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## Investment companies industry developments, 2009; Audit risk alerts

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Investment Companies Industry Developments – 2009

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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A U D I T R I S K A L E R T

2009

# Investment Companies Industry Developments

STRENGTHENING AUDIT INTEGRITY  
SAFEGUARDING FINANCIAL REPORTING



AICPA®

A U D I T   R I S K   A L E R T

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2009

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STRENGTHENING AUDIT INTEGRITY  
SAFEGUARDING FINANCIAL REPORTING



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## Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of investment companies with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an *other auditing publication*, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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## How This Alert Helps You

**.01** This Audit Risk Alert (alert) helps you plan and perform your investment company audits and also can be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

**.02** Certain accounting guidance referenced in this alert has been codified into the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*<sup>TM</sup> (ASC). On June 30, 2009, FASB issued FASB Statement No. 168, *The FASB Accounting Standards Codification<sup>TM</sup> and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*. On the effective date of this statement, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). At that time, FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. Once effective, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. See the discussion of FASB ASC in the "Accounting Issues and Developments" section of this alert.

## Audit Risk

**.03** It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of the risks (both inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to balances, classes, or disclosures and the risk (detection risk) that the auditor will not detect such misstatements.

**.04** The auditor's combined assessment of inherent risk and control risk is described as the risks of material misstatement. The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.

**.05** As set forth in paragraph .12 of AU section 312, the auditor may reduce audit risk by determining overall responses and designing the nature, timing, and extent of further audit procedures. Furthermore, paragraph .19 of

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AU section 312 explains that the auditor should seek to reduce audit risk at the individual balance, class, or disclosure level in such a way that will enable the auditor to express an opinion on the financial statements as a whole at an appropriately low level of audit risk.

## Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

**.06** AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows: "The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures." Obtaining this understanding is further complicated by the rapidly changing economic environment. In accordance with paragraph .04 of AU section 314, the auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

**.07** The auditor's understanding of the entity and its environment consists of an understanding of the following:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

**.08** Appendix A of AU section 314 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to the categories previously discussed. Understanding the effects of the current economic climate on each specific audit client is a key step in designing the audit plan.

**.09** Business risks result from conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies. The setting of inappropriate objectives and strategies also results in business risks. Just as the external environment changes, the handling of the entity's business also is dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement; however, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements; however, not all business risks give rise to risks of material misstatement.

**.10** Additionally, investment companies may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social,

technical, and competitive forces). After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding. Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

## Economic and Industry Developments

### The Current Economic Crisis

.11 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's financial statements.

.12 Currently, the U.S. economy continues to demonstrate mixed results. Some key occurrences that exhibit this include the following:

- U.S. real gross domestic product (GDP), the broadest measure of economic activity, continues to be negative.
- The number of jobless claims remains high.
- The Federal Reserve has maintained the federal funds interest rate at a historically low level.
- Millions of households owe more on their mortgages than their homes are currently worth. The number of residential home foreclosures continues to increase.
- The increase in corporate mergers, which shows evidence of executive optimism.
- The financial markets continue to experience instability—historic lows followed by rallies. In March 2009, the S&P 500 and Dow Jones Industrial Average reached their 12-year lows and NASDAQ closed at its lowest point since October 2002. However, by mid-September, both the S&P 500 and the Dow Jones Industrial indexes increased in value by 50 percent.
- The demand for U.S. Treasury bills has increased at a staggering rate, which drove the interest rate for these Treasury bills to less than 1 percent in March 2009. Rates continue to remain at historic lows (one-half percent or less) through mid-September 2009.
- The Treasuries-Over-Euro-Dollar Spread reached 4.63 percent in October 2008, a historic high, before returning to 1.04 percent in March 2009 and 0.19 percent by September 2009.

### Key Economic Indicators

.13 The GDP measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to an estimate from the Bureau of Economic Analysis, real

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GDP decreased at an annual rate of 0.7 percent in the second quarter of 2009. This data indicates a moderation in the slowing of the economy seen in the fourth quarter of 2008 and first quarter of 2009, which experienced decreases of 6.3 percent and 5.5 percent, respectively.

.14 The unemployment rate began to level out from June through September 2009. During that period it remained between 9.4 percent and 9.8 percent. An unemployment rate of 9.8 percent represents approximately 15.1 million people. Since the start of the recession in December 2007, the number of unemployed persons has increased by as much as 7.6 million or 4.9 percentage points.

.15 As of March 2009, the Federal Reserve had decreased the target for the federal funds rate more than 5.0 percentage points to less than 0.25 percent. The Federal Reserve noted in its September 23, 2009, press release "that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

### Government Intervention to Curtail the Economic Crisis

.16 The U.S. government has taken unprecedented actions to prevent worsening economic conditions, including passing the American Recovery and Reinvestment Act of 2009 (Recovery Act) and the Emergency Economic Stabilization Act of 2008 (EESA), facilitating the sale of ailing banks and dramatically increasing the monetary programs available from the Federal Reserve. The results of all of these actions have not been fully realized to date.

#### *The American Recovery and Reinvestment Act of 2009*

.17 In February 2009, President Obama signed legislation designed to work hand in hand with the EESA to stimulate the U.S. economy. The Recovery Act is designed primarily to combat the rising unemployment trends, put more money in the hands of consumers, and reduce the likelihood that state and local governments will need to raise taxes significantly. According to the White House press release, the legislation will do the following:

- Create or save 3.5 million jobs in the next 2 years
- Provide direct tax relief to working and middle class families
- Double the U.S. renewable energy generating capacity over 3 years
- Stimulate private investment in renewable energy through tax credits and loan guarantees
- Invest \$150 billion in U.S. infrastructure projects
- Provide funds to U.S. state and local governments to support health and education programs

.18 Many of the provisions of this legislation took effect immediately in an effort to stimulate consumer spending and boost the economy. The total cost of the spending in the Recovery Act is \$787 billion, which is in addition to the \$700 billion in the EESA. Many economists are concerned that further financial support may be necessary before an economic recovery is possible. Additionally, the federal government developed the Web site [www.recovery.gov](http://www.recovery.gov) to facilitate a transparent process to ensure accountability for the execution of the package.

### ***Other Government Intervention***

**.19** The passage of the Recovery Act came shortly after the passage of the EESA, which was signed into law in October 2008. As stated in Section 2 of the EESA bill, it "provide[s] authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States" to ensure the economic well-being of Americans.

**.20** The EESA authorized the U.S. Treasury to create the Troubled Assets Relief Program (TARP), the original intent of which was to use \$700 billion to purchase illiquid mortgage assets from banks. As part of TARP, the Capital Purchase Program (CPP) was intended to inject \$250 billion of capital into banks. Half of the CPP funds were distributed to 9 of the largest financial institutions in the nation, which held approximately 55 percent of U.S. banking assets. The other half of the funds were allocated for smaller financial institutions. The clear intent of the CPP was for the participating banks to increase lending; however, many question if the banks have responded accordingly.

**.21** In addition to bailout funds targeting financial institutions, a \$17.4 billion rescue package for the U.S. automakers was issued in December 2008. The first \$13.4 billion was lent to the automakers immediately, and the remaining \$4 billion was lent in subsequent months. The U.S. government will continue to work directly with automakers.

**.22** The complete effects of the Recovery Act, as well as the other government interventions, will take time to be felt throughout the economy; however, the primary goal is to increase market confidence and liquidity.

### **Industry Trends and Conditions**

#### ***State of the Investment Company Industry***

**.23** The second quarter of 2009 showed a positive shift in the market, which indicates investors are starting to be less cautious and are more likely to take risks again. According to Strategic Insight, a total of \$136 billion flowed into stock and bond funds in the second quarter, excluding money market mutual funds and exchange traded funds—the largest inflow of capital since the first quarter of 2007. Of that inflow, approximately two-thirds went to stock funds and one-third went to bond funds, which exhibits the increased risk appetite of investors. Late last year, investors were doing just the opposite; they were pulling out of stock and bond funds and investing in low yielding money market funds and safe Treasury bonds.

**.24** An overall increase in total net assets of money market mutual funds also remains apparent. According to Investment Company Institute (ICI) data, from the start of 2008 through September 2009, the total net assets of money market mutual funds increased 8.5 percent. Although variances existed between mid-February 2008 and September 2009, no net change occurred during that time.

**.25** Further, according to ICI, August 2009 saw an increase in total net assets of the nation's mutual funds of \$185.3 billion or 1.8 percent, as compared to July 2009. The net assets of stock funds, hybrid funds, taxable bond funds, municipal bond funds, and money market funds all increased during that time period. The two negative changes were 1.6 percent and 0.9 percent drops in the net assets of taxable money market funds and tax free money market funds,

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respectively. The August 2009 year to date net cash flows of long-term funds all show a positive story: stock mutual funds, hybrid mutual funds, taxable bond mutual funds, and municipal bond mutual funds have net cash inflows of \$15.0 billion, \$3.1 billion, \$175.3 billion, and \$44.6 billion, respectively.

.26 Although the economy is starting to show signs of recovery, policy-makers continue to analyze and dissect the events of the last two years with the hopes of understanding the economic crisis and how to prevent one from happening again. With the results of this research, new rules continue to be created and released that will shape the future of the financial markets.

### *ICI's Money Market Reporting Group Report*

.27 ICI's Money Market Working Group was created in November 2008 with the goal of developing recommendations to "improve the functioning of the money market and the operation and regulation of funds investing in that market." Further, the group made "recommendations to minimize risks and help assure the orderly functioning of this vitally important market. The group [identified] needed improvements in market and industry practices; regulatory reforms, including improvements to SEC rules governing money market mutual funds; and possibly legislative proposals."

.28 A major force that contributed to the creation of the Money Market Working Group occurred when Reserve Primary Fund, a large money market fund, had its net asset value (NAV) drop below \$1 per share and "break the buck" in September 2008 as a direct result of its holdings of Lehman Brothers debt. This marked the second time in history a fund "broke the buck" and the first time for a money market fund of significant size. It had dramatic reverberations over the following days in the form of massive redemptions, which prompted the government to intervene with the U.S. Treasury Department's temporary guarantee program for money market funds. The working group also wanted to understand why various money market funds fared so differently during this period.

.29 After careful research and analysis, the group made the following eight recommendations:

- Impose minimum liquidity requirements and regular stress testing
- Tighten the portfolio maturity limit
- Raise the capital quality standards
- Require advisers to adopt "know your client" procedures
- Enhance required disclosures
- Assure shareholders are treated fairly when a fund's NAV drops below \$1 per share
- Enhance government oversight of the money market
- Address market confusion about which entities are money market funds

.30 The group believes these recommendations would better prepare money market funds for the next period of economic difficulty and "have been designed to further strengthen an already resilient product."

.31 Suggestions for money market reform from other parties include floating NAVs, insurance for money market funds, requiring funds to become special



purpose banks with capital requirements and deposit insurance, and requiring investors making large redemptions to accept them in kind for an equal share of each security in the fund's portfolio.

.32 The Money Market Working Group has concerns about each of these proposals. The underlying theme behind the concerns is that the economy is still fragile and not stabilized; therefore, a shift in the fundamentals and attractiveness of money market funds could be detrimental to the recovery of the economy.

.33 In June 2009, the SEC issued proposed rule Release No. IC-28807 *Money Market Fund Reform* to address many of these recommendations. The proposed rule is further discussed in the "SEC Developments" section of this alert. Readers are encouraged to review the report, located on ICI's Web site at [http://ici.org/pdf/ppr\\_09\\_mmwg.pdf](http://ici.org/pdf/ppr_09_mmwg.pdf).

### ***Treasury's Extension of Temporary Guarantee Program for Money Market Funds***

.34 In September 2008, the Treasury created its temporary guarantee program for money market funds through the Exchange Stabilization Fund. This program enabled the Treasury to guarantee eligible shareholders a \$1 share price for any eligible money market mutual fund that participates in the program. To be eligible, money market mutual funds must be regulated under Rule 2a-7 of the Investment Company Act of 1940, publicly offered, registered with the SEC, and have a policy of maintaining a stable NAV share price of \$1 or greater. This program provided coverage to shareholders for amounts held in participating money market funds as of the close of business on September 19, 2008. If an investor had an increase in the number of shares held in a fund after that date, only the amount held on that date was guaranteed. The guarantee was triggered if the fund's NAV fell below \$0.995 and required the fund to commence liquidation. The fund's NAV on September 19, 2008, determined the fee associated with participation in this program.

.35 This program initially had a 3 month term. In November 2008, the program was extended through April 30, 2009, but only for funds already participating in the program. At that time, the program covered more than \$3 trillion of assets. A few months later, in March 2009, the Treasury again announced the extension of this program through September 18, 2009, with consistent eligibility restrictions. The program at this time also covered more than \$3 trillion of assets. Under congressional legislation, the program could not be extended beyond September 18, 2009.

.36 The goal of this program was to stabilize and restore confidence in the money market fund arena. The success will be measured by the affect the expiration of the program has on the money market, if any. The expiration of this program in mid-September did not produce any shocks to the marketplace and was considered a nonevent. This lack of reaction can be attributed to the program's success in achieving its goal.

.37 Concurrent with the expiration of this program, the SEC adopted Release No. IC-28903 *Disclosure of Certain Money Market Fund Portfolio Holdings*, an interim final temporary rule that requires a money market fund to report its portfolio holdings and valuation information to the SEC when the market based NAV per share drops below \$0.9975. This reporting requirement is substantially similar to those required by the temporary guarantee

program for money market funds. This interim final temporary rule is effective from September 18, 2009, through September 17, 2010. Comments were due on October 26, 2009. Readers should remain alert for developments.

### ***Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility***

.38 Also in September 2008, the asset-backed commercial paper (ABCP) money market mutual funds liquidity facility (AMLF) was created. This program extended nonrecourse loans to U.S. depository institutions and bank holding companies to finance their purchases of high quality ABCP from money market mutual funds so that money funds could meet demands for redemption. In early December 2008, the Federal Reserve extended the expiration date of AMLF to April 2009 "in light of continuing strains in financial markets." In January 2009, three related rules were adopted for this program. The first provided a temporary limited exception from the Federal Reserve Board's (FRB's) leverage and risk-based capital rules for bank holding companies and state member banks. The second provided a temporary limited exception from sections 23A and 23B of the Federal Reserve Act, "Relations with Affiliates" and "Restrictions on Transactions with Affiliates," respectively. The third provided a temporary exception allowing all insured depository institutions to provide liquidity to their affiliates for assets typically funded in the tri-party repo market.

.39 In February 2009, the AMLF was extended through October 30, 2009, "in light of continuing substantial strains in many financial markets." By June 2009, the Federal Reserve announced another extension of this program through February 1, 2010. Though usage of AMLF has declined considerably, the FRB judged it appropriate to extend the program given the continued fragility of market conditions. The board also established a redemption threshold whereby a money market mutual fund would have to experience net asset outflows of at least 5 percent in a single day or 10 percent within the 5 prior business days before it can sell qualifying ABCP. Any purchase of eligible ABCP from a money market mutual fund could be pledged to AMLF at any time within 5 business days following the date the threshold redemption levels were met.

.40 As discussed in the Federal Reserve monthly report on credit and liquidity programs and the balance sheet, as of May 2009, there were 3 or fewer borrowers of AMLF, with a total borrowed amount of \$26 billion. Amounts of AMLF credit outstanding has dramatically decreased from the start of 2009. As of the week ended December 31, 2008, there was \$24 billion of credit outstanding under AMLF, and by the week ended August 26, 2009, there was only \$79 million of credit outstanding to 3 or fewer borrowers.

### ***Target Date Retirement Funds***

.41 The economic crisis of the past 2 years has affected all forms of investments, including target date retirement funds. These funds have been considered useful tools for investors who did not have the time or knowledge to manage their portfolio, especially as retirement approaches. Funds are built around a retirement year in order to target different investments and adjust risk levels appropriately over time. However, these funds were not immune to the market turmoil and took significant losses during 2008. The most surprising aspect of these declines was their wide range. For example, funds that had a retirement year of 2010 fell between 3.6 percent and 41 percent in 2008,



largely due to substantially different weightings between equity and fixed income securities. This prompted the question whether any improvements should be made to the regulations and guidance governing target date funds used for retirement savings.

