

Accounting

Determining the Fair Value of a Financial Asset in a Market that Is Not Active

On October 3, 2008, the Financial Accounting Standards Board (FASB) issued proposed FASB Staff Position (FSP) No. FAS 157-d, *Determining the Fair Value of a Financial Asset in a Market That Is Not Active*. If finalized, this FSP would amend FASB Statement No. 157, *Fair Value Measurements*, to clarify its application in an inactive market by providing an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. Application issues include: (a) how management's internal assumptions should be considered when measuring fair value when relevant observable data do not exist; (b) how observable market information in a market that is not active should be considered when measuring fair value; and, (c) how the use of market quotes should be considered when assessing the relevance of observable and unobservable data available to measure fair value.

The key existing principles of Statement No. 157 that are illustrated in the example include:

- A fair value measurement represents the price at which a transaction would occur between market participants at the measurement date. In situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same; that is, the price that would be received by the holder of the financial asset in an orderly transaction that is not a forced liquidation or distress sale at the measurement date.
- In determining fair value for a financial asset, the use of management's internal assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable market data do not exist. In some cases an entity may determine that observable market data (Level 2) require significant adjustment based on unobservable data and thus would be considered a Level 3 fair value measurement. Regardless of the valuation technique, an entity must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.
- Broker quotes may be an input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. In a liquid market, a broker quote should reflect market information from actual transactions. However, when markets are less active, brokers may rely more on models with inputs based on the information available only to the broker. In weighing a broker quote as an input to fair value, an entity should place less reliance on quotes that do not reflect the result of market transactions.

For recurring fair value measurements using significant unobservable inputs (Level 3), Statement No. 157 requires an entity to reconcile the beginning and ending balances, including separately presenting changes that occurred during the period that are attributable to transfers in and/or out of Level 3. (See related article below.) For nonrecurring fair value measurements using significant unobservable inputs, Statement No. 157 requires an entity to disclose a description of the inputs and the information used to develop those inputs. The FASB strongly encourages a similar disclosure for recurring fair value measurements affected by the proposed FSP. Comments on the proposed FSP were due October 9, 2008, and the proposed FSP can be viewed at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas157-d.pdf.

The FASB has scheduled a meeting for October 10 at which it is expected to finalize the FSP after considering comments received. If finalized, the proposed FSP would be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application would be accounted for as a change in accounting estimate.

As discussed in the article below, certain clarifications regarding the application of Statement No. 157 were provided jointly on September 30, 2008, by the SEC staff and FASB. The FASB believes that the guidance in the proposed FSP is consistent with and amplifies the guidance contained in the clarification issued jointly earlier by the SEC staff and the FASB.

Clarification Regarding the Application of Statement No. 157

The SEC's Office of the Chief Accountant and the staff of the Financial Accounting Standards Board (FASB) have been engaged in extensive consultations with participants in the capital markets, including investors, preparers, and auditors, on the application of fair value measurements in the current market environment. Although the FASB proposed additional interpretative guidance on fair value measurement on October 3, 2008 as discussed in the article above, the SEC staff and FASB staff jointly issued a press release on September 30, 2008 to immediately address some of the fair value measurement questions that have been cited as most urgent. Following is a summary of certain clarifications that were provided jointly based on the fair value measurement guidance in FASB Statement No. 157, *Fair Value Measurements*:

- When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable. Further, in some cases, using unobservable inputs may be more appropriate than using observable inputs; for example, when significant adjustments are required to available observable inputs, it may be appropriate to utilize an estimate based primarily on unobservable inputs.
- Broker quotes may be an input when measuring fair value, but are not necessarily determinative if an active market does not exist for the security.
- The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence.
- A quoted market price in an active market for the identical asset is most representative of fair value and thus is required to be used generally without adjustment. Transactions in inactive markets may be inputs when measuring fair value, but would likely not be determinative. If they are orderly, transactions should be considered in management's estimate of fair value. However, if prices in an inactive market do not reflect current prices for the same or similar assets, adjustments may be necessary to arrive at fair value.

