin until the firm resigns or is terminated). The PCAOB has now determined that providing tax services to such a person during the portion of the audit period preceding the beginning of the professional engagement period does not necessarily impair a firm’s independence, and therefore amended the Rule to exclude from its scope tax services provided during the portion of the audit period that precedes the beginning of the professional engagement period. The amendment to Rule 3523 will become effective immediately if approved by the SEC. In the meantime, however, the PCAOB further adjusted the implementation schedule for Rule 3523 as it applies to tax services provided during the audit period to allow the SEC sufficient time to consider whether to approve the amendment to Rule 3523. Therefore, the PCAOB will not apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins.

Financial Institutions

Reporting Interest Income on Impaired Loans

FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, states, "A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." The Statement, however, does not specifically address how a creditor should recognize, measure, or display interest income on an impaired loan. Although Statement No. 114 does not specifically address how a financial institution should recognize, measure, or display interest income on an impaired loan, the Instructions for Preparation of Consolidated Reports of Condition and Income (call report instructions) published by the Federal Financial Institutions Examination Council indicate that impaired loans should normally be placed on nonaccrual status at the time they first become impaired and it is determined that full collection of principal and interest is not probable. Cash payments received on impaired loans that have been placed on nonaccrual status should be reported in accordance with the criteria for the cash basis recognition of income for nonaccrual loans.

Per the call report instructions, financial institutions should not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset (a) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (b) for which payment in full of principal or interest is not expected, or (c) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.

There are limited situations, which are exceptions to this general rule, under which an asset need not be placed in nonaccrual status. However, any state statute, regulation, or rule that imposes more stringent standards for nonaccrual of interest takes precedence over the call report instructions.

While an asset is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis as long as the remaining recorded investment in the asset (i.e., after charge-off of identified losses, if any) is deemed to be fully collectible. When recognition of interest income on a cash basis is appropriate, it should be handled in accordance with generally accepted accounting principles. One acceptable accounting practice involves allocating contractual interest payments among interest income, reduction of the recorded investment in the asset, and recovery of prior charge-offs. If this method is used, the amount of income that is recognized would be equal to that which would have been accrued on the asset's remaining recorded investment at the contractual rate. A financial institution may also choose to account for the contractual interest in its entirety either as income, reduction of the recorded investment in the asset, or recovery of prior charge-offs, depending on the condition of the asset, consistent with its accounting policies for other financial reporting purposes.

Instructions for Preparation of Consolidated Reports of Condition and Income is available in full at http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_041_200803_i.pdf.

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