.42 In June 2009, the SEC and Department of Labor held a joint hearing to discuss target date funds and other similar investment options. As Chairman Mary L. Schapiro stated in her June 18, 2009, speech, this joint hearing was intended to be, "[a] discussion of target date funds, their construction, their role in retirement investing, their allocation to various investment classes, and the understanding—or perhaps misunderstanding—of target date funds by retail investors." She went on to note that the joint hearing would discuss how SEC regulations affect target date funds and if they foster investor understanding of these funds, their risk characteristics and fees, and the meaning of a particular target date in a fund's name. Possible amendments to SEC regulations are under consideration based on these discussions.

### ***Changes to the Small Business Investment Company Program***

.43 Section 505 of the Recovery Act, "SBIC Program Changes," makes changes to the Small Business Investment Company (SBIC) program regarding the formula for calculating maximum leverage, the aggregate investment limitations related to portfolio diversification, and the percentage of financings required to be made in smaller enterprises. The Small Business Administration (SBA) plans on publishing regulations to implement these changes in the near future.

.44 *Leverage* is financial assistance that SBA provides to an SBIC by guaranteeing debt securities. The new formula has a maximum amount of leverage being made available to 1 SBIC that may not exceed \$150 million or 300 percent of the SBIC's regulatory capital, whichever is less. *Regulatory capital* is the paid-in private capital of the SBIC in addition to any binding capital commitments that the SBIC received from institutional investors. For 2 or more SBICs under common control, the maximum amount of outstanding SBA-provided leverage is \$225 million. Further, the Recovery Act makes changes in this formula for SBICs licensed on or after October 1, 2009, who certify that not less than 50 percent of their investments will be made in companies in low income geographic areas.

.45 Secondly, the Recovery Act changed the calculation of the maximum amount that an SBIC can invest in a single company or group of affiliated companies, known as the *overline limit*. It changed this overline amount from 20 percent of an SBIC's private capital to 10 percent of the sum of private capital and the total amount of leverage projected by the SBIC in its SBA-approved business plan at the time of the grant of the company's license. This calculation is generally equivalent to raising the overline limit to 30 percent of private capital for those SBICs that project the use to 2 tiers of leverage.

.46 Lastly, the Recovery Act changed the percentage of financings that SBICs requesting leverage must provide to smaller enterprises. All SBICs with leverage commitments issued on or after February 17, 2009, must certify that at least 25 percent of all future financing dollars will be in smaller enterprises. A *smaller enterprise* is defined as an entity that, together with any affiliates, either has a maximum net worth of \$6 million and average after-tax net income for its last 2 fiscal years of no more than \$2 million or meets the size standard in Title 13 U.S. *Code of Federal Regulations* (CFR) Part 107.201 for the industry in

which it is primarily engaged. Constituents should be alert for the publication of the related regulation to implement these changes.

.47 The SBA also announced changes to goodwill financing procedures. The new rules originally had proposed limiting such financings to the lesser of \$250,000 or half of the loan value. The SBA received comments from lenders and business brokers stating that this limit would greatly hinder business acquisitions. In late September 2009, the SBA rescinded and replaced the guidance. Effective October 1, 2009, goodwill and other intangible assets can amount up to \$500,000 with no limit on the percentage of the loan. Readers are encouraged to review the full details of the new guidance.

### ***Client Commission Agreements***

.48 As investment advisers seek to provide enhanced value to their clients, additional emphasis has been placed on client commission agreements (CCAs). All payment structures utilizing investor commissions to fund the purchase of research services under section 28(e) of the Securities Exchange Act of 1934, "Exchange, broker, and dealer commissions; brokerage and research services," including proprietary (bundled) arrangements and third-party independent arrangements, are CCAs. From the SEC's interpretive release Release No. 34-54165 *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, an option exists that allows the broker-dealer to create a pool of research dollars, funded by commissions paid by managed accounts, to pay for research services as instructed by the money manager. The SEC would like to make it as easy as possible for money managers to pay for independent research.

.49 The SEC also issued a no-action letter to Goldman, Sachs & Co. in early 2007 that confirmed research firms who are not broker-dealers may be compensated for providing research services to their money manager clients through payments from a commission pool set apart in a client commission arrangement under section 28(e) without registering as broker-dealers. This decision is pursuant to a number of factors that must be present, including the following:

- The money manager must be responsible for independently determining the value of the research services under 28(e), although the money manager's good faith determination may be based on input from the research firm. The broker-dealer may not be involved in determining the value of the research services to the money manager.
- The research firm must receive payment from a pool of commissions that, by agreement between the broker-dealer and the money manager, is set aside for obtaining research services.
- Payment to the research firm may not be conditioned, directly or indirectly, on the execution of any particular transaction or transactions in securities that are described or analyzed in the research services.
- The research firm may provide the research services in return for payment from a pool of commissions, but may not perform other functions that are typically characteristic of broker-dealer activity (for example, soliciting brokerage transactions by disseminating quotations, accepting or handling customer orders, introducing or

carrying customer accounts, receiving or holding customer funds or securities, and so on).

.50 This no-action letter can be accessed at <http://sec.gov/divisions/marketreg/mr-noaction/2007/goldmansachs011707-15a.pdf> and the interpretive release can be accessed at [www.sec.gov/rules/interp/2006/34-54165.pdf](http://www.sec.gov/rules/interp/2006/34-54165.pdf). Further, in July 2008, the SEC issued proposed rule Release No. 34-58264 Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices. The proposed rule can be accessed at <http://sec.gov/rules/proposed/2008/34-58264.pdf>. Readers should remain alert for developments on this topic.

### ***Recommendation of Changing Rule 12b-1 by Chairman Schapiro***

.51 In Chairman Schapiro's testimony before the U.S. Senate subcommittee on financial services and general government on June 2, 2009, one of her discussion points related to Rule 12b-1 fees. This rule permits mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distributing funds. In 2008, broker-dealers collected \$13 billion in 12b-1 fees. Schapiro asked the SEC staff to prepare a recommendation on Rule 12b-1, stating that, "[t]hese fees, with their bureaucratic sounding name and sometimes unclear purpose, are not well understood by investors . . . If issues relating to these fees undermine investor interests, then we at the SEC have an obligation to step in and adjust our regulations." Further, she called for a comprehensive re-examination of the rule. At the time of this writing, no proposals have been released by the SEC. Readers should be alert for any developments from the SEC on this topic.

### ***Proposed Changes to the Financial System***

.52 In June 2009, the administration revealed proposed rules that would significantly shape the new "normal." The proposed rules would change the level of oversight the U.S. government has on financial markets and give the Federal Reserve more methods to oversee the economy. The proposed rules are intended to prevent the current economic crisis from happening again. At the time of this writing, the proposed rules have yet to be fully addressed by Congress. The administration established five key objectives in its new proposal, including:

- Require strong supervision and regulation of all financial firms
- Provide the government with tools to effectively manage financial crises
- Strengthen consumer protection
- Strengthen regulation of core markets and market infrastructure
- Improve international regulatory standards and cooperation

.53 This first objective—requiring strong supervision and regulation of all financial firms—would be achieved by a new national bank supervisor and a financial services oversight council of regulators as well as the elimination of the federal thrift charter and loopholes in the Bank Holding Company Act. A new level of power also would be given to the Federal Reserve to supervise and regulate any financial firm that is "found to pose a threat to our economy's financial stability based on their size, leverage, and interconnectedness to the financial system." Critics worry whether the Federal Reserve has the toughness and expertise to oversee commercial banks, investment banks, big hedge funds,

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private equity funds, and other financial institutions. Additionally, advisers to hedge funds and other private pools of capital (including private equity funds and venture capital funds) will be required to register with the SEC once their assets under management exceed a modest threshold. Lastly, accounting standards would be reviewed to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices. Fair value accounting standards would be reviewed to identify changes that could provide market participants with fair value information and greater transparency regarding expected cash flows of investments.

**.54** The second objective—providing the government with tools to effectively manage financial crises—would be achieved primarily by preventative actions. This includes imposing more stringent capital, activity, and liquidity requirements on large, interconnected firms, requiring large financial firms to prepare and continuously update a credible plan for the rapid resolution of the firm in the event of severe financial distress, and providing the government with emergency authority to resolve any large, interconnected firm in an orderly manner. To invoke this authority, the Treasury Department would need to determine whether the firm is in default or in danger of defaulting, whether the failure of the firm would have serious adverse effects on the financial system, and whether the use of the special resolution authority would avoid or mitigate these adverse effects.

**.55** The third objective—strengthening consumer protection—would be achieved by the creation of a new Consumer Financial Protection Agency. This agency would have broad authority to protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate all providers of such products and services. For example, this agency would have the authority to reform mortgage laws. This agency would aim to improve and simplify disclosures so consumers have a clear understanding of the benefits and costs associated to the transaction. It also would define standards for "plain vanilla" products that are simple and have straightforward pricing. Although this would create a safer financial marketplace for consumers, critics claim the simplified products would make it difficult for financial firms to distinguish themselves and would stifle innovation for financial products. On the other hand, many see the underlying cause of our economic crisis to be a system that allowed consumers to enter into loans that they should not have qualified or that had terms they did not understand.

**.56** The fourth objective—strengthening regulation of core markets and market infrastructure—would be primarily achieved through comprehensive regulation of the derivatives market, tightening regulation on credit rating agencies, and changing securitization laws. All credit default swap and other over the counter (OTC) derivative markets would be subject to regulation for the first time. They also would be required to be centrally cleared and executed on exchanges and other transparent trading venues. Customized OTC derivatives also would require higher capital charges. By implementing these regulations, the derivative markets could become much less profitable, but could also reduce systemic risk by providing more insight into aggregate market participant liabilities and facilitating central netting of counterparty exposures. Further, many derivatives are customized and complicated, which suggests that their regulation may not be possible and would undermine the goals of the regulation. The SEC will continue to tighten regulation on credit rating agencies to ensure firms have robust policies and procedures to manage and disclose conflicts of

interest. Regulators also will aim to reduce their use of credit ratings in regulations and supervisory practices. In regard to securitization, the originator or sponsor of a securitization would need to retain five percent of the credit risk of securitized exposures. This securitization rule is aimed to align the motives of loan originators with the end investor of a mortgage security; both parties would now have a stake in ensuring that the borrowers will not default on their loans.

.57 Lastly, the fifth objective—improving international regulatory standards and cooperation—would be accomplished by numerous actions. These include strengthening the international capital framework, subjecting foreign financial firms operating in the United States to the same standards as U.S. firms, improving oversight of global financial markets, and enhancing supervision of internationally active financial firms.

.58 The overall sentiment about the administration's plan is that it is ambitious and that reform is definitely needed; however, many groups have strong opposing views about varying aspects of this plan. Further, the question concerning how these reforms may diminish profits and growth of the financial sector has been raised. The 4 most debated aspects of the plan include the consumer protection agency, the 5 percent stake in securitizations, the dramatically increased power of the Federal Reserve, and the regulation of the derivative markets.

## Legislative and Regulatory Developments

### SEC Comments and Observations

**Disclaimer:** The following comments represent the views of the accounting staff of the SEC's Division of Investment Management and do not necessarily reflect the views of the commission or other members on the commission's staff. These comments were compiled by the AICPA Investment Companies Expert Panel and have not been approved or endorsed by the SEC or its staff. This is not intended to be a comprehensive list.

### *Mergers and Liquidation*

.59 The SEC staff has noted an increase in fund mergers and liquidations based on the frequency of questions and N-14 filings received by the SEC staff. The staff expressed concern that some registrants may be attempting to merge away funds with historically poor performance into funds with little or no performance history. Registrants are reminded to look to the 1994 North American Security Trust no-action letter for guidance on evaluating which entity would be deemed the accounting survivor of the fund merger. The evaluation includes consideration of the investment adviser, fund size, fund composition, fund strategy, and expense arrangements, among other things. A registrant should weigh all of these factors in order to conclude upon the accounting survivor.

.60 Where differences in procedures and policies between funds participating in a merger exist (for example, valuation procedures and accounting policies) that will result in changes affecting investors, disclosures in the proxy statements should detail the changes and how the changes will affect investors going forward. Subsequent financial statement disclosures would only need to convey the current accounting policies and procedures of the surviving fund.

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**.61** During fund mergers, most registrants look to utilize Rule 488 of the Securities Act of 1933, "Effective Date of Registration Statements Relating to Securities to Be Issued in Certain Business Combination Transactions," (Rule 488) which provides automatic effectiveness to a registration statement filed on Form N-14 30 days after the date of such filing. Rule 488 requires the registration statement to be materially accurate and complete. A material omission of required financial information (for example, pro-forma financial statements, audited financial statements, or auditor consents) would cause the registration statement not to qualify for 30 day automatic effectiveness under Rule 488.

**.62** The SEC staff reminded registrants that 11-02(b) of Regulation S-X, "Form and content," permits registrants to provide a narrative description of the pro-forma effects of the merger instead of providing pro-forma financial statements, when there are a limited number of pro-forma adjustments and the pro-forma adjustments are easily understood.

**.63** The SEC staff also reminded registrants that when funds bear the costs associated with mergers, the pro-forma capitalization table should be adjusted to reflect the costs and the statement of assets and liabilities should reflect the costs as a pro-forma adjustment. The statement of operations should not reflect these costs as a pro-forma adjustment because such costs are non-recurring.

**.64** The SEC staff provided guidance for the presentation of pro-forma fee tables and capitalization tables in N-14 filings for registrants contemplating multiple mergers. Multiple mergers occur when three or more funds merge and the merger is not contingent upon shareholders of each fund approving the merger. In the pro-forma fee table, the SEC staff would not object if registrants disclose a range of possible expense ratios, which would include the highest and lowest expense ratio and the expense ratio that would be incurred if all funds merged. In the pro-forma capitalization table, the SEC staff would not object if registrants disclose the same combinations as disclosed in the pro-forma fee table or the most likely combination. The SEC staff also cited the 1995 "Dear CFO" letter, which allows registrants to present one set of pro-forma financial statements reflecting the combination of all funds involved in the proposed merger.

**.65** Registrants should be aware of Article 3-18 of Regulation S-X, "Special Provisions as to Registered Management Investment Companies and Companies Required to Be Registered as Management Investment Companies," which requires financial statements included in filings to be current (within 245 days of the effective date of the filing). If the date of the financial statements exceeds 245 days of the effective filing date, the registrant needs to include additional unaudited information.

### ***Distressed Securities***

**.66** Management has the duty to look for and assess information relating to distressed securities. As such, management should have an appropriate process in place to monitor the market, identify troubled securities, and react timely by taking appropriate write-downs or ceasing interest accruals. Registrants should look to Article 12 of Regulation S-X, *Form and Content of Schedules*, for guidance on required disclosures relating to nonincome producing securities. For example, if the security has defaulted on interest payments, it should be flagged in the schedule of investments as a nonincome producing security.



If there has been a partial interest payment, such information should also be flagged or disclosed by the fund.

**.67** Registrants can also look to the 1994 "Dear CFO" letter that provides guidance on how a security should be disclosed in the schedule of investments when it has been written down to zero. A security should be removed from the schedule only after the fund has identified the security as worthless for federal income tax purposes. Omitting securities from the schedule prior to the determination of worthlessness for tax purposes may be misleading to investors interested in evaluating the fund's investments.