Determining whether impairment of an investment is other-than-temporary is a matter that often requires the exercise of reasonable judgment based upon the specific facts and circumstances of each investment. To assist in making this judgment, SEC Staff Accounting Bulletin Topic 5M provides a number of factors that should be considered.

The clarifications on fair value accounting are available in full at <http://www.fasb.org/news/2008-FairValue.pdf>.

Reconciliation Required for Level 3 Fair Value Measurements

For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition, this article serves as a reminder that paragraph 32 of FASB Statement No. 157, *Fair Value Measurements*, requires the reporting entity to disclose information for recurring fair value measurements using significant unobservable inputs (Level 3) that enables financial statement users to assess the effect of the

measurements on earnings (or changes in net assets) for the period. To meet that objective, the reporting entity must disclose certain information for each interim and annual period separately for each major category of assets and liabilities. For fair value measurements using significant unobservable inputs (Level 3), the reporting entity must disclose a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to:

- Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities);
- Purchases, sales, issuances, and settlements (net); and
- Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs).

When an asset or liability is transferred into or out of the Level 3 category from a higher level, there is diversity in practice as to how this is reflected in the reconciliation. There are generally three alternatives as to the value disclosed for the transfer:

- The fair value of the item at the beginning of the annual reporting period;
- An intra-period value (the value on the date the item was actually transferred into or out of Level 3); or
- The fair value of the item at the end of the annual reporting period.

As discussed above, the purpose of these disclosures is to enable financial statement users to assess the effect of the measurements on earnings (or changes in net assets) for the period. The use of the first alternative (i.e., disclosing the transfer at the fair value of the item at the beginning of the reporting period) results in any recognized gain or loss being disclosed in the reconciliation. We believe this alternative therefore provides the most transparent disclosures of the three alternatives. The selection of an alternative as to the disclosure of transfers in the required reconciliation is an accounting policy election that should be consistently applied to all transfers into or out of the Level 3 category. Reporting entities should document this accounting policy election and also consider disclosing it if deemed significant.

FASB's Proposals Regarding the Application of FIN 48 by Private Entities

At its October 1, 2008 meeting, the Financial Accounting Standards Board (FASB) discussed certain matters regarding FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*. The resulting proposed changes to FIN 48 will be exposed for public comment through a proposed FASB Staff Position (FSP).

The FASB voted to propose a one-year deferral of the effective date of FIN 48 for pass-through entities. If this proposal is finalized, the effective date of FIN 48 for pass-through entities would be for annual periods beginning after December 15, 2008. Early adoption of FIN 48 for pass-through entities is still permitted; however, the FASB also voted to develop guidance on how pass-through entities should apply FIN 48.

For purposes of determining an entity's status as a pass-through entity, the FASB decided that the determination should be based on the entity's federal income tax status, regardless of how various state or foreign jurisdictions might view the entity. Therefore, a Subchapter S corporation that is a pass-through entity for federal purposes is eligible for the deferral even though certain state or foreign jurisdictions might not recognize that pass-through status. The question of whether the deferral would apply to a subsidiary of a pass-through entity that itself is not a pass-through entity was not discussed.

The Board also voted to propose exempting all private entities from certain disclosure requirements of FIN 48. The proposal would eliminate, for all private entities, the following two disclosure requirements:

- Paragraph 21(a), which requires a tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period; and
- Paragraph 21(b) which requires disclosure of the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rates.

Upon issuance, the FSP will be subject to a 30-day public comment period after which the FASB will make its final decision on whether to delay the effective date for pass-through entities and reduce the disclosure requirements for all private entities.

Impact of Provider Credit Deterioration on Derivatives

The significant credit deterioration of an investment banking firm (e.g., Lehman Brothers) can obviously have ripple effects on the accounting for various investments. One area that is impacted is the accounting for derivatives under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Significant credit deterioration can affect both the hedge effectiveness of, and the amounts recorded in the financial statements for, a derivative.

Companies that have hedging derivatives with investment banking firms that are experiencing credit deterioration need to carefully examine their specific facts and circumstances to consider the implications of such credit deterioration. For example, a common provision in an interest-rate swap is that the contract is automatically terminated if the provider experiences a credit-rating downgrade or files for bankruptcy. Other contracts may not terminate in this manner upon credit deterioration and must continue to be accounted for pursuant to Statement No. 133. Each contract must be analyzed to determine the appropriate accounting treatment.

When an interest-rate swap contract is terminated automatically upon counterparty default as the result of a credit-rating downgrade or bankruptcy, it ceases to be a derivative. From that point forward, the contract must be reflected on the balance sheet as either an asset or a liability (i.e., a receivable from or a payable to the counterparty). The resulting receivable would need to immediately be assessed for collectibility with any resulting loss reflected in earnings as of that date. The receivable would then need to be reassessed on an ongoing basis in accordance with FASB Statement No. 5, *Accounting for Contingencies*. Gain contingencies arising from obligations that may not have to be honored also would need to be accounted for in accordance with Statement No. 5.

When a counterparty is experiencing credit deterioration and a derivative, such as an interest-rate swap, is not terminated, companies must assess the possibility of whether the counterparty to the interest-rate swap will default by failing to make any contractually required payments as scheduled in the derivative instruments. There will likely be hedge ineffectiveness that needs to be recognized in earnings. Furthermore, deterioration of a derivative counterparty's credit worthiness can potentially prevent the hedging relationship from being highly effective on an ongoing basis, which would cause hedge accounting to cease at that point and appropriate termination accounting would result. Derivative contracts that cease to be eligible for hedge accounting must continue to be reflected on the balance sheet at fair value. The change in fair value of the derivative contract must be reflected in earnings until maturity or termination of the contract.

September EITF Developments

At its September 24, 2008 meeting, the Financial Accounting Standards Board ratified the final consensus for Emerging Issues Task Force (EITF) Issue No. 08-5, "Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement." This Issue concludes that the issuer of debt with a third-party credit enhancement that is inseparable from the debt instrument must not include the effect of the credit enhancement in the fair value measurement of the liability. However, the issuer must disclose the existence of a third-party credit enhancement on its issued debt. The Issue is effective on a prospective basis in the first reporting period beginning on or after December 15, 2008.

At its September 10, 2008 meeting, the EITF reached tentative conclusions on the following 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

- *Issue No. 08-7, "Accounting for Defensive Intangible Assets"*

This Issue applies to all acquired intangible assets in situations in which the acquirer does not intend to actively use the asset but intends to hold the asset to prevent its competitors from obtaining access to the asset (a defensive intangible asset), unless the intangible asset must be expensed in accordance with other accounting literature. The EITF reached a consensus-for-exposure 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.

- *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-for-exposure 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. The EITF also reached a consensus-for-exposure that an equity-classified instrument (including an embedded feature that is separately recorded in equity) within the scope of this Issue should be presented as a component of noncontrolling interest in the consolidated financial statements, whether the instrument was entered into by the parent or the subsidiary. However, if an equity-classified instrument within the scope of this Issue was entered into by the parent and expires unexercised, the carrying amount of the instrument would be reclassified from the noncontrolling interest to the controlling interest.

Also, at the September 10, 2008 EITF meeting, the SEC Observer announced the SEC staff's views regarding the interaction between EITF Topic D-98, "Classification and Measurement of Redeemable Securities" and FASB Staff Position No. APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement).

The minutes of the September 10, 2008 EITF meeting are available at http://www.fasb.org/eitf/09-10-08_mtg_minutes.pdf.