### ***Securities Lending***

**.68** An area of increased SEC staff scrutiny is securities lending, specifically as it relates to how the fair value of investments made with cash collateral received in connection with securities lending transactions were determined prior to the height of the credit crisis in September 2008. Many registrants used cash collateral to purchase pooled investment vehicles that were similar to Rule 2a-7 money market mutual funds, although these funds were not registered under the Investment Company Act of 1940. These pools typically held investments with lower credit quality and longer maturities than permitted by Rule 2a-7. As a result, the valuations of the securities in these investment pools were more volatile than the valuations of securities held in money market funds complying with Rule 2a-7, and in some instances, the collateral pool's NAV per share based on market values dropped below \$1 per share. Addressing concerns about overall collateral pool liquidity, securities lending agents continued to process shareholder transactions at \$1 per share, but placed restrictions regarding how investors would be redeemed out of these investment pools. In some cases, funds requesting redemptions over certain thresholds or electing to withdraw from the securities lending program altogether, would be paid in-kind (that is, not in cash) in order to help regulate decreased pool liquidity levels. Some registrants, despite the decrease in value and liquidity of the securities that made up the pool, continued to value these collateral pool investments at \$1 per share until the fourth quarter of 2008. Given that many of these investment pools' market values declined below \$1 per share much earlier than the fourth quarter of 2008, coupled with the redemption restrictions, the SEC staff is questioning whether write-downs should have been taken prior to the fourth quarter of 2008.

**.69** The SEC staff indicated that, in some cases, it was apparent that registrants did not have appropriate policies and procedures in place to monitor the valuation of securities that were acquired with cash collateral received in conjunction with securities lending transactions. The SEC staff stated that registrants are responsible for the fair value determination of cash collateral investments.

**.70** The SEC staff expressed concern over some disclosures they have seen in recent filings. These disclosures were either unclear or lacking altogether. For example, the SEC staff noted that the disclosures in financial statements should convey whether losses have actually been incurred during the reporting period rather than stating that losses may be incurred. Disclosures in the accounting policy footnotes for some funds mentioned that investments of cash collateral received in connection with securities lending programs may decline in value, when in fact the values did decline. If losses were incurred, it should be clearly communicated in the footnotes of the financial statements.

***Fulcrum Fees Under Rule 205-2(c) of the Investment Advisers Act of 1940***

.71 The SEC staff has noted some advisers are switching to the use of fulcrum fees as compensation for their advisory services provided to mutual funds. *Fulcrum fees* are performance based fees in which advisers to mutual funds are compensated depending on how well their managed fund performed relative to a particular benchmark. The fulcrum fee is made up of two components—the base fee (also referenced as the "fulcrum fee" in Rule 205-2(c) of the Investment Advisers Act of 1940, "Definition of 'specified period' Over Which the Asset Value of the Company or Fund under Management is Averaged"), which represents the midpoint of the entire fulcrum fee, and the incentive adjustment. Generally, the adviser is paid the base fee if the fund's performance matches the performance of the benchmark. If the fund outperforms its benchmark, the adviser receives an incentive payment in addition to the base fee. Conversely, if the fund underperforms its benchmark, the adviser is penalized and the base fee is reduced by a negative incentive adjustment. When calculating payments to advisers under a fulcrum fee arrangement, the incentive portion of the fee is required to be calculated using the average net assets over the rolling performance measurement period. However, when calculating the base portion of the fulcrum fee, funds have the option to either apply the base rate to average net assets over the rolling performance measurement period or apply the base rate to current level average net assets (or as Rule 205-2(c)(2) states, "asset value averaged over the most recent subperiod,"—which represents the period between payments). Whichever option is approved by the fund's board, it must be applied consistently. In recent months, some funds switching to a fulcrum fee arrangement are opting to rely on Rule 205-2(c). Fulcrum fee arrangements pursuant to Rule 205-2(c) may result in the adviser reimbursing the fund. This situation can occur when there is a significant decline in assets coupled with poor performance because the negative performance adjustment, when translated from a percentage to dollars, exceeds the base fee. In this scenario, the base portion of the fee is calculated on current level net assets that are much lower than average net assets over the rolling performance measurement period. When funds rely on Rule 205-2(c)(2) to calculate the base portion of the fulcrum fee, the SEC staff is reviewing the disclosure describing the terms of the advisory fee agreement and looking for specific disclosure stating that the adviser will reimburse the fund when the negative incentive adjustment exceeds the base fee.

.72 In addition, the SEC staff has observed instances when advisers have attempted to limit the incentive adjustment to a multiple of the base fee (for example, the incentive adjustment cannot exceed two times the base fee). The SEC staff has objected to these adjustments because it results in the incentive adjustment being tied to current level net assets rather than the average net assets over the rolling measurement period. Also, the SEC staff has objected to other fulcrum fee arrangements when the maximum negative incentive adjustment was less than the maximum positive incentive adjustment.

***Expense Recapture Plans***

.73 In an *expense recapture plan*, the adviser and the fund enter into an agreement whereby the adviser can recapture expenses waived in prior years to the extent that the fund achieves economies of scale relevant to the established expense cap. The SEC staff has seen instances where funds instituted a cap



in the first year of operations and then increased the cap in subsequent years above the current expense ratio. The SEC staff reminds registrants that they cannot begin to recapture prior year expenses incurred under previous expense cap arrangements solely because of an increase in the current year's expense cap. Prior year expenses can be recaptured only if the current expense ratio is less than the prior year expense cap that was in place when such prior year expenses were waived.

### **Multiclass Presentation**

.74 Most funds disclose the class-specific amounts for expenses and distributions on the face of the statement of operations or statement of changes in net assets, respectively. Due to increases in the number of classes offered by some funds, the statements of operations and changes in net assets can be cluttered. The SEC staff indicated that they would not object if a fund presents aggregate amounts (for example, total 12b-1 fees or total distributions) in the financial statements and the class-specific amounts within the accompanying notes to the financial statements.

### **Financial Reporting**

.75 The SEC staff has observed instances where counterparties to derivative instruments and interest rates on particular debt securities have not been identified in the financial statements. Registrants should look to Article 12 of Regulation S-X for required disclosures for each investment in the schedule of investments. The SEC staff indicated that the identification of the counterparty is a material component of a security's description since a fund is exposed to the risk of nonperformance by a counterparty. The SEC staff also expects to see disclosure relating to counterparty risk because it is an important part of the overall financial statement disclosure requirements.

.76 The SEC staff noted two types of payments from affiliates, as defined in the Audit and Accounting Guide *Investment Companies* (the guide): (a) to reimburse the effect of a loss (realized and unrealized) on a portfolio investment, often the result of circumstances outside the fund's, or its affiliates' control, such as an issuer default, and (b) to make the fund whole relative to a realized loss on a portfolio investment made by the fund's adviser in violation of the fund's investment restrictions. The guide requires the fund to state these payments from affiliates separately in the statement of operations as a realized gain, provide a description of the reason for the payments in the notes to the financial statements, and disclose the impact of the payments on the fund's total return in the financial highlights. The SEC staff noted that the fund may receive other payments from affiliates for other reasons. An evaluation must be made to determine whether to disclose the payments on the statement of operations or the statement of changes in net assets. Regardless of the type of payment received, the fund should separately disclose the payments received in the respective financial statement, show the impact on the total return relating to such items in the financial highlights, and provide narrative disclosure of the reasons why such payments were made.

### **Enforcement—Valuation**

.77 The SEC staff highlights two recent enforcement actions relating to valuation in order to remind registrants about the importance of communicating valuation information to the board. The first enforcement action is a complaint against an adviser to a business development company (BDC). The SEC

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alleged that from 2002 to 2005, the adviser substantially overstated the values of two specific private investments that accounted for more than half of the investment portfolio of the BDC in order to generate higher advisory fee income. Management allegedly had material information relating to the valuation of the private investments that could adversely affect their fair values; however, management allegedly did not share that information with the board of directors, the independent auditors, or the investors. The full text of the SEC's complaint is available at [www.sec.gov/litigation/complaints/2009/comp21178.pdf](http://www.sec.gov/litigation/complaints/2009/comp21178.pdf).

**.78** The second enforcement action was against an adviser to a mutual fund. The SEC alleged that management of the fund disclosed to a select group of shareholders the reasons and the likelihood that some of its securities may have to be repriced, which gave these shareholders privileged information over others. Therefore, the informed shareholders would have had the opportunity to cash out their investments in the mutual fund before the fund's NAV declined even further. The SEC also alleged that management did not take into account certain readily available information about the subprime residential mortgage market when valuing its mortgage-backed securities. Management also did not factor in widely reported data about the weakening of an index that had served as a benchmark used to measure risk of a particular mortgage-backed security. In addition, management continued to override lower vendor quotes on some of the funds' investments using higher single quotes from various broker-dealers, one which had a pricing methodology that had been neither reviewed nor approved by the valuation committee. The fund's board adopted a three-tiered valuation system where the first and most preferred valuation method was the use of prices obtained from third-party pricing vendors; the second was the use of prices obtained from one or more third-party broker-dealers; and the third and least preferred method was the use of prices recommended by the fund's portfolio management team. Despite having this three-tiered system, management relied on prices obtained from a single broker-dealer (second tier) or prices recommended by the portfolio management team (third tier) even though the fund was receiving vendor prices (first tier) because no diligence and oversight process was in place to monitor the use of such single broker-dealer quotes or prices recommended by the portfolio management team. Similar to the previously mentioned BDC enforcement action, the SEC alleged management withheld negative information around some of the securities' valuations from the valuation committee. The SEC staff noted that registrants, in certain cases, could rely on a single broker-dealer quote; however, controls and procedures should be in place to monitor how the broker-dealer is deriving the quote. Management should make every effort to obtain multiple quotes whenever possible and should work with their pricing vendors to price those securities for which only a single broker quote is available. The SEC staff reviews a registrant's price challenge process, sources used for pricing, and the board's involvement in the valuation process. The full text of the enforcement action is available at [www.sec.gov/litigation/admin/2009/34-60059.pdf](http://www.sec.gov/litigation/admin/2009/34-60059.pdf).

***Interactive Data***

**.79** In February 2009, the SEC issued a final rule that will require funds to submit their risk and return summaries in interactive data, beginning with initial registration statements, and posteffective amendments that are annual updates to effective registration statements that become effective after January 1, 2011. The full text of the rule is available at [www.sec.gov/rules/final/2009/33-9006.pdf](http://www.sec.gov/rules/final/2009/33-9006.pdf). The commission has not determined whether the schedule of

investments and financial statements will be required to be filed in interactive data.

## SEC Developments

### ***Proposed Rule on Custody of Funds or Securities of Clients by Investment Advisors***

.80 In May 2009, the SEC issued proposed rule Release No. IA-2876 *Custody of Funds or Securities of Clients by Investment Advisors* and requested comments by July 28, 2009. This proposed rule is in response to the Bernard L. Madoff Investment Securities Ponzi scheme (and several others that have come to light) and its goal is to provide additional safeguards around client funds and securities. The proposed rule would amend the custody rule under the Investment Advisers Act of 1940 and related forms. The amendments would require registered investment advisers who have custody of client funds or securities to have an annual surprise examination by an independent public accountant to verify these funds and securities.

.81 Additionally, the proposed rule states that, if client accounts are not maintained by an independent qualified custodian, the adviser or related person must obtain a written report from an independent public accountant each calendar year that includes an opinion on the qualified custodian's controls related to the adviser's or related person's controls relating to custody of client assets. An *independent qualified custodian* is someone other than the adviser or a related person. The independent public accountant issuing the written report must be registered with and subject to regular inspection by the Public Company Accounting Oversight Board (PCAOB). These amendments are intended to provide the SEC with better information about the custodial practices of registered investment advisers. The SEC estimated that approximately 9,500 investment advisers would be subject to surprise examination requirements and about 370 advisers would be subject to the requirement for a written internal control report.

.82 Currently, as described in Rule 206(4)-2 of the Investment Advisers Act of 1940, "Custody or Possession of Funds or Securities of Clients," an adviser acting as general partner of a limited partnership (or other pooled investment vehicle) can follow any 1 of 3 approaches to comply with the reporting requirements of this amended custody rule. Under each of these options, the account statements or audited financial statements may be sent to the investors' independent representatives rather than the investors themselves. The first approach states that a pooled investment vehicle may be audited annually and the audited financial statements must be sent to all the investors in the pooled investment vehicle within 120 days after the pool's fiscal year-end. The second approach states that a qualified custodian may send quarterly account statements directly to the investors in the pool. Lastly, the third approach states that the adviser may send its own quarterly statements to the investors and undergo an annual surprise examination. If an adviser to a fund of funds uses the first approach, it has 180 days from the end of the fund of funds' fiscal year-end to distribute the audited financials to investors. A *fund of funds* is defined in the rule as a pooled investment vehicle that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person of the pool, its general partner, or its adviser. A related person of an adviser includes officers,

partners, directors, most employees, and anyone controlled by, controlling, or under common control with the adviser. In late July 2009, the Center for Audit Quality (CAQ), which is affiliated with the AICPA, and the AICPA submitted comment letters to the SEC on this proposal. The CAQ letter can be located at [www.thecaq.org/newsroom/pdfs/CAQ%20CommentLetter\\_InvestmentAdvisers.pdf](http://www.thecaq.org/newsroom/pdfs/CAQ%20CommentLetter_InvestmentAdvisers.pdf) and the AICPA's letter can be located at <http://sec.gov/comments/s7-09-09/s70909-765.pdf>.

.83 Some highlights of the CAQ's comment letter include the following:

- Examples of situations in which the nature and extent of evidence to verify the existence of investments can provide challenges to the examinations.
- Discussion on whether the costs associated with the verification of 100 percent of the investments and confirmation of all client balances outweigh the benefits provided.
- Whether changes to Rule 206 should be reviewed in association with other similar requirements elsewhere in the regulations for other financial institutions, such as Rule 17f-1, "Custody of Securities with Members of National Securities Exchanges," and Rule 17f-2, "Custody of Investments by Registered Management Investment Company," under the Investment Company Act of 1940.
- Whether special treatment should be considered for investments in nonregistered pooled investment vehicles, such as hedge funds, which would only be able to confirm the balances held by their investors as of the day they close their financial records.
- In situations where investment advisers have engaged an independent custodian of funds and securities, but only have deemed custody as a result of the ability to deduct fees from an account or being a general partner (or general partner equivalent) to a partnership (or partnership equivalent), the SEC should consider allowing such investment advisers to elect either to have a Statement on Auditing Standards (SAS) 70 type 2 internal control report issued or to have a surprise examination performed.
- A requirement to have different independent public accountants perform the surprise examination and internal control examination could result in increased costs without providing any substantive benefit.
- The element of surprise would be enhanced if the independent public accountant has the freedom to choose a period starting from the last date of the previous official surprise examination, which would encompass no less than 4 months and no more than 18 months.

.84 The AICPA's comment letter included the following remarks:

- Consider modernizing examination methodology, scope, and applicable standards to increase efficiency and reduce the cost of the surprise examination, including detailed comments and suggestions.
- Focus the applicability of the surprise examination requirement on investment advisers who have custody beyond an ability to deduct advisory fees.

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- Consider ways to exclude specific advisers with custody provided an independent review mechanism at the qualified custodians exists to verify and reconcile debits from advisory accounts with the advisory agreement.
- Assess ways that existing internal control-related examinations can be incorporated into the internal control report requirement under the proposal.
- Consider whether a type 2 SAS 70 report is the most appropriate format for the internal control report.
- Reevaluate the estimated costs of the surprise examination.
- Take into account that the surprise annual examination and the internal control examination are two separate auditing and attest engagements and the performance of one should not impair the independence of the other.
- Maintain the requirement in the proposal that requires PCAOB registration, inspection, and oversight only for auditors of an adviser who is an issuer or an adviser acting as a qualified custodian.
- Subject auditors of qualified custodians to PCAOB registration, inspection, and enforcement authority, with triennial inspections for auditors of nonissuer qualified custodians.
- Reassess whether the PCAOB registration and inspection status of accountants should be part of the form ADV because this information is readily and publicly available on the PCAOB Web site.

.85 The SEC has received hundreds of comment letters on this issue that can be viewed at the SEC's Web site. Readers should remain alert for a final rule issuance. The full proposal can be accessed at <http://sec.gov/rules/proposed/2009/ia-2876.pdf>.

***Proposed Rule on Facilitating Shareholder Director Nominations***

.86 In June 2009, the SEC issued rule proposals Release Nos. 33-9046 and 34-60089 *Facilitating Shareholder Director Nominations*. The goal of the proposed rules is to remove any obstacles to the exercise of shareholders' rights to nominate and elect directors to company boards of directors and consequently facilitate the ability of shareholders to hold boards responsible. During this time of economic crisis, the accountability and responsiveness of some boards of directors have been questioned, which prompted this proposed rule. Under certain circumstances, the rules would require a company to include a shareholder's (or group of shareholders') nominees for director in their proxy materials, unless the nomination of director candidates by shareholders is prohibited by either the company's governing documents or the laws of its state of incorporation. Under certain circumstances, a company would also be required to disclose shareholder proposals that would amend, or request an amendment to, a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations, provided the proposal does not conflict with other SEC disclosure rules. The proposed rule contains a tiered approach that would determine whether a shareholder or group of shareholders owns a sufficient interest in the company to be eligible to nominate one or more candidates for director. Further, the existing exemptions from SEC proxy rules and the beneficial ownership requirements also have related proposed changes.

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.87 Currently, under Exchange Act Rule 14a-8, "Proposals of Security Holders," a shareholder may submit a proposal for inclusion in a company's proxy statement if the shareholder meets certain ownership criteria. However, circumstances do exist at times when management may choose to omit a shareholder proposal, subject to a no-action review by the SEC staff. One of these circumstances involved a shareholder proposal relating to a director election. In 2007, this was slightly amended to confirm the proxy could exclude a shareholder proposal that would result in an immediate election contest or that would establish a process for shareholders to conduct a future election that involves director candidates other than those nominated by the board of directors.

.88 As drafted, the proposal applies to investment companies generally in the same manner as other registrants. Comments were due to the SEC by August 17, 2009. Readers can access the proposal at <http://sec.gov/rules/proposed/2009/33-9046.pdf> and should be alert for a final rule issuance on this topic by the SEC.

### ***Proposed Rule on Money Market Fund Reform***

.89 On June 30, 2009, the SEC issued proposed rule Release No. IC-28807, which had been considered since 2008, when the money markets came to a standstill during the height of the economic crisis. The SEC wants to make the money market industry more resilient and better equipped to handle short-term disruptions and also increase investor protection in a fund is unable to maintain a stable NAV. The proposed amendments would achieve the following:

- Tighten the risk-limiting conditions of Rule 2a-7 by, among other things, requiring funds to maintain a portion of their portfolios in instruments that can be easily convertible to cash, reducing the weighted average maturity of portfolio holdings, and limiting funds to investing in the highest quality portfolio securities
- Require money market funds to report their portfolio holdings monthly to the SEC
- Permit a money market fund that has "broken the buck" to suspend redemptions to allow for the orderly liquidation of fund assets

.90 Additionally, the liquidity aspects in the proposed rule provide different requirements for retail money market funds and institutional money market funds. Retail funds would need to keep at least 5 percent of their assets in cash, U.S. Treasuries, or investments convertible to cash within 1 day and at least 15 percent must be liquid within 1 week. Institutional funds would need to keep at least 10 percent of their assets in cash, U.S. Treasuries, or investments convertible to cash within 1 day and at least 30 percent must be liquid within 1 week. The difference is attributable to the increased frequency that institutional investors tend to move large amounts of money.

.91 Further, the proposal poses the question whether money market funds should have a floating NAV rather than a stabilized NAV. A concern in regard to a floating NAV for money market funds is that it could trigger a major relocation of assets from money market mutual funds to other investments such as banks and certificates of deposit. Comments on the proposal were due to the SEC by September 8, 2009.

.92 Some of the practical consequences of this proposal could be that companies will have a harder time raising capital by issuing commercial paper because, currently, most money market funds can invest up to 5 percent of



their assets in second tier securities; however, the new proposal would prohibit any ownership in second tier securities. These companies may be forced to resort to more expensive bank loans if commercial paper is no longer a viable option. Another result of this proposal may be the reduction of returns for investors in money market funds. On the other hand, the increased level of safety from these changes could cause an increase in demand for money market funds compared to riskier investments. Readers can access the proposal at <http://sec.gov/rules/proposed/2009/ic-28807.pdf>.

**.93** As discussed in the "Treasury's Extension of Temporary Guarantee Program for Money Market Funds" section of this alert, the SEC adopted interim final temporary rule Release No. IC-28903, which requires a money market fund to report its portfolio holdings and valuation information to the SEC when the market based NAV per share drops below \$0.9975. This interim final temporary rule is effective from September 18, 2009, through September 17, 2010. Comments were due on October 26, 2009.

### ***Proposed Rule on Proxy Disclosure and Solicitation Enhancements***

**.94** In July 2009, the SEC issued proposed rule Release No. IC-28817 *Proxy Disclosure and Solicitation Enhancements*, which would require registrants to make additional disclosures in proxy and information statements, annual reports, and registration statements under the Securities Exchange Act of 1934 and registration statements under the Securities Act of 1933 as well as the Investment Company Act of 1940, regarding the following:

- Overall compensation policies and their affect on risk taking
- Stock and option awards of executives and directors
- Director and nominee qualifications and legal proceedings
- Company leadership structure
- The board's role in the risk management process
- Potential conflicts of interest of compensation consultants that advise companies

**.95** Further, it proposes amendments to rules governing the proxy solicitation process. The timing of reporting of information regarding proxy results would also be accelerated.

**.96** These proposed amendments are in response to the increased focus on corporate accountability and the need for investors to make the most informed decisions possible. General changes to increase transparency such as these have received much attention over the economic crisis of the past two years. As described in the release, part of the underlying rationale of increased disclosure on a company's broader compensation policies is that

[A]t some companies, compensation policies have become disconnected from long-term company performance because the interests of management and some employees, in the form of incentive compensation arrangements, and the long-term well-being of the company are not sufficiently aligned. Critics have argued that, in some cases, the structure and the particular application of incentive compensation policies can create inadvertent incentives for management and employees to make decisions that significantly, and inappropriately, increase the company's risks, without adequate recognition of the risks to the company.

.97 Comments were due to the SEC on September 15, 2009. If these amendments are adopted, the SEC anticipates they would become effective by the 2010 proxy season. The full text of the proposal can be accessed at <http://sec.gov/rules/proposed/2009/33-9052.pdf>.

***Final Rule on Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies***

.98 In January 2009, the SEC issued Release No. IC-28584 *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*. This final rule amends the form used by mutual funds to register under the Investment Company Act of 1940 and to offer their securities under the Securities Act of 1933. It also requires key information to be disclosed in a summary section at the front of the prospectus in plain English and in a standardized order. This key information includes investment objectives and strategies, risks, costs, and performance. Further, this amendment requires a multiple fund prospectus to present the summary information for each fund sequentially and not integrate the information for more than one fund, with one exception. This exception is applicable for summary information that is identical for multiple funds and that is presented at the end of all the individual summaries within a multiple fund statutory prospectus. This rule also changes how a company may satisfy its mutual fund prospectus delivery obligation. Companies will now have the option to provide key information in a summary prospectus to investors, provided on a Web site. Investors will have the ability to request the statutory prospectus be sent to them. Lastly, the amendments of the rule are intended to provide investors of exchange-traded funds with more useful disclosures.

.99 This rule stems from a widespread view that prospectuses are too long and complicated and, therefore, rarely read. The intent of the rule is to provide a user friendly summary that is not overwhelming to the average investor. The proposed rule regarding the disclosure framework was originally released by the SEC in November 2007. The proposed amendments were modified in response to focus group testing and comment letters. These amendments were effective on March 31, 2009; however, the SEC established a transition period after the effective date of the amendments to form N-1A to provide funds time to update their prospectuses or to prepare new registration statements under the revised form. In general, all prospectuses or posteffective amendments filed after January 1, 2010, must comply with the new format. The full text of the final rule can be accessed at <http://sec.gov/rules/final/2009/33-8998.pdf>.

***Final Rule on Amendments to Rules for Nationally Recognized Statistical Rating Organizations***

.100 In February 2009, the SEC issued Release No. 34-59342 *Amendments to Rules for Nationally Recognized Statistical Rating Organizations*, which had an effective compliance date of April 10, 2009, except for the amendment to 17 CFR 240.17g-2(d), which had a compliance date of August 10, 2009. These rule amendments are intended to address concerns about the integrity of nationally recognized statistical rating organizations' (NRSROs) credit rating procedures and methodologies by imposing additional requirements on them. These requirements include the following:



- Increasing the transparency of the rating methodologies by strengthening the NRSRO's disclosure of performance measurement statistics and the procedures and methodologies used by the NRSRO in determining credit ratings for structured finance products and other debt securities on form NRSRO.
- Prohibiting certain transactions that create conflicts of interest.
- Enhancing the NRSRO's recordkeeping obligations under 17 CFR 240.17g-2(d) to assist the SEC in performing regulatory and oversight functions. This includes posting—in eXtensible Business Reporting Language (XBRL) format—a random sample of 10 percent of the issuer-paid credit ratings and their histories. This applies to each class of credit ratings for which the NRSRO is registered and has issued 500 or more ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated. Each new ratings action should be reflected in such histories no later than 6 months after the date of the rating action, on its corporate Web site.
- Furnishing the SEC with an additional annual report—an unaudited report of the number of credit ratings that were changed during the fiscal year in each class of credit ratings that the NRSRO is registered with the SEC.

.101 This final rule stems from a series of related actions by the SEC, which were first proposed in June 2008. Based on comment letters, this final rule includes significant revisions from the proposed rules, primarily regarding practical impediments. The full text of the final rule can be accessed at <http://sec.gov/rules/final/2009/34-59342.pdf>.

### ***Final Rule on Interactive Data for Mutual Fund Risk and Return Summary***

.102 Also in February 2009, the SEC issued Release No. IC-28617 *Interactive Data for Mutual Fund Risk / Return Summary*, which requires open-end management investment companies (mutual funds) to provide the risk and return summary section of their prospectuses (to the SEC and on their Web sites) in interactive data format using XBRL. Additionally, investment companies will be permitted to submit portfolio holdings information in the SEC's voluntary program without being required to submit other financial information. The final rules are intended to make risk and return summary information easier for investors to analyze and assist in automated regulatory filings and business information processing. This rule has an effective date of July 15, 2009, and a compliance date of January 1, 2011. Some specifics of the rule include the following:

- Mutual funds must submit a new exhibit with their risk and return summary information in interactive data format, beginning with initial registration statements, and posteffective amendments that are annual updates to registration statements that become effective after January 1, 2011.
- An interactive data file submitted with a registration statement must be filed as a posteffective amendment under Rule 485(b), "Immediate Effectiveness," under the Securities Act of 1933 and must be filed after effectiveness of the related filing, but in no case

later than 15 business days after the effective date of the related filing.

- An interactive data file submitted with a prospectus filed pursuant to Rule 497(c) or (e), "Filing of Investment Company Prospectuses—Number of Copies," under the Securities Act of 1933 may be submitted with the filing or subsequent thereto, but no later than 15 business days after the related filing.
- A mutual fund that is required to submit an interactive data filing to the SEC must also post the same information in interactive format on its Web site no later than the end of the calendar day it was submitted (or was required to submit) the information to the SEC.
- A mutual fund that does not submit or post the required interactive data will lose the ability to file posteffective amendments to its registration statement until the requirements are met.
- New SEC Regulation S-T addresses the liability for an interactive data file; however, these liability provisions are only applicable through October 31, 2014, at which point an interactive data file will be subject to the same liability provisions as the related official filing.
- The voluntary program is being modified to allow for participation by mutual funds with respect to risk and return summary information through January 1, 2011, but continues to allow investment companies to participate with respect to financial statement information. Therefore, the voluntary program will continue after the compliance date for the financial statements of investment companies that are registered under the Investment Company Act of 1940, BDCs, and other entities that report under the Securities Exchange Act of 1934 and prepare their financial statements under Article 6, *Registered Investment Companies* of Regulation S-X.
- Registered investment companies, business development companies, and other entities that report under the Securities Exchange Act of 1934 and prepare their financial statements in accordance with Article 6 of Regulation S-X are permitted to submit exhibits under the voluntary program containing a tagged schedule of portfolio holdings without having to submit other financial information in an interactive format.

**.103** These amendments are in line with the SEC's goal of promoting efficient and transparent capital markets. The full text of this rule can be accessed from the SEC's Web site at <http://sec.gov/rules/final/2009/33-9006.pdf>.

### ***Internal Revenue Service Revenue Procedure 2009-28***

**.104** In May 2009, the IRS issued Revenue Procedure 2009-28, which sets forth the circumstances when the filing of form 8927 "Determination Under Section 860(e)(4) by a Qualified Investment Entity" by a regulated investment company (RIC) or real estate investment trust (REIT), is treated as a self-determination of an adjustment to its taxable income for purposes of the Internal Revenue Code (IRC) §860(e) "Determination." Until now, the IRS had not specified the instructions for the determination. This revenue procedure states that the date of self-determination will be the date of the postmark on the

envelope containing form 8927. The date is relevant because a deficiency dividend must be distributed on or within 90 days after the date of determination. This revenue procedure was effective July 1, 2009. The full text of the revenue procedure can be located at [www.irs.gov/irb/2009-20\\_IRB/ar11.html](http://www.irs.gov/irb/2009-20_IRB/ar11.html).

### **IRS Revenue Procedure 2009-15**

.105 In February 2009, the IRS issued Revenue Procedure 2009-15, which allows distributions of a RIC or a REIT's own stock to qualify as a distribution pursuant to section 301 *Distribution of Property* of the IRC. This procedure amplifies and supersedes Revenue Procedure 2008-68, which provides temporary guidance regarding stock distributions by publicly traded REITs. The IRS will treat a distribution of stock by a RIC or REIT as a distribution of property and the amount of such distribution is equivalent to the amount of money that could have been received instead, if

- the distribution is made by the entity to its shareholders with respect to its stock,
- stock of the entity is publicly traded on an established securities market in the United States,
- the distribution is declared with respect to a taxable year ending on or before December 31, 2009,
- pursuant to each declaration, each shareholder may elect to receive their total entitlement under the declaration in either money or stock of the distributing entity of equivalent value subject to a limitation on the amount of money to be distributed in the aggregate to all shareholders, provided that
  - such limitation is not less than 10 percent of the aggregate declared distribution, and
  - if too many shareholders elect to receive money, each one electing to receive money will receive a pro rata amount of money corresponding to the shareholder's respective entitlement, but in no event will the shareholder receive less than 10 percent of his or her entire entitlement in money.
- the calculation of the number of shares will be determined as close as practicable to the payment date based upon a formula utilizing market prices, and
- for any shareholder participating in the dividend reinvestment program (DRIP), the DRIP applies only to the extent that, in the absence of DRIP, the shareholder would have received the distribution in money.

.106 This procedure is effective for distributions declared on or after January 1, 2008, with respect to a taxable year ending on or before December 31, 2009. The full text of the procedure can be located at [www.irs.gov/pub/irs-drop/rp-09-15.pdf](http://www.irs.gov/pub/irs-drop/rp-09-15.pdf).

.107 In September 2009, the FASB Emerging Issues Task Force (EITF) addressed whether shares issued pursuant to the terms of the no-action letter should be accounted for as discrete stock issuances or, alternatively, as stock dividends (equivalent to stock splits) with retrospective adjustment of per share

data and related share amounts. A consensus emerged (subject to public exposure) that accounting for the share issuance as a stock dividend would be appropriate, to be applied to fiscal periods ending on or after December 15, 2009. Readers should consult the FASB Web site, referring to the Proposed Accounting Standards Update (ASU)—*Equity (Topic 505) and Earnings per Share (Topic 260): Accounting for Stock Dividends, Including Distributions to Shareholders with Components of Stock and Cash (A Consensus of the FASB Emerging Issues Task Force)*. Comments on this proposed ASU were due on October 26, 2009.