FASB Proposes Revised Definition of Discontinued Operations

Currently, the definitions of a discontinued operation in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and in International Financial Reporting Standard (IFRS) 5, *Non-current Assets Held for Sale and Discontinued Operations*, are not convergent. Statement No. 144 defines a discontinued operation as a component of an entity that has been disposed of or is classified as held for sale provided that (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction, and (b) the entity will not have any significant continuing involvement in the operations of

the component after the disposal transaction. IFRS 5 defines a discontinued operation as a component of an entity that either has been disposed of or is classified as held for sale, and (a) represents a separate major line of business or geographical area of operations, (b) is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or (c) is a subsidiary acquired exclusively with a view to resale.

In their joint project on financial statement presentation, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) decided to develop a common definition of a discontinued operation and require common disclosures for all components of an entity that have been disposed of or are classified as held for sale. However, constituents have asked the Boards to accelerate the issuance of guidance on discontinued operations separately from the joint financial statement presentation project. As a result, the FASB has issued proposed FASB Staff Position (FSP) No. FAS 144-d, *Amending the Criteria for Reporting a Discontinued Operation*. The intent of this FSP is to develop a definition of a discontinued operation, and disclosure requirements for all components of an entity that have been disposed of or are classified as held for sale, that are convergent with the definition and disclosure requirements of International Financial Reporting Standards. Concurrently, the IASB has issued an Exposure Draft, *Discontinued Operations*, which proposes amendments to IFRS 5 that are identical to those proposed in the FASB's FSP.

If finalized, the proposed FSP would amend the definition of a discontinued operation in Statement No. 144 to be a component of an entity that is (a) an operating segment (as defined in FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*) and either has been disposed of or is classified as held for sale; or (b) a business (as defined in FASB Statement No. 141 (revised 2007), *Business Combinations*) that meets the criteria to be classified as held for sale on acquisition. The FSP applies to all entities (public and nonpublic business entities and not-for-profit entities) regardless of whether an entity is within the scope of Statement No. 131. The FSP also would amend the disclosure requirements of Statement No. 144 for all components of an entity that either have been disposed of or are classified as held for sale regardless of whether a component of an entity is reported in the income statement as a discontinued operation or in continuing operations. The amended disclosures would require that, for a component of an entity that either has been disposed of or is classified as held for sale, an entity must provide financial information that will enable users of financial statements to assess the financial effect of that disposal on the entity.

If finalized, the FSP would be effective for financial statements issued for fiscal years beginning after December 15, 2009, and interim periods within those fiscal years, with earlier application permitted. The FSP would be applied retrospectively to all periods presented. Proposed FSP No. FAS 144-d is available for comment until January 23, 2009 at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas144-d.pdf.

FASB Issues Three Exposure Drafts

The Financial Accounting Standards Board (FASB) recently issued three separate but related Exposure Drafts for public comment:

- Proposed FASB Statement, *Amendments to FASB Interpretation No. 46(R)*, if finalized, would add guidance to FASB Interpretation (FIN) No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, for determining whether an enterprise must consolidate a special-purpose entity (SPE), including those previously considered qualifying SPEs. The proposed Statement would require ongoing assessments to determine whether an entity is a variable interest entity (VIE) and whether an enterprise is the primary beneficiary of a VIE. This proposed Statement also would require enhanced disclosures to provide more transparent information about an enterprise's involvement in a VIE, including a requirement for sponsors of a VIE to disclose information even if they do not hold a significant variable interest in the VIE.
- Proposed FASB Statement, *Accounting for Transfers of Financial Assets*, if finalized, would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to remove (a) the concept of a qualifying SPE from Statement No. 140 and (b) the exceptions from

applying FIN 46(R) to qualifying SPEs. Most securitization entities that previously met the requirements of a qualifying SPE under Statement No. 140 that are VIEs would now be required to be evaluated under the revised guidance in the proposed amendment to FIN 46(R), including entities that transfer financial assets, hold a variable interest in such an entity, or both. The proposed amendment of Statement No. 140 would also revise and clarify the derecognition requirements for transfers of financial assets and the initial measurement of beneficial interests that are received as proceeds by a transferor in connection with transfers of financial assets. Further, the proposed Statement would expand the information that a reporting entity provides in its financial statements about transfers of financial assets, including through securitization transactions.