### **SEC No-Action Letter to American Capital**

**.108** On June 30, 2009, the SEC issued a no-action letter to American Capital, Ltd. regarding its distribution paid partly in stock. American Capital is a closed-end investment company that has elected to be regulated under the Investment Company Act of 1940 as a BDC. Further, American Capital is listed and traded on NASDAQ. American Capital requested no-action relief to permit it to declare and distribute the 10 percent cash minimum for distributions of investment company taxable income or net long-term capital gains made in reliance on Revenue Procedure 2009-15. American Capital specifically requested no-action relief from section 18(a)(1)(B) "Capital Structure of Investment Companies" of the Investment Company Act of 1940, which makes it unlawful

for any registered closed-end company to issue any class of senior security, or to sell any such security of which it is the issuer, unless . . . provision is made to prohibit the declaration of any dividend (except a dividend payable in stock of the issuer), or the declaration of any other distribution, upon any class of the capital stock of such investment company . . . unless, in every such case, such class of senior securities has at the time of the declaration of any such dividend or distribution . . . an asset coverage of at least 300 per centum after deducting the amount of such dividend [or] distribution.

**.109** As of March 31, 2009, and December 31, 2008, American Capital's asset coverage had fallen substantially below 300 percent. The company stated, however, that allowing them to make a cash distribution under Revenue Procedure 2009-15 was in the best interests of both the senior security holders and the shareholders because failure to comply with the 10 percent minimum cash distribution would cause the company to fail to qualify for pass-through tax status, resulting in substantial corporate tax liability. The SEC staff concluded that they would not recommend action against American Capital under the preceding sections of the act if American Capital pays the 10 percent cash minimum for distributions of investment company taxable income or net long-term capital gain. The full letter can be accessed at [www.sec.gov/divisions/investment/noaction/2009/americancapital063009.htm](http://www.sec.gov/divisions/investment/noaction/2009/americancapital063009.htm).

### **U.S. Treasury Securities Fails Charge Trading Practice**

**.110** The Treasury Market Practice Group and the Securities Industry and Financial Markets Association (sponsors) published *U.S. Treasury Securities Fails Charge Trading Practice* to provide a standard procedure that market participants may use to assess and pay fails charges for certain delivery failures in the market for U.S. treasury securities. A *delivery failure* occurs when one party fails to deliver treasuries to another party (nonfailing party) by the date previously agreed to by the parties. This trading practice is a recommendation

by the sponsors in order to preserve and enhance the efficiency and operational integrity of the treasuries market. This trading practice provides a mechanism for compensating a nonfailing party in connection with a failed delivery. Further, this trading practice is also endorsed by the Federal Reserve Bank of New York. Any adopter of this trading practice should consider incorporating it into the terms of its relevant transactions in treasuries.

.111 The trading practice describes the 2 following limited scenarios when a failing party would not be subject to a fails charge under this trading practice:

- Any transaction settling through a clearing agency where the rules of such agency subject a failing party to a fails charge
- If the fails charge over the life of such delivery failure is less than or equal to \$500 (if a transaction is executed by an agent on behalf of multiple principals and the allocation of the transaction to such principals is disclosed to their counterparty in the ordinary course, the \$500 threshold will be applied separately to the fails charge calculated for each principal)

.112 The trading practice provides a specific formula to calculate the fails charge that accrues on each calendar day in the period from and including the date of such delivery failure but excluding the date the delivery failure is resolved. It also incorporates the most recent target level for the federal funds rate and the amount of funds or market value of the securities due from the nonfailing party.

.113 The trading practice also provides application guidance to common transaction types involving the delivery of treasuries against the payment of funds or the pledge or title transfer of securities such as: cash market transactions, repurchase transactions, securities loan transactions, option transactions, and forward transactions. This trading practice can be accessed at [www.sifma.org/capital\\_markets/docs/Fails-Charge-Trading-Practice.pdf](http://www.sifma.org/capital_markets/docs/Fails-Charge-Trading-Practice.pdf).

## Commodity Futures Trading Commission Developments

### *Commodity Futures Trading Commission Annual "Dear CPO" Letter*

.114 On January 26, 2009, Commodity Futures Trading Commission (CFTC) developments staff issued its annual letter to commodity pool operators (CPOs) outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. A similar letter is anticipated in January 2010. The letter emphasized the CFTC staff's concerns and, accordingly, may alert the auditor to high risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff suggests that CPOs share the letter with their independent auditors.

.115 Major concerns addressed in the letter include the following:

- Due dates of commodity pool financial filings and late filings
- Complex entities and complex capital structures
- Requests for limited relief from U.S. generally accepted accounting principles (GAAP) compliance for certain offshore commodity pools
- Accounting developments, including the following:
  - Fair value measurements
  - Alternative investments and audit considerations

- AICPA technical guidance regarding offering costs (Technical Question and Answer [TIS] section 6910.23, "Accounting Treatment of Offering Costs Incurred by Investment Partnerships" [AICPA, *Technical Practice Aids*], and TIS section 6910.24, "Meaning of 'Continually Offer Interests'" [AICPA, *Technical Practice Aids*])

.116 The CFTC issued similar letters in prior years, which are available on its Web site. The 2009 letter notes that those letters should be consulted with respect to commodity pool annual financial statements and reporting. Specifically, relevant and still applicable information available in such prior letters includes the following:

- AICPA Statement of Position (SOP) 03-04, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide, Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships* (AICPA, *Technical Practice Aids*, ACC sec. 10,890), primarily codified in FASB ASC 946-210 (2005 CPO letter; an illustration of the investments schedule and additional fund of funds disclosures can be found in attachment B)
- Reports for pools for the fiscal year when an initial claim of exemption under Regulation 4.13 is filed (2006 CPO letter)
- Notice of replacement of accountant (2006 CPO letter)
- Notice regarding election of fiscal year other than calendar year (2006 CPO letter)
- Requests for confidential treatment of commodity pool annual reports (2006 CPO letter)
- AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships* (AICPA, *Technical Practice Aids*, ACC sec. 10,660), primarily codified in FASB ASC 946-210, applicability to both required audited and unaudited commodity pool annual financial reports (2004 CPO letter)
- Filing of initial annual reports and final annual reports (2007 CPO letter).

.117 CFTC interpretations and other staff letters are available on the CFTC's Web site, [www.cftc.gov](http://www.cftc.gov).

### **Commodity Pools**

.118 National Futures Association (NFA) adopted compliance rules applicable to CPOs. The rules include the following:

- Rule 2-45 prohibits a CPO from permitting a commodity pool to use any means to make a direct or indirect loan or advance of pool assets to the CPO or any other affiliated person or entity.
- Rule 2-46, effective when NFA completes the necessary programming changes, requires a CPO, within 45 days after the end of each quarterly reporting period, to report the following:
  - The identity of the pool's administrator, carrying broker(s), trading manager(s), and custodians.



- A statement of changes in NAV for the quarterly reporting period.
- Monthly performance for the 3 months comprising the quarterly reporting period.
- A schedule of investments identifying any investment that exceeds 10 percent of the pool's NAV at the end of the quarterly reporting period.

### ***Commodity Pool Operator Periodic Account Statements and Annual Financial Reports***

**.119** The CFTC proposed to amend rules governing the periodic account statements and annual financial reports that CPOs are required to provide to commodity pool participants. Annual financial reports also are to be filed with the NFA. The amendments proposed would do the following:

- Permit, under certain circumstances, use of International Financial Reporting Standards (IFRSs) in the preparation of commodity pool annual reports;
- Specify detailed information that must be included in the periodic account statements and annual reports for commodity pools with more than one series or class of ownership interest;
- Clarify that the periodic account statements must disclose either the NAV per outstanding participation unit in the pool or the total value of a participant's interest or share in the pool;
- Extend the time period for filing and distributing annual reports of commodity pools that invest in other funds;
- Codify existing CFTC staff interpretations regarding the proper accounting treatment and financial statement presentation of certain income and expense items in the periodic account statements and annual reports;
- Streamline annual reporting requirements for pools ceasing operation; and
- Clarify and update several other requirements for periodic and annual reports prepared and distributed by CPOs.

**.120** For current information on the status of the CFTC proposal, readers should refer to the CFTC Web site, [www.cftc.gov](http://www.cftc.gov), under the Law and Regulation tab.

### **Reporting of Adjusted Basis in Securities Transaction**

**.121** The EESA, in addition to the provisions previously discussed, includes new rules for determining and reporting the basis of certain securities. The new reporting requirements are in sections 6045(g) and (h), 6045A, and 6045B of the IRC, which are specifically included in the Energy Improvement and Extension Act of 2008, a division of the EESA. As a result of the new rules, financial institutions will be required to track investors' cost basis for stocks acquired after Jan. 1, 2011; mutual fund shares and dividend reinvestment plans bought beginning in 2012; and debt instruments, options and other securities in 2013. In February 2009, the IRS released Notice 2009-17, which indicated that the IRS intends to issue additional guidance regarding important details relating to the new cost basis reporting law. The notice included question for



public comment for 36 specifically listed topics, such as those previously mentioned. Comments were due on March 2, 2009. Readers are encouraged to visit the IRS Web site at [www.irs.gov](http://www.irs.gov) for additional developments.

## Audit and Attestation Issues and Developments

### Audit Risks Arising From Current Economic Conditions

.122 The continued, challenging recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients in prior years. Some risks that may affect an entity in the current economic environment are as follows:

- Constraints on the availability of capital and credit
- Going concern and liquidity issues
- Marginally achieving explicitly stated strategic objectives
- Use of off-balance-sheet financing
- Special purpose entities, joint ventures, or other complex financing arrangements
- Volatile real estate and business markets
- The credit crisis, which can cause significant measurement uncertainty, including accounting estimates and fair value measurements

.123 Although many of these risks are not new to businesses, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constantly changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

.124 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern given the current economic conditions. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

### *Investment Company Audit Risks Arising From Current Economic Conditions*

.125 Auditors should consider the overall effect of risks on an entity's portfolio of subprime mortgages and related investments (for example, ABCP or high yield debt or loans). The auditor may consider the entity's internal control as well as policies that affect the management and monitoring of these investments. In particular, the auditor may consider the extent that the entity analyzes the collateral supporting various asset-backed securities and whether

the entity has enhanced its monitoring procedures in light of the deterioration in collateral that has been exhibited.

**.126** Auditors also should consider the increased difficulty of obtaining reliable valuations for certain types of asset-backed securities, given the decrease in market liquidity. Again, the auditor may consider the entity's controls over valuation, in particular the extent to which the entity monitors valuations obtained from brokers and external pricing services for consistency with its own observations of market conditions. In addition, the auditor may consider the involvement of valuation committees or other internal review groups independent of portfolio managers in assessing the day-to-day reasonableness of security valuations and overriding quotations that appear to be unrepresentative. This is of equal importance for money market funds that are permitted to use the amortized cost valuation method only if the results are not materially different from those obtained by valuing securities using current market quotations.

**.127** To the extent either asset-backed or traditional fixed-income securities have experienced credit deterioration, the auditor may consider whether income that has been recognized as receivable on the securities remains collectible. The 2009 Audit and Accounting Guide *Investment Companies* (the guide) notes in paragraphs 2.73–.74:

In accordance with the guidance provided in FASB ASC 450, [*Contingencies*,] accrued interest should be written off when it becomes probable that the interest will not be collected and the amount of uncollectible interest can be reasonably estimated. As explained by paragraphs 17–18 of FASB ASC 946-320-35, the portion of interest receivable on defaulted debt securities written off that was recognized as interest income should be treated as a reduction of interest income. Write-offs of purchased interest should be reported as increases to the cost basis of the security, which will result in an unrealized loss until the security is sold.

**.128** The guide also provides guidance on accounting for expenditures made in support of defaulted debt securities. The disclosure requirements of FASB ASC 825-10-50 relating to concentrations of credit risk for all financial instruments also should be considered.

**.129** The auditor should consider the existence of financial covenants and the entity's compliance with those covenants to the extent an investment vehicle has employed leverage. The auditor may obtain an understanding of management's ongoing compliance monitoring process. If the vehicle is no longer in compliance with the covenants, the auditor should assess the appropriate accounting and reporting implications, including AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1). A more detailed discussion of going concern follows.

**.130** The advisers or other sponsors of a number of registered and unregistered money market funds have either purchased distressed securities directly from the funds at their amortized cost (above current market value) or have entered into credit support agreements to enable the funds to continue to engage in shareholder transactions at a constant \$1 per share NAV. Preparers and auditors of investment company financial statements should review paragraphs 7.82–.84 in the guide for accounting and disclosure guidance for payments made to an investment fund by affiliates. Additionally, the staff of the SEC Division of

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### Audit Risk Alert

Investment Management has indicated their views for appropriate accounting and disclosure by money market funds for credit support agreements through several no-action letters issued in 2008.

**.131** In certain instances, the auditor may need special skills or knowledge to plan and perform auditing procedures for institutions that deal with subprime mortgage-backed and other asset-backed securities. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), states that "for some derivatives and securities, [GAAP] may prescribe presentation and disclosure requirements." Furthermore, AU section 332 advises the auditor to consider the form, arrangement, and content of the financial statements (including the notes) when evaluating the adequacy of presentation and disclosure. Auditors also may consider using a specialist when determining how to audit an entity that deals in derivatives. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance on the use of a specialist during an engagement and is discussed in more detail in the "Using the Work of a Specialist" section of this alert.

### Auditing Alternative Investments

**.132** The AICPA Practice Aid *Alternative Investments—Audit Considerations* is a useful tool for auditors that focuses on the existence and valuation assertions associated with alternative investments, but also discusses general considerations pertaining to auditing alternative investments, management representations, disclosure of certain significant risks and uncertainties, and reporting. As defined in the foreword of the practice aid, *alternative investments* are

investments for which a readily determinable fair value does not exist . . . includ[ing] private investment funds meeting the definition of an investment company . . . such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds.

**.133** You can access the full text of this practice aid on the AICPA's Web site at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/alternative\\_investments.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/alternative_investments.htm).

**.134** The practice aid suggests that, when the auditor determines the nature and extent of audit procedures, he or she should include verifying the existence of alternative investments. Confirming investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Confirmation of existence of the holdings of the alternative investments on a security-by-security basis may constitute adequate audit evidence. Even if the fund manager confirms all requested information, the auditor may, based on his or her assessment of the risks of material misstatement, perform additional procedures, such as the following:

- Observe management site visits or telephone calls to investee funds (or reviewing documentation of such calls or visits)
- Review executed partnership, trust, limited liability corporation, or similar agreements

- Inspect other documentation supporting the investor's interest in the fund (for example, correspondence from the fund or trustee acknowledging transactions with the fund)
- Review periodic statements from the fund reflecting investment activity and comparing activity with amounts reported by the investor
- Vouch relevant cash receipts and disbursements

**.135** Using one or more of the preceding approaches or another audit procedure in order to gather sufficient appropriate audit evidence with respect to the existence assertion requires considerable auditor judgment.

**.136** Given the state of the economy, many funds are imposing limitations on redemptions and some are even unwinding. As this occurs, the fair value measurements applied to these investments will fall under increased scrutiny and become even more important. Further, in September 2009, FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, which discusses fair value measurement of alternative investments. For more details, see the "Fair Value" section of this alert or the ASU on FASB's Web site at [www.fasb.org](http://www.fasb.org).

## Auditing Fair Value Measurements

**.137** In addition to understanding the evolving accounting guidance relative to fair value accounting, auditors should be aware of audit issues involving fair value accounting that remain a hot topic during the economic crisis. It is management's responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332.