- Proposed FASB Staff Position (FSP) No. FAS 140-e and FIN 46 (R)-e, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities*, if finalized, would amend Statement No. 140 to require public entities to provide additional disclosures about transfers of financial assets. The proposed FSP also would amend FIN 46(R) to require public enterprises to provide additional disclosures about their involvement with VIEs. Further, this proposed FSP would require certain disclosures by a public enterprise that is (a) a sponsor that has a variable interest in a VIE, irrespective of the significance of the variable interest and (b) an enterprise that holds a significant variable interest in a qualifying SPE but was not the transferor of financial assets to the qualifying SPE. The purpose of this proposed FSP is to improve disclosures by public entities and enterprises until the pending amendments to Statement No. 140 and FIN 46(R) are effective.

If finalized, the proposed Statements would be effective at the beginning of a reporting entity's first fiscal year that begins after November 15, 2009. These proposed Statements are available for comment until November 14, 2008 at <http://www.fasb.org/draft/index.shtml>.

The effective date for the proposed FSP would be the first reporting period (interim and annual) that ends after issuance of the FSP for public entities. The FASB anticipates that this FSP would be issued in the fourth quarter of 2008, which means it would be effective for financial statements issued as of December 31, 2008 for calendar-year-end public entities. The proposed FSP is available for comment until October 15, 2008 at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas140-e&fin46r-e.pdf.

PCFRC Meets

The Private Company Financial Reporting Committee (PCFRC) met in Boston on September 18 and 19, 2008. Although numerous topics affecting private companies were discussed, the most prevalent and important for this meeting were FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, the Accounting and Review Services Committee (ARSC) Reliability Project, an update on the International Accounting Standards Board (IASB) project on reporting by private entities (formerly the Small and Medium Size Entity (SME) project), and an update on the status of the Financial Accounting Standards Board (FASB) leasing project.

The PCFRC has been seeking relief on behalf of private companies from the FASB for the requirements of FIN 48 for over a year. FIN 48 requires the measurement, recognition and disclosure about income tax uncertainties in the financial statements of all entities, including pass-through entities (such as LLCs, Subchapter S corporations, and partnerships). The PCFRC has asserted that users of private company financial statements do not find the information required by FIN 48 to be useful, and preparers assert the cost of compliance exceeds the benefit. Accordingly, the PCFRC agreed to send another letter to the FASB that seeks to (a) exempt private companies from FIN 48, (b) defer the effective date of FIN 48 pending further guidance from the FASB on the application to pass-through entities, or (c) provide disclosure relief for all private companies. On October 1, 2008, the FASB declined to exempt private companies from FIN 48, but did vote to propose a one-year deferral of the effective date of FIN 48 for pass-through entities so the FASB staff can prepare further guidance for those entities and to provide relief from certain disclosures. These conclusions will be addressed in one or more proposed FASB Staff Positions expected to be issued soon and which are covered in more detail in a related article in this publication.

The independence rules require that the external accountant must be independent in order to issue a report on a client's financial statements. Those independence rules stipulate that the accountant may not be a part of the

internal control structure of a client (among other requirements). This requirement prohibits the external accountant from providing certain accounting services for the client (such as maintaining depreciation schedules, posting to the general ledger, and preparing financial statements) even though the external accountant's involvement in such activities may produce more reliable financial statements. As a result, the ARSC formed a task force to consider an alternative framework for use in the development of technical guidance that could be issued by the ARSC. The objectives of the ARSC are to protect the public interest and provide practitioners the guidance they need to effectively perform compilation and review services. Work by the task force is ongoing and more will be reported about its activities as the project continues.