**.138** In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach. Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures. Because of the wide range of possible fair value measurements—from relatively simple to complex—and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data; (b) developing independent fair value estimates for corroborative purposes; or (c) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the

auditor evaluates whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. In relation to FASB ASC 820, *Fair Value Measurements and Disclosures*, this might include whether the market is distressed, whether the transaction was an orderly transaction, the reasonableness of the determination within the fair value hierarchy of inputs, and the reasonableness of the underlying assumptions.

### ***Fair Values of Securities***

**.139** The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). The extent that these prices are based on quoted prices from an active market or other observable inputs will be a consideration on the auditor's procedures, as well. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (typically fair value, as defined in FASB ASC 820-10-20). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB ASC 820, quoted prices in active markets are considered level 1 inputs.

**.140** When an entity performs its own valuation, fair value testing procedures may include the following:

- Assessing the reasonableness and appropriateness of the model
- Comparing the assumptions to industry reports or benchmarks
- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transactions

**.141** Whether the inputs to the entity's valuation model are observable determines their characterization as level 2 or level 3 inputs within FASB ASC 820. When extensive judgment is needed, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

**.142** Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles. The AICPA has released a proposed redrafted SAS on auditing accounting estimates, including fair value. See the "On the Horizon" section of this alert for further details.

#### **PCAOB Staff Audit Practice Alert No. 4**

.143 Following the issuances of FASB Staff Position (FSP) FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, FSP FAS 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, and FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, in April 2009, the PCAOB issued Staff Audit Practice Alert (PA) No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.04) (these FSPs were codified in FASB ASC 820-10; primarily at FASB ASC 310-55, 325-40, and 320-10; and FASB ASC 270-10-50, 320-10, 825-10-50, respectively). PA No. 4 made the following observations:

- Auditors operating under PCAOB standards for audits and reviews should be aware that some PCAOB standards include descriptions of accounting requirements that are no longer current. Auditors should disregard descriptions of accounting requirements in PCAOB standards that are inconsistent with the guidance previously mentioned. The PCAOB is planning to remove descriptions of accounting requirements from auditing standards as it replaces or substantively revises its interim standards. Further, the PCAOB has on its agenda a project to address the auditing standards related to auditing accounting estimates and auditing fair value measurements.
- The auditor should test the entity's fair value measurements and disclosures; because of the wide range of measurements, from fairly simple to complex, and the varying levels of risk of material misstatement, planned audit procedures may vary significantly in nature, timing and extent.
- PA No. 4 also noted that, in accordance with Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), "[a] change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph", if comparability of the financial statements has been materially affected.

.144 This PA also discusses auditor considerations related to reviews of interim financial information, impairment losses, and fair value disclosures (including those in management's discussion and analysis). The related AU section guidance to these topics is further discussed in this alert.

#### **Auditing Accounting Estimates**

.145 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both subjective and objective factors with professional skepticism. As discussed in



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paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

**.146** For example, in the current market, new patterns may emerge. In this economic climate, a key aspect of AU section 342 is for an auditor to determine the reasonableness of management's accounting estimates with an extra degree of professional skepticism. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

**.147** The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342. The AICPA has released a proposed redrafted SAS on auditing accounting estimates, including fair value. See the "On the Horizon" section of this alert for further details.

### Using the Work of a Specialist

**.148** It may be necessary to use a specialist (such as a valuation expert) to assist in auditing complex or subjective matters. Examples of matters when an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336 provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), is applicable rather than AU section 336.

**.149** When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements.



## Consideration of an Entity's Ability to Continue as a Going Concern

**.150** The consideration of an entity's ability to continue as a going concern is required in every audit performed under generally accepted auditing standards and is an especially important consideration in the current state of the economy. An entity's ability to continue as a going concern is affected by many factors related to the current uncertain economy, such as the industry and geographic area where it operates, the financial health of its customers, and financing sources.

**.151** As explained by paragraph .02 of AU section 341, the auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report. Therefore, this is an ongoing evaluation that extends through the date of the auditor's report.

**.152** The auditor has a responsibility to evaluate whether a substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time. AU section 341 notes that this is a period not to exceed one year beyond the date of the financial statements being audited.

**.153** Audit teams may find it useful to have preliminary discussions about going concern considerations during engagement planning meetings; however, as noted in AU section 341, it is not necessary to design audit procedures around specifically identifying the possibility of a going concern because results of typical audit procedures should illuminate any indicators. These procedures may consist of analytical procedures, review of subsequent events, review of compliance with financing agreements, review of board minutes, inquiry of legal counsel, and confirmation with related third parties of the details of arrangements to provide or maintain financial support.

**.154** Some risks related to the current state of the economy that may influence an entity's ability to continue as a going concern include the following:

- The entity is experiencing significant redemptions from investors.
- The financial condition of the adviser is deteriorating.
- The entity is not performing consistent with investor expectations, competitors, or other benchmarks.
- An entity's financial health could be significantly weakened if its investors have been strongly affected by the economic crisis.
- Some entities may be hesitant to include informative and transparent going concern disclosures.

**.155** If the auditor believes a substantial doubt on the entity's ability to continue as a going concern exists, the next steps are to obtain management's plans to mitigate the effect of such conditions and then assess the likelihood that these plans can be effectively implemented. Additionally, auditors may consider posing the following questions to help make their assessment on the likelihood of management's plans to successfully mitigate their going concern risk:

- Have trading margins and limits been reduced by brokers and counterparties? If so, how does management believe such changes will affect the ability to continue with the funds strategy?

- If negative performance trends exist, how does management plan on turning them around?
- If turnover of key personnel has occurred, what actions are being taken to replace these positions?
- What is the plan to maintain or increase the balance sheet liquidity?
- Do any restrictions exist that could limit management's ability to carry out these plans?

**.156** If, after considering management's plan, an auditor determines a substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should communicate with those charged with governance of the entity, in accordance with AU section 341. In that instance, the auditor also should consider the effects on the entity's financial statements and the adequacy of the related disclosures, and an explanatory paragraph should be added to the audit report following the opinion paragraph.

**.157** Alternatively, if management's plan mitigates the risk of the entity's ability to continue as a going concern, the auditor should consider disclosing the primary conditions that gave rise to the initial doubt and management's plans. These disclosures are especially important for financial statement users to fully comprehend the entity's financial strength and ability to continue as a going concern.

**.158** FASB has undertaken a project that will relocate the guidance related to going concern from the realm of auditing standards to accounting standards. See the "On the Horizon" section of this alert for further details.

### Auditor Responsibilities for Subsequent Events

**.159** In September 2009, the AICPA issued TIS section 8700.02, "Auditor Responsibilities for Subsequent Events" (AICPA, *Technical Practice Aids*), which discusses the effects of the company's responsibility to disclose the date through which the subsequent events have been evaluated on the auditor's responsibilities for subsequent events. This TIS section was issued in response to FASB's issuance of FASB Statement No. 165, *Subsequent Events* (codified in FASB ASC 855, *Subsequent Events*). This new guidance is discussed in the "Accounting Issues and Developments" section of this alert. Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to, or disclosure in, the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the auditor's report. This typically will result in the same date being used for both the auditor's report and the date disclosed by management through which they have evaluated subsequent events. The auditor may consider discussing these dating requirements with management in advance of beginning the audit and include any agreed upon understanding in the engagement letter. The full TIS section can be accessed at [www.aicpa.org/download/acctstd/TIS-8700\\_02.pdf](http://www.aicpa.org/download/acctstd/TIS-8700_02.pdf).

### Consideration of Fraud in a Financial Statement Audit

**.160** AU section 316 is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to

obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, as stated in paragraph .02 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1).

**.161** Three conditions generally are present when fraud occurs:

- Management or other employees have an incentive or are under pressure, which provides a reason to commit fraud.
- Circumstances exist (for example, the absence of controls, ineffective controls, or the ability of management to override controls) that provide an opportunity for a fraud to be perpetrated.
- Those involved are able to rationalize committing a fraudulent act.

**.162** The current economic situation may result in unexpected losses and possibly cause financing or liquidity difficulties for many entities. Additionally, management may be valuing many illiquid securities using inherently subjective methodologies. Management may rationalize a valuation based upon long term prospects rather than current market conditions. These situations may provide management additional opportunity and incentive to commit fraud.

**.163** Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. AU section 316 provides additional information, including ways for the auditor to respond to the risk of material misstatement due to fraud.

## Accounting for Losses Due to Fraud

**.164** A topic of discussion for management and their auditors is the manner how losses due to fraud are reflected in the financial statements. FASB ASC 250-10 provides guidance on accounting changes and error corrections and may be useful to accountants and auditors. It is important that the auditor understand how the decision to account for losses due to fraud was reached and that proper disclosure be made in the financial statements.

**.165** Auditors also may consider whether management has properly disclosed or recognized any liability associated with the potential clawback of distributions received from the perpetrator of Ponzi schemes. In the case of Bernard L. Madoff Investment Securities, a possibility exists that the bankruptcy trustee may file lawsuits to recover funds distributed to investors prior to the discovery of the fraud for the purpose of redistributing the funds. Management, in conjunction with appropriate legal counsel, should determine the probability and result of such a lawsuit and disclose or accrue a potential liability, as required by FASB ASC 450.

## Evaluating the Existence of Assets

**.166** The Madoff case, and other recent fraud investigations, brings to light a number of risks that continually need to be considered and responded

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to by management and auditors. Due to the nature of securities and other financial instruments, determining and testing the ownership and existence of investments has become more difficult. Often, securities and other investments purchased on behalf of an entity are held in the name of a broker organization, which may or may not be a custodian; generally, custodians do not obtain a paper document, only an electronic record of the assets.

**.167** Some examples of risks inherent in investment transactions that may be relevant when assessing the existence of investments include the following:

- The assets involved may not be readily available to physical inspection.
- A lack of effective, independent, third-party oversight.
- The information received from a broker organization in the form of monthly statements or in response to audit confirmation requests may require further verification to assess its reliability.
- The transactions may be complex in nature, making them difficult to understand.

**.168** Management has a responsibility to design an internal control system that is responsive to the risk of existence of assets (in addition to the valuation of assets). As part of their risk assessment procedures, auditors need to assess those controls and determine if the controls have been implemented. Depending on the results of those assessments, the auditor should design an audit strategy that takes into consideration the entity's controls, including testing those controls, if they are to be relied upon and used as part of the auditor's audit evidence regarding the existence assertion. If the auditor's assessment indicates that management's design or operation of controls is not effective, then those deficiencies should be communicated to those charged with governance if the control deficiency is a significant deficiency or material weakness.

**.169** Examples of procedures that can be performed by management that are designed to assess the existence of assets could include the following:

- Obtaining through site visits and documenting an understanding of existence controls placed in operation by any service organization that is utilized by the entity and periodically reassessing that understanding
- Obtaining evidence through direct testing or a SAS 70 type 2 report that the service organization's existence controls are appropriately designed and operating effectively
- Inspecting other documentation supporting the entity's interest in the investment (for example, correspondence from the broker organization or trustee acknowledging transactions with the fund)

### Communication With Those Charged With Governance

**.170** In addition to instances in which communication with those charged with governance in other auditing sections is discussed, other select measures are outlined in AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), that are specifically relevant during an economic crisis and when measuring fair value. AU section 380 establishes standards and provides guidance on the auditor's communication with those charged with governance. As noted in paragraph .05 of AU section 380, the auditor must communicate with those charged with

governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The auditor should communicate his or her views about the quality of the entity's significant accounting policies, accounting estimates, and financial statement disclosures.

.171 AU section 341 expands on the applicability of AU section 380 when the auditor has concluded that substantial doubt exists about the entity's ability to continue as a going concern. In that case, the auditor should communicate to those charged with governance the nature of the events or conditions identified, the possible effect on the financial statements, the sufficiency of the related disclosures, and the effects on the auditor's report.

### **Communicating Internal Control Related Matters Identified in an Audit**

.172 In October 2008, the AICPA Auditing Standards Board (ASB) issued SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 115 amends SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325A), and further clarifies standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements.

.173 The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion), except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1). This new standard is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted.

.174 In general, SAS No. 115 retains many of the provisions of SAS No. 112; it provides guidance to (a) enhance the auditor's ability to identify and evaluate deficiencies in internal control during an audit, and then (b) communicate to management and those charged with governance those deficiencies that the auditor believes are significant deficiencies or material weaknesses.

.175 The key differences between SAS No. 115 and SAS No. 112 lie in the definitions of *material weaknesses* and *significant deficiencies*. Under SAS No. 112, the auditor applied criteria of likelihood and magnitude described in that standard to determine if a control deficiency reached the threshold of significant deficiency or material weakness. Under SAS No. 115, the same criteria are used; however, more judgment is allowed in determining whether a control deficiency is a significant deficiency.

### **Definitions of Significant Deficiency and Material Weakness**

.176 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable

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possibility exists when the likelihood of the event is either *reasonably possible* or *probable* because those terms are used in FASB ASC 450-20-25-1 (originally, these terms appeared in FASB Statement No. 5, *Accounting for Contingencies*).<sup>1</sup>

**.177** A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

### The Evaluation Process

**.178** Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity's internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rises to the level of a significant deficiency or material weakness. The severity of a deficiency in internal control depends on the following:

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies
- Whether a reasonable possibility exists that the entity's controls will fail to prevent or to detect and correct a misstatement of an account balance or disclosure

**.179** The severity of a deficiency does not depend on whether a misstatement actually occurred. If the auditor identifies a deficiency in internal control but has not identified an actual misstatement related to that deficiency, the auditor cannot automatically conclude that the deficiency is not a significant deficiency or a material weakness. If a misstatement has been identified, the auditor should consider the potential for further misstatement in the financial statements being audited.

**.180** The AICPA published Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting [www.cpa2biz.com](http://www.cpa2biz.com).

## Withdrawal of GAAP Hierarchy From Auditing Standards

**.181** In August 2009, the ASB voted to withdraw SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*,

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<sup>1</sup> The term *reasonably possible* as used in the definition of the term *material weakness* has the same meaning as defined in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450-20-25-1:

When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. The terms probable, reasonably possible, and remote identify three areas within that range, as follows:

- a. *Probable*. The future event or events are likely to occur.
- b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
- c. *Remote*. The chance of the future event or events occurring is slight.

Therefore, the likelihood of an event is a *reasonable possibility* when it is more than remote.



as amended, from the auditing literature for nonissuers. This SAS was withdrawn as a result of recent pronouncements by FASB, Governmental Accounting Standards Board, and Federal Accounting Standards Advisory Board to incorporate their respective GAAP hierarchies into their respective authoritative literature.

.182 Interpretation No. 3, "The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events," of AU section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, as amended also will be withdrawn automatically because the ASB did not direct that the interpretation be retained and moved elsewhere within the literature.

.183 The effective date of the withdrawal is September 2009 to reflect the effective date of FASB ASC, which is effective for financial statements for interim and annual periods ending after September 15, 2009.

.184 Further information about recent ASB projects and activities is available at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/).

## Audit Confirmations

### PCAOB Concept Release on Audit Confirmations

.185 In April 2009, the PCAOB issued a concept release on possible revisions to AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), for public comment. Confirmations are typically an important source of evidence for auditors as independent third party sources verify the data on the confirmation. The PCAOB's concept release addresses the nine following areas of possible change to the current confirmation guidance:

- Expansion of the definition of *confirmation* to include direct access to information held by a third party
- Establishes a presumption that the auditor will request the confirmation of accounts receivable
- Discusses factors to consider in designing confirmation requests
- Updates the requirement for maintaining control over confirmation requests for advances in technology
- Adds further direction on evaluating the reliability of confirmation responses
- Eliminates the ability for the auditor to omit performing alternative procedures for nonresponses to positive confirmation requests
- Adds considerations for when management requests an auditor to not confirm a select account, transaction, and so on
- Evaluates disclaimers and restrictive language on confirmation responses
- Considers whether the use of negative confirmations should continue to be allowed

.186 Generally speaking, the concept release does not contemplate major changes to the confirmation process; rather, it addresses developments in technology and related risk factors. Comments were due to the PCAOB at the end of May 2009. Readers should be alert to developments on this issue.