Members of the PCFRC generally agreed that private companies may be affected sooner than public companies by the continuing emergence and development of international accounting standards and the adoption of those standards by entities in the United States. The PCFRC believes this to be true because many private companies are owned or controlled by foreign entities. A final vote by the IASB on the SME project is expected in late 2008 with issuance of the standard in the first quarter of 2009. It was also reported that the SME document will be a stand-alone document (that is, it will not refer to the full body of accounting standards issued by the IASB) and is expected to be updated only every two years. Private entities need to be mindful of developments in this area as loan, shareholder, and other agreements may need to be amended or a waiver from compliance may need to be obtained if an entity changes from U.S. generally accepted accounting principles to international generally accepted accounting principles.

The FASB is expected to complete its leasing project by 2011. However, that project will only consider lessee accounting. Lessor accounting is expected to be part of the broad revenue recognition project. In general, the FASB is expected to adopt International Financial Reporting Standards for financing leases, which means that virtually all leases will be recognized on a lessee's balance sheet. The FASB has tentatively concluded to measure the lease obligation at the present value of expected payments (discounted at the lessee's incremental borrowing rate), which will also include the best estimate of contingent rents and rents expected to be paid during periods covered by a renewal option. The asset will initially be reported at the same amount as the liability. The FASB has not yet discussed subsequent accounting for either the asset or liability. Those and other matters are expected to be determined in time for a Preliminary Views document to be published by the end of the year with an Exposure Draft expected to be issued in 2009. If this schedule is maintained, this project will impact the financial statements of all entities and in a significant way in the relatively near term. A possible positive outcome of the project may be that entities will negotiate leases for economic reasons rather than to achieve an accounting outcome.

The next meeting of the PCFRC is scheduled for November 13 and 14 in New Orleans.

Auditing

AT 501 Superseded by New SSAE

The Auditing Standards Board recently approved a Statement on Standards for Attestation Engagements (SSAE) for reporting on a nonissuer's internal control over financial reporting, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*. This new SSAE substantially conforms to the standard used for reporting on an issuer's internal control over financial reporting - Public Company Accounting Oversight Board Auditing Standard (AS) No. 5, *An Audit of Internal Control That is Integrated with an Audit of Financial Statements*. The new SSAE supersedes AT Section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*. The new SSAE is effective for dates or periods ending on or after December 15, 2008, and is therefore effective for December 31, 2008 audits of financial institutions that are required to have an examination of internal control over financial reporting pursuant to the requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

The new SSAE establishes requirements that are applicable when an examination of internal control over financial reporting is integrated with an audit of financial statements. As a practical matter, a reporting entity will want to

engage the same firm to audit both its financial statements and its internal control over financial reporting as it will result in the most effective and efficient engagement. The new SSAE has provisions that will affect both the auditor and the reporting entity. Among other provisions, the new SSAE:

- Revises the definitions of the terms significant deficiency and material weakness to conform with the definitions in AS 5.
- Discusses how to identify significant accounts and disclosures and their relevant assertions.
- Describes how to determine the likely sources of potential misstatements within a given significant account or disclosure.
- Introduces the top-down approach for identifying the most important controls to test.
- Incorporates the auditor's fraud risk assessment into the planning process for the examination of internal control and provides guidance on the types of controls used to identify and prevent material financial statement misstatements resulting from fraud.
- Includes an illustrative management report containing the reporting elements described in the SSAE and guidance for reporting under Section 112 of FDICIA.

ASB Issues Exposure Draft

The Auditing Standards Board (ASB) recently issued an Exposure Draft, which includes a proposed Statement on Auditing Standards (SAS), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, and a proposed preface to Codification of Statements on Auditing Standards, "Principles Governing an Audit Conducted in Accordance With Generally Accepted Auditing Standards". The Exposure Draft is a part of the ASB's undertaking to revise all of its SAS in accordance with its clarity drafting conventions.

Consistent with the ASB's strategy to converge its standards with those of the International Auditing and Assurance Standards Board, the proposed SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, has been drafted using International Standard on Auditing (ISA) 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, as a base. See related article regarding this ISA below. Although based on ISA 200, the proposed SAS uses terms and phrases that are more commonly used in the United States, and contains examples and guidance that are more appropriate in the U.S. environment. The ASB believes that such changes will not create differences between the application of ISA 200 and the application of the proposed SAS.