### ***AICPA Exposure Draft on External Confirmations***

.187 In May 2009, the ASB issued the exposure draft of a proposed SAS, *External Confirmations*, to both apply the clarity drafting conventions and to converge with International Standards of Auditing (ISAs). This SAS would supersede SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330). The proposed SAS would be effective for audits of financial statements for periods beginning on or after December 15, 2010. This effective date is provisional but will not be earlier than December 15, 2010. The proposed SAS is not expected to change practice in any significant respect.

.188 The most noteworthy changes to the existing standard include the following:

- Responsibilities of the auditor when management refuses to allow the auditor to send a confirmation request
- Application material regarding the use of oral responses to confirmation requests
- The definition of *confirmation* has changed and includes direct access by the auditor to information held by a third party

.189 Comments were due by August 31, 2009, and are available for public inspection after September 30, 2009, at the offices of the AICPA. A matrix document is available for constituents. The matrix compares ISA 505, *External Confirmations*, the proposed SAS, and AU section 330. A mapping document that maps the requirements of AU section 330 to the proposed SAS is also available. The SAS draft is available at [www.aicpa.org/download/auditstd/FINAL\\_ED\\_External\\_Confirmations\\_2.pdf](http://www.aicpa.org/download/auditstd/FINAL_ED_External_Confirmations_2.pdf).

### ***AICPA Practice Aid Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools, Second Edition***

.190 This recently issued AICPA Practice Aid updates the previous edition of *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* and provides guidance for audits of futures commission merchants, introducing brokers, and commodity pools (collectively referred to as commodity entities). This practice aid is intended to provide practitioners with nonauthoritative practical guidance related to the special matters unique to the regulatory, accounting, and auditing aspects of this industry. It includes an overview of the commodity industry, and a discussion of a commodity entity's functions, books and records, including regulatory recordkeeping requirements.

.191 This second edition, prepared by the AICPA Commodity Practice Aid Task Force, has been revised to provide industry specific guidance for commodity entities. It includes exhibits containing both sample letters and sample reports to assist independent accountants in reporting on the financial statements and other written assertions of commodity entities.

.192 Chapter 8 of this practice aid concentrates on accounting, auditing, and regulatory considerations and includes illustrative financial statements for commodity pools that meet the definition of an *investment company* and follow the provisions of FASB ASC 946, *Financial Services—Investment Companies*.

## Accounting Issues and Developments

### Investment Company Technical Practice Aids

**.193** The AICPA has recently issued four TIS sections that discuss numerous investment company issues. These questions and answers can be located in TIS sections 6910.29–.32 (AICPA, *Technical Practice Aids*).

**.194** TIS section 6910.29, "Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations," discusses several scenarios when a nonregistered investment partnership that reports capital by investor class has provisions in the governing documents that delay the recognition of certain events in the capital accounts until certain conditions have been met. In summary, this guidance recommends the recognition and allocation of cumulative unrealized gains (losses), carried interest, and clawback provisions in the equity balances of each class of shareholder or partner at the balance sheet date. This treatment is analogous to an "as if" approach, which assumes the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all resulting gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date, consistent with the provisions of the partnership's governing documents.

**.195** TIS section 6910.30, "Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets," discusses the disclosure requirements of FASB ASC 946-210-50-6 related to investments in a nonregistered investment partnership's portfolio. It concludes that, even if a nonregistered investment partnership owns an interest in an investee fund that constitutes less than 5 percent of the nonregistered investment partnership's net assets, the reporting investment partnership should apply the guidance contained in paragraphs 8–9 of FASB ASC 946-210-50. This guidance states that nonregistered investment partnerships that own interests in another investment partnership (investee fund) are required to disclose the investment partnership's proportional share of any underlying investment owned (either directly or through an investee fund) in any issuer that exceeds 5 percent of the reporting investment partnership's net assets at the reporting date.

**.196** TIS section 6910.31, "The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the '5 Percent Test' Described in TIS Section 6910.30," discusses how a nonregistered reporting investment partnership should calculate its proportional share of any investments owned by an investee fund in applying the 5 percent test described in TIS section 6910.30 and where it should be disclosed within the financial statements. The reporting investment partnership should calculate its proportional share of any investments owned by the investee fund as its percentage ownership of the investee fund. The disclosure of investments in issuers exceeding 5 percent of reporting investment partnership net assets should be made either on the face of the (condensed) schedule of investments or within the financial statement footnotes.

**.197** TIS section 6910.32, "Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund's Debt," provides additional guidance

to consider when a partnership has provided guarantees related to an investee fund's debt. These additional disclosures are described in FASB ASC 460-10-50 and include loss contingencies and the guarantor's obligation.

### FASB Statement No. 161

**.198** In March 2008, FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, which was codified primarily in sections 50 and 55 of FASB ASC 815-10. This guidance is intended to improve investors' understanding of how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under FASB ASC 815, *Derivatives and Hedging*, and how derivative instruments and related hedged items affect the entity's financial position, financial performance, and cash flows.

**.199** This guidance achieves these improvements by requiring qualitative disclosures about objectives and strategies for using derivatives and requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity's liquidity by requiring disclosure of derivative features that are credit risk related. Finally, it requires cross referencing within footnotes to enable financial statement users to locate important information about derivative instruments.

**.200** This guidance is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. FASB also has clarified, in FSP FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45*; and *Clarification of the Effective Date of FASB Statement No. 161*, the effectiveness provisions to include annual financial statements, including the final interim period of the year. This FSP was codified in FASB ASC 815-10 and 460-10.

### Fair Value

**.201** Among the reputed causes cited for the economic crisis, the guidance in FASB ASC 820 (formerly FASB Statement No. 157) has received a great deal of attention. FASB ASC 820-10-20 defines *fair value* and establishes a framework for measuring fair value.

**.202** This guidance defines *fair value* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." A contention with this guidance is the difficulty of applying the existing guidance in an illiquid or distressed market, such as the current one. This difficulty has the potential to allow inconsistencies in application by accountants and auditors. Prior to the issuance of FSP FAS 157-4, which is codified in FASB ASC 820-10, the areas of the fair value guidance that related to measuring fair value in an illiquid market were limited to the following mentions:

- "An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)."

- "Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are . . . [w]illing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so."
- "For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if . . . [t]he transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty."

**.203** Both the SEC and FASB took notice of constituents' desire for further guidance. In September 2008, the SEC issued *SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting* to provide immediate clarifications on fair value in illiquid markets for preparers and auditors until FASB was able to provide additional interpretative guidance.

***Determining Whether a Market is Not Active and a Transaction Is Not Distressed***

**.204** On April 9, 2009, FASB issued FSP FAS 157-4, which is codified in FASB ASC 820-10. The purpose of this FSP is to provide additional guidance in the application of fair value accounting in an inactive market; it also supersedes FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. Among other points, the new guidance

- affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions (that is, in the inactive market).
- clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active.
- requires an entity to base its conclusion about whether a transaction was or was not orderly on the weight of the evidence.
- includes an example that provides additional explanation on estimating fair value when the market activity for an asset has declined significantly.
- requires an entity to disclose a change in valuation technique (and the related inputs) resulting from the application of this guidance and to quantify its effects, if practicable, by major category.
- applies to all fair value measurements when appropriate.

**.205** This guidance also contains new disclosures that require the reporting entity to

- disclose the inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period (in both interim and annual periods).

- define *major category* (as discussed in FASB ASC 820-10-50) for equity securities and debt securities to be *major security types* as discussed in "Pending Content" of both FASB ASC 320-10-501B and 942-320-50-2.

**.206** This new guidance is effective for interim and annual reporting periods ending after June 15, 2009, and shall be applied prospectively. Early adoption is permitted for periods ending after March 15, 2009. Earlier adoption for periods ending before March 15, 2009, is not permitted. This FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this FSP requires comparative disclosures only for periods ending after initial adoption.

### ***Measuring Liabilities Under FASB Statement No. 157***

**.207** On August 27, 2009, FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value*. This ASU was issued to increase the consistency in the application of FASB ASC 820 to liabilities because many constituents had expressed concern. This ASU applies to all entities that measure liabilities at fair value under FASB ASC 820 and amends sections of FASB ASC 820-10.

**.208** This ASU states that, in circumstances in which a quoted price in an active market for the identical liability is not available, fair value of the liability must be measured by either (a) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities, or similar liabilities when traded as assets, or (b) another valuation technique that is consistent with the principles of FASB ASC 820, such as an income approach or a market approach. Further, if a restriction on the transference of the liability exists, the ASU clarifies that an entity is not required to factor that in to the inputs of the fair value determination. Lastly, the ASU also clarifies that a quoted price in an active market for the identical liability, or an unadjusted quoted price in an active market for the identical liability, when traded as an asset, are level 1 measurements within the fair value hierarchy. The guidance in this ASU is effective for the first reporting period (including interim periods) beginning after issuance. The full text of the ASU can be accessed from FASB's Web site at [www.fasb.org](http://www.fasb.org).

### ***Investments in Certain Entities That Calculate NAV per Share (or Its Equivalent)***

**.209** In September 2009, FASB issued ASU No. 2009-12. This guidance was issued because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis and, as of the reporting entity's measurement date, if the investment both

- does not have a readily determinable fair value. The FASB ASC glossary states that an equity security has a readily determinable fair value if it meets any of the following conditions:
  - The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the OTC market, provided that those prices or quotations for the OTC market are publicly



reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year;

- The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously; or
  - The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions; and
- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes are not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946.

**.210** As a practical expedient, this ASU permits a reporting entity to measure the fair value of an investment within its scope on the basis of the NAV per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the investment's fair value.

**.211** This ASU also requires disclosures by major category of investment about the attributes of investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

**.212** These amendments are effective for interim and annual periods ending after December 15, 2009, and are included in FASB ASC 820-10. Early application is permitted in financial statements for earlier and interim and annual periods that have not been issued. An entity may elect to early adopt the measurement amendments of this ASU and defer the adoption of the disclosure provisions of FASB ASC 820-10-50-6A until periods ending after December 15, 2009. An AICPA Practice Aid, *Alternative Investments—Audit Considerations*, also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments. See the "Auditing Alternative Investments" section of this alert for further details.

### ***FASB Project to Improve Disclosures About Fair Value Measurements***

**.213** The objective of this FASB project is to improve disclosures about fair value measurements. This project was one of those added to FASB's agenda as a result of the SEC study on fair value accounting as well as input provided by FASB's Valuation Resource Group and other constituents. Many of the proposed

changes are also intended to conform to existing disclosure requirements under IFRSs.

.214 FASB released a proposed ASU, *Fair Value Measurements and Disclosures: Improving Disclosures about Fair Value Measurements*, on August 28, 2009, with comments due by October 12, 2009. The three new proposed disclosure requirements would be as follows:

- *Effect of reasonably possible alternative level 3 inputs.* If a change in one or more of the significant inputs to a level 3 fair value measurement to reasonably possible alternative inputs would significantly change the fair value measurement, the reporting entity would state that fact and disclose the potential effect of those changes.
- *Information about transfers in or out, or both, of levels 1 and 2.* A reporting entity would disclose the amount of significant transfers in and out of levels 1 and 2 fair value measurements and the reasons for the transfers.
- *Activity in level 3 fair value measurements.* In the reconciliation for level 3 fair value measurements, information about purchases, sales, issuances, and settlements would be presented on a gross basis rather than as one net number.

.215 Additional clarification for certain existing disclosures in FASB ASC 820-10 is also discussed in the proposed ASU. First, it states that an entity must provide fair value measurement disclosures for each class of assets and liabilities. A *class* is often a subset of assets or liabilities within a line item in the statement of financial position; however, an entity needs to apply judgment in determining the appropriate classes of assets and liabilities. Secondly, the ASU clarifies that for level 2 or 3 fair value measurements, an entity is required to provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements.

.216 FASB's goal is to issue a final ASU that would be effective for interim and annual periods ending after December 15, 2009, except for level 3 sensitivity disclosures, which would be effective for annual and interim reporting periods ending after March 15, 2010. Readers should remain alert for developments on this issue. FASB's progress on this project can be viewed at [www.fasb.org/fas157\\_improving\\_disclosures\\_about\\_fvm.shtml](http://www.fasb.org/fas157_improving_disclosures_about_fvm.shtml).

## FASB Statement No. 168

.217 FASB Statement No. 168, as codified in FASB ASC 105, *Generally Accepted Accounting Principles*, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. This new standard flattens the GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. This statement creates FASB ASC 105. Should an accounting change result from a change in the relative authoritative standing of a particular GAAP principle, an entity should disclose the nature and reason for the change in accounting principle in its financial statements.

**.218** FASB Statement No. 168 is the final standard that will be issued by FASB in that form. It was added to FASB ASC through ASU No. 2009-02 on June 30, 2009. No new standards in the form of statements, staff positions, EITF abstracts, or AICPA accounting SOPs, for example, will be issued. Instead, FASB will issue ASUs. FASB will not consider ASUs as authoritative in their own right. Instead, they will serve only to update FASB ASC, provide background information about the guidance, and provide the basis for conclusions on changes made to FASB ASC.

## FASB ASC

**.219** On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. At that time, FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. Once effective, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. This change will affect accountants and auditors alike.

**.220** FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing the authoritative literature in a topically organized structure. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the EITF, and the AICPA) to organize them under approximately 90 topics. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy. FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as select SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance.

**.221** FASB ASC is not intended to change U.S. GAAP or any requirements of the SEC; rather, it is part of FASB's efforts to reduce the complexity of accounting standards and also to facilitate international convergence. Moreover, FASB ASC does not include governmental accounting standards. The purposes behind the codification project include the following:

- Reduce the amount of time and effort required to solve an accounting research issue
- Mitigate the risk of noncompliance with standards through improved usability of the literature
- Provide accurate information with real-time updates as new standards are released
- Assist FASB with the research and convergence efforts required during the standard setting process
- Become the authoritative source of literature for the completed XBRL taxonomy
- Clarify that guidance not contained in FASB ASC is not considered authoritative

**.222** FASB ASC uses a topical structure in which guidance is organized into *areas*, *topics*, *subtopics*, *sections*, and *subsections*. These terms are defined as follows:

**Areas.** The broadest category in FASB ASC, which represent a grouping of topics.

**Topics.** The broadest categorization of related content, which correlate with the International Accounting Standards (IASs) and IFRSs.

**Subtopics.** Subsets of a topic, which are generally distinguished by type or scope.

**Sections.** Categorization of the content, into such groups as recognition, measurement, or disclosure. The sections' structure correlates with the IASs and IFRSs.

**Subsections.** Further segregation and navigation of content below the section level.

**.223** Topics, subtopics, and sections are numerically referenced. This effectively organizes the content without regard to the original standard setter or standard from which the content was derived. An example of the numerical referencing is FASB ASC 305-10-05, in which *305* is the *Cash and Cash Equivalents* topic, *10* represents the "Overall" subtopic, and *05* represents the "Overview and Background" section. Constituents are encouraged to begin using FASB ASC, which can be accessed at <http://asc.fasb.org/home>. To read more about FASB ASC, including recent developments and updates, please see the AICPA's dedicated FASB ASC Web site at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/FASB+Accounting+Standards+Codification/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/FASB+Accounting+Standards+Codification/).

### **Referencing FASB ASC in Your Documentation**

**.224** You should consider how and when your entity will begin referencing FASB ASC in your documentation (policy and procedures, technical memorandums, financial statements and filings, engagement working papers, and so on). It is only prudent to reflect current GAAP in your documentation. The FASB Notice to Constituents (NTC) includes a section on referencing FASB ASC in footnotes and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*."

**.225** On the other hand, they do suggest using the detailed numerical referencing system in working papers, articles, textbooks, and related items. The NTC also provides some detailed examples of how to reflect the numerical referencing in such documents. However, if you need to reference certain grandfathered guidance not included in FASB ASC (a listing can be found in FASB Statement No. 168), use of the old terminology would still be appropriate. The following are some examples of how and when to implement the new FASB referencing system.