The proposed SAS establishes the overall objectives of the auditor, which are (a) to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and (b) to report on the financial statements, or otherwise as required by the SASs, in accordance with the auditor's findings. The ASB believes that if an auditor fulfills these overall objectives and meets applicable ethical requirements, such as the AICPA Code of Professional Conduct, the auditor will have fulfilled the requirements currently stated in the 10 general, field work, and reporting standards that are contained in SAS No. 95, *Generally Accepted Auditing Standards*, as amended. Accordingly, the proposed SAS would supersede SAS No. 95.

The ASB has concluded, however, that the functions of the 10 general, field work, and reporting standards are valuable in setting the structure for the codification of the SASs, in describing what an audit is, and for use in the classroom and the courtroom. To preserve these functions of the 10 standards, the ASB has proposed a preface to Codification of Statements on Auditing Standards, "Principles Governing an Audit Conducted in Accordance

With Generally Accepted Auditing Standards". The proposed principles in the preface are not requirements and do not carry any authority. Rather, they are the fundamental principles that govern an audit and are supported by the objectives and requirements of the individual SASs.

The Exposure Draft is available for comment until December 30, 2008 at http://www.aicpa.org/download/auditstd/ED_Preface_and_Overall_Objectives.pdf.

SEC

SEC Commences Study of "Mark-to-Market" Accounting

Under the Emergency Economic Stabilization Act (EESA) of 2008, the SEC is required to conduct a study of "mark-to-market" accounting. The study is to be completed by January 2, 2009, in consultation with the Secretary of the Treasury and the Board of Governors of the Federal Reserve System. Under the terms of the EESA, the study will focus on:

- The effects of such accounting standards on a financial institution's balance sheet;
- The impacts of such accounting on bank failures in 2008;
- The impact of such standards on the quality of financial information available to investors;
- The process used by the Financial Accounting Standards Board (FASB) in developing accounting standards;
- The advisability and feasibility of modifications to such standards; and
- Alternative accounting standards to those provided in FASB Statement No. 157, Fair Value Measurements.

Financial Institutions

Impairment of FHLB Stock

Many financial institutions own investments in stock issued by one of the Federal Home Loan Banks (FHLBs). The FHLBs are government-sponsored entities (GSE). As a result of the financial difficulties experienced by other GSE (i.e., the Federal National Mortgage Association and Federal Home Mortgage Corporation), some have questioned whether banks should be recording other-than-temporary impairment (OTTI) for their FHLB stock.

The level of required investment in FHLB stock is based on the balance of outstanding loans the financial institution has from an FHLB. Although FHLB stock is a financial instrument that represents an equity interest in an FHLB, it does not have a readily determinable fair value and is not accounted for under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Instead, an investment in FHLB stock is accounted for in accordance with AICPA Statement of Position (SOP) No. 01-6, *Accounting by Certain Entities that Lend to or Finance the Activities of Others*.

According to SOP 01-6, FHLB stock is generally viewed as a long-term investment. Accordingly, when evaluating FHLB stock for impairment, its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The determination of whether the decline affects the ultimate recoverability is influenced by criteria such as the following:

- The significance of the decline in net assets of the FHLBs as compared to the capital stock amount for the FHLBs and the length of time this situation has persisted.
- Commitments by the FHLBs to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBs.

- The impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLBs.
- The liquidity position of the FHLBs.

On September 24, 2008, Federal Deposit Insurance Corporation Chief Accountant Robert Storch held a webcast regarding current accounting issues. During that call, Mr. Storch expressed his view that FHLB stock is not impaired at this time. However, financial institutions should continue to periodically evaluate their FHLB stock for impairment.

International

IASB Proposes Revised Definition of Discontinued Operations

Currently, the definitions of a discontinued operation in International Financial Reporting Standard (IFRS) 5, *Non-current Assets Held for Sale and Discontinued Operations*, and in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, are not convergent. As a result, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have issued guidance that will produce convergence. The IASB has issued an Exposure Draft, *Discontinued Operations*, which results in the same guidance as in a proposed FASB Staff Position issued by the FASB. For further information about that guidance, please see the article titled “FASB Proposes Revised Definition of Discontinued Operations” in the Accounting section of this issue.

By adopting a definition for discontinued operations that reflects the definition of operating segments in IFRS 8, *Operating Segments*, the proposals would also increase consistency between IFRSs and strengthen the basic principle in IFRS 5. The proposed definition could result in fewer items being recognized in financial statements as discontinued operations than at present. However, the additional disclosures would give information about components of an entity that have been disposed of or are held for sale but do not meet the definition of a discontinued operation. The IASB’s Exposure Draft is available for comment until January 23, 2009 at http://www.iasb.org/NR/rdonlyres/B47D08C2-A78A-49E8-92A7-63A9DE737629/0/ED_Discontinued_Operations_IFRS_5.pdf.

Proposed Exemptions for First-time Adopters of IFRS

The International Accounting Standards Board (IASB) recently published an Exposure Draft of proposed amendments to International Financial Reporting Standard (IFRS) 1, *First-time Adoption of International Financial Reporting Standards*, to provide certain exemptions for first-time adopters of IFRS. The amendments propose:

- To allow an entity that used full cost accounting under its previous generally accepted accounting principles (GAAP) to elect, at the date of transition to IFRSs, to measure exploration and evaluation assets at the amount determined under the entity’s previous GAAP and to measure oil and gas assets in the development or production phases by allocating the amount determined under the entity’s previous GAAP for those assets to the underlying assets pro rata using reserve volumes or reserve values as of that date.
- An exemption for an entity with operations subject to rate regulation. Such an entity could elect to use the carrying amount of items of property, plant and equipment held, or previously held, for use in such operations as their deemed cost at the date of transition to IFRSs if both retrospective restatement and using fair value as deemed cost are impracticable (as defined in International Accounting Standard 8, *Accounting Policies, Changes in Accounting Estimates and Errors*).
- To exempt companies with existing leasing contracts accounted for in accordance with IFRIC 4, *Determining whether an Arrangement contains a Lease*, from reassessing the classification of those contracts according to IFRSs when the same classification has previously been made in accordance with national generally accepted accounting principles.

The Exposure Draft, *Additional Exemptions for First-time Adopters (Proposed amendments to IFRS 1)*, is available for comment until January 23, 2009 at http://www.iasb.org/NR/rdonlyres/2663F948-DBDE-453F-8950-ABD3FCF9B76B/0/ED_IFRS_1_Additional_Exemptions.pdf.

Seven ISAs Released

The International Auditing and Assurance Standards Board (IAASB) recently released seven International Standards on Auditing (ISAs). These standards result from the IAASB's program of redrafting existing standards following its clarity drafting conventions. The recently clarified ISAs include ISA 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. This ISA contains an overview of an audit to aid in understanding its purpose and scope; defines the respective authority of the requirements and guidance in ISAs; and contains the most fundamental requirements for auditors. It emphasizes the importance of sound and consistent professional judgment by the auditor, and the necessity for sufficient audit evidence to support the auditor's opinion.

In addition to ISA 200 (Revised and Redrafted), the IAASB also released:

- ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit*
- ISA 450 (Revised and Redrafted), *Evaluation of Misstatements Identified during the Audit*
- ISA 530 (Redrafted), *Audit Sampling*
- ISA 610 (Redrafted), *Using the Work of Internal Auditors*
- ISA 705 (Revised and Redrafted), *Modifications to the Opinion in the Independent Auditor's Report*
- ISA 706 (Revised and Redrafted), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

To date, the IAASB has released 22 redrafted ISAs, and is on track to finalize its complete set of clarified ISAs by the end of this year. The clarified ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009.

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