- *Nonpublic entities.* For nonpublic entities without interim filings, preparers choosing to reference specific accounting guidance in financial statements would make those references to FASB ASC for

the first annual period ending after September 15, 2009. For example, a nonpublic entity with a July 31, 2009, year-end would not reference FASB ASC in its financial statements, but a nonpublic entity with a December 31, 2009, year-end would reference FASB ASC in its financial statements.

- *Public entities.* The SEC recently shared with the CAQ SEC Regulations Committee some views on referencing FASB ASC in financial statements. For interim and annual financial statements for periods ending after September 15, 2009, the SEC stated that any references to specific elements of GAAP should use the FASB ASC reference. Therefore, a public entity filing financial statements for the quarter ended September 30, 2009, should reference FASB ASC in its financial statements. In addition, the SEC stated that references to specific GAAP (FASB ASC references) should be on a consistent basis for all periods presented. However, the SEC has encouraged companies to make financial statements more useful to users by drafting financial statement disclosures to avoid specific GAAP references and to more clearly explain accounting concepts.

**.226** Also, because FASB ASC is not intended to change GAAP, the consistent use of references to only FASB ASC for all periods presented (including periods before the authoritative release of FASB ASC) is appropriate.

**.227** It is prudent to expect that audit, attest, or compilation and review working papers associated with financial statements for a period ending after September 15, 2009, also would reflect FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

**.228** However, if your entity will continue to follow grandfathered guidance not included in FASB ASC, it would still be appropriate to reference those standards (and not FASB ASC). The listing of all grandfathered guidance can be found in FASB Statement No. 168, as well as a listing of examples of grandfathered guidance.

**.229** Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC Web site: [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/FASB+Accounting+Standards+Codification/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/FASB+Accounting+Standards+Codification/).

## Consolidation of Variable Interest Entities

**.230** In June 2009, FASB issued FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*,<sup>2</sup> which changes how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly affect the entity's economic performance.

**.231** This statement also amends FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation*

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<sup>2</sup> At the date of this writing, this guidance has not yet been included in FASB ASC. Readers are encouraged to visit the FASB ASC Web site at <http://asc.fasb.org/home> and monitor updates.

of *ARB No. 51* (codified primarily in FASB ASC 810-10), to eliminate the quantitative approach previously required for determining the primary beneficiary of a variable interest entity, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

**.232** Entities will be required to provide additional disclosures about involvement with variable interest entities and any significant changes in risk exposure due to that involvement. Entities also will be required to disclose how involvement with a variable interest entity affects the entity's financial statements.

**.233** FASB Statement No. 167 retains the scope of FASB Interpretation No. 46(R) with the addition of entities previously considered qualifying special purpose entities because the concept of these entities was eliminated in FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*.<sup>3</sup>

**.234** This statement also discusses the objectives of its required disclosures and notes that an entity may need to supplement the minimum required disclosures to meet these objectives. The objectives are for the financial statement users to have an understanding of the following:

- The significant judgments and assumptions made by an enterprise in determining whether it must consolidate a variable interest entity or disclose information about its involvement in a variable interest entity, or both
- The nature of restrictions on a consolidated variable interest entity's assets and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- The nature of and changes in the risks associated with an enterprise's involvement with the variable interest entity
- How an enterprise's involvement with the variable interest entity affects the enterprise's financial position, financial performance, and cash flows

**.235** This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.

## Accounting for Transfers of Financial Assets

**.236** Also in June 2009, FASB issued FASB Statement No. 166,<sup>4</sup> which is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125* (which was codified in FASB ASC 860, *Transfers and Servicing*), and will require more information about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. It eliminates the concept of a qualifying special purpose entity, changes the requirements

<sup>3</sup> See footnote 2.

<sup>4</sup> See footnote 2.



for derecognizing financial assets, and requires additional disclosures. The purpose of this standard is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets.

**.237** Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance.

**.238** The primary objectives of the disclosure requirements of this guidance are to provide the financial statement users with a clear understanding of the following:

- A transferor's continuing involvement (as defined in this pronouncement), if any, with transferred financial assets
- The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets
- How servicing assets and servicing liabilities are reported under this pronouncement
- For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows

**.239** These objectives must be met by the disclosures, regardless of the specific requirements of the pronouncement. It may be the case that an entity provides greater detail than what is a required disclosure to meet these objectives depending on the facts and circumstances.

**.240** FASB Statement No. 166 must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

## Subsequent Events

**.241** In May 2009, FASB issued FASB Statement No. 165, which has been codified in FASB ASC 855, and is effective for interim and annual periods ending after June 15, 2009. This statement is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available to be issued).

The purpose of this disclosure is to alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

.242 In particular, this statement sets forth the following:

- The period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date

.243 FASB states that this statement should not result in significant changes in current practice with regard to the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. Further, in September 2009, the AICPA issued two TIS sections regarding this guidance. TIS section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. TIS section 8700.02 is discussed in the "Audit and Attestation Issues and Developments" section of this alert. Both TIS sections can be accessed at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/Recently+Issued+Technical+Practice+Aids.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/Recently+Issued+Technical+Practice+Aids.htm).

## FSP EITF 99-20-1

### *Impairment Guidance for Beneficial Interests*

.244 In January 2009, FSP EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue 99-20*, was issued. The FSP and EITF 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, were primarily codified in FASB ASC 325-40. Beneficial interests held by investment companies are within the scope of this FSP and related EITF because it is practice for them to report interest income as a separate item in their income statements, even though the investments are accounted for at fair value. The carrying amount of the beneficial interest used for purposes of measuring interest income should be adjusted based on the application of the accounting model described in the as amended EITF.

.245 Interest income for a beneficial interest should be recognized based on the estimated future cash flows using the effective interest method and these cash flows should be updated throughout the life of the beneficial interest. If upon evaluation it is probable that a favorable (or an adverse) change occurred in these estimated cash flows, then the amount of accretable yield should be recalculated on the date of evaluation as the excess of estimated cash flows over the beneficial interest's reference amount. The reference amount is equivalent

to the initial investment less cash received to date plus yield accreted to date. This adjustment should be accounted for prospectively as a change in estimate in accordance with FASB ASC 250, *Accounting Changes and Error Corrections*. Note that subsequent to the initial transaction date, *estimated cash flows* are the holder's estimate of the amount and timing of estimated principal and interest cash flows based on the holder's best estimate of current information and events.

**.246** When developing an estimate of future cash flows, the holder should consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts. This information typically includes the remaining payment terms of the security, prepayment speeds, the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral. To achieve that objective, the holder should consider, for example, industry analyst reports and forecasts, sector credit ratings, and other market data that are relevant to the collectability of the security.

**.247** The holder also should consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract) and whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods as for some securities backed by nontraditional loans. Thus, the holder should consider whether a security backed by currently performing loans will continue to perform when required payments increase in the future (including balloon payments). The holder also should consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, the holder needs to assess the effect of that decline on the ability of the holder to collect the balloon payment. Readers are encouraged to review the entire FSP at [www.fasb.org](http://www.fasb.org).

## FSP FAS 140-4 and FIN 46(R)-8

**.248** In December 2008, FASB issued FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*, and was effective for public entities for the first reporting period (interim or annual) ending after December 15, 2008. FASB Statement Nos. 166 and 167 supersede this FSP; however, they do carry forward most of the disclosures previously required by the FSP. Readers should refer to FASB Statements Nos. 166 and 167 for the current disclosure requirements.

## Accounting for Uncertainty in Income Taxes

**.249** FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, was issued in July 2006 with an effective date of fiscal years beginning after December 15, 2006. In December 2008, FASB issued FSP FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Entities*, which continued the deferral of FASB Interpretation No. 48 started by FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, in February 2008. FSP FIN 48-3 deferred the effective date of FASB Interpretation No. 48 for certain

nonpublic enterprises. The FASB ASC glossary defines a *nonpublic enterprise* as an entity that does not meet any of the following criteria:

- Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the OTC market (including securities quoted only locally or regionally).
- It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an OTC market, including local or regional markets).
- Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

**.250** Nonpublic consolidated entities of public enterprises that apply U.S. GAAP and any nonpublic enterprise that has already applied the provisions of FASB Interpretation No. 48 in a full set of annual financial statements are not eligible for the deferral. The guidance deferred the effective date of FASB Interpretation No. 48 until the annual financial statements for fiscal years beginning after December 15, 2008. Therefore, a calendar year nonpublic company (such as a private investment company) would need to apply FASB Interpretation No. 48 in 2009 for the first time.

**.251** In September 2009, FASB issued ASU No. 2009-06, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This update affects all nongovernmental entities and the disclosure amendments only apply to nonpublic entities. The four main provisions of the ASU include the following:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.
- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (FASB ASC 740-10-50-15[a]-[b]).

**.252** For entities that are currently applying the guidance on accounting for uncertainty in income taxes, this ASU is effective for interim and annual periods ending after September 15, 2009. For those entities that have deferred the application of accounting for uncertainty in income taxes in accordance with FSP FIN 48-3 (FASB ASC 740-10-65-1[e]), this ASU is effective upon adoption of those standards.

## Accounting for Redeemable Equity Instruments

**.253** In August 2009, FASB issued ASU 2009-04, *Accounting for Redeemable Equity Instruments—Amendment to Section 480-10-S99*. This ASU represents an update of FASB ASC 480-10-S99 to include the SEC staff announcement regarding the application of Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"* (ASR 268). ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable: at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer. The full ASU can be accessed from FASB's Web site at [www.fasb.org](http://www.fasb.org).

## Convergence With IFRSs

**.254** Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit [www.fasb.org](http://www.fasb.org) and [www.iasb.org](http://www.iasb.org).

## IFRSs Roadmap

**.255** In August 2008, the SEC voted to publish for public comment a proposed roadmap that could lead to the use of IFRSs by U.S. issuers beginning in 2014. The SEC would make a decision in 2011 on whether adoption of IFRSs is in the public interest and would benefit investors. The proposed multiyear plan sets out several milestones that, if achieved, could lead to the use of IFRSs by U.S. issuers in their filings with the SEC. The top 20 companies in each industry, as determined by market capitalization, could elect to begin filing IFRSs financial statements for fiscal periods ending after December 15, 2009. If, in 2011, the SEC adopts IFRSs for all filers, the roadmap suggests mandatory filing for large accelerated filers beginning in 2014, accelerated filers in 2015, and nonaccelerated filers in 2016. At present, registered investment companies are excluded from the proposed roadmap. The extended comment period ended in April 2009.

**.256** The proposed roadmap sets forth seven milestones that will influence the SEC's decision to adopt IFRSs for all filers. These milestones relate to the following:

- Improvements in accounting standards
- Accountability and funding of the International Accounting Standards Committee Foundation
- Improvement in the ability to use interactive data for IFRSs reporting
- Education and training relating to IFRSs

- Limited early use of IFRSs when this would enhance comparability for U.S. investors
- Anticipated timing of future rulemaking by the SEC
- Implementation of the mandatory use of IFRSs by U.S. issuers

.257 Additionally, the roadmap discusses two alternatives for U.S. issuers that elect to use IFRSs to disclose U.S. GAAP information. Proposal A suggests that a U.S. issuer who elects to file IFRSs financial statements would provide the reconciling information from U.S. GAAP to IFRSs called for under IFRS 1, *First-time Adoption of International Financial Reporting Standards*, in a footnote to its audited financial statements. This information would include the restatement of and reconciliation from the prior year's financial statements and related disclosures. Proposal B suggests that U.S. issuers that elect to file IFRSs financial statements would provide the reconciling information from U.S. GAAP to IFRSs required under IFRS 1 and also would disclose on an annual basis certain unaudited supplemental U.S. GAAP financial information covering a three year period. This unaudited supplemental financial information would be in the form of a reconciliation from IFRSs to U.S. GAAP.

.258 The roadmap does not address how the SEC would mandate IFRSs; however, the SEC noted that an option

would be for the FASB to continue to be the designated standard setter for purposes of establishing the financial reporting standards in issuer filings with the Commission. In this option our presumption would be that the FASB would incorporate all provisions under IFRS, and all future changes to IFRS, directly into generally accepted accounting principles as used in the United States. This type of approach has been adopted by a significant number of other jurisdictions when they adopted IFRS as the basis of financial reporting in their capital markets.

.259 The full text of the roadmap can be viewed on the SEC Web site at <http://sec.gov/rules/proposed/2008/33-8982.pdf>. Users are encouraged to closely monitor the progress of this initiative.

### ***IFRS for Small and Medium-sized Entities***

.260 In July 2009, the IASB issued *International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)*. *IFRS for SMEs* is an approximately 230-page significantly reduced and simplified version of full IFRSs. In creating *IFRS for SMEs*, the IASB eliminated many accounting topics that are not generally relevant to private companies (for example, earnings per share and segment reporting), easing the financial reporting burden on private companies through a cost-benefit approach. *IFRS for SMEs* is a self-contained global accounting and financial reporting standard applicable to the general purpose financial statements of, and other financial reporting by, entities that are known in many countries as SMEs.

.261 *IFRS for SMEs* is intended to be used by entities that publish general purpose financial statements for external users and do not have public accountability. Under the IASB's definition, an entity has public accountability if it files or is in the process of filing its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market or if it holds assets in a fiduciary capacity for a broad group of outsiders. Examples of entities that hold assets in



a fiduciary capacity include banks, insurance companies, brokers and dealers in securities, pension funds, and mutual funds. It is not the IASB's intention to exclude entities that hold assets in a fiduciary capacity for reasons incidental to their primary business (for example, travel agents, schools, and utilities) from utilizing *IFRS for SMEs*.

**.262** Unlike public companies, U.S. private companies are not required to use a particular basis of accounting when preparing their financial statements. The factors that drive a private company's choice of which financial accounting and reporting framework to follow in preparing its financial statements depend upon each company's objectives and the needs of their financial statement users. Currently, private companies in the United States can prepare their financial statements in accordance with U.S. GAAP, as promulgated by FASB; an other comprehensive basis of accounting, such as cash or tax basis; or full IFRSs, among others. Now, with the issuance of *IFRS for SMEs*, U.S. private companies have an additional option.

**.263** Some U.S. private companies may find the simplified *IFRS for SMEs* an attractive alternative to the more complicated and voluminous U.S. GAAP. Those private companies may find *IFRS for SMEs* to be a more relevant and less costly financial accounting and reporting standard than U.S. GAAP. Being based on full IFRSs and missing many accounting topics, *IFRS for SMEs*, therefore, differs from U.S. GAAP in a variety of areas. Some of the key differences under *IFRS for SMEs* are the following:

- Disclosures are simplified in a number of areas including pensions, leases and financial instruments.
- Last in, first out is prohibited.
- Goodwill and indefinite life intangible assets are amortized over a period not exceeding 10 years.
- Depreciation is based on a components approach.
- The temporary difference approach to income tax accounting is simplified.
- Reversal of impairment charges, if certain criteria are met, is allowed.
- Accounting for financial assets and liabilities makes greater use of cost.

**.264** Some key challenges that may be present in choosing to use *IFRS for SMEs* include understanding the differences between *IFRS for SMEs* and U.S. GAAP, the willingness of financial statement users to accept financial statements prepared under *IFRS for SMEs*, working with and accepting a more principles-based set of accounting standards compared to the more rules-based U.S. GAAP, the impact on taxes and tax planning strategies, and the impact on financial reporting metrics.

**.265** The AICPA welcomes the introduction of *IFRS for SMEs* in the United States. Private companies should be allowed to choose the financial accounting and reporting framework that best suits their objectives and the needs of their financial statement users. *IFRS for SMEs* represents another valuable financial accounting and reporting option for private companies to consider using, depending upon their unique circumstances.

**.266** In May 2008, the AICPA Governing Council voted to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of AICPA Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01), gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs* has been removed. CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *IFRS for SMEs* within their individual state. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs*, and a private company's expenditure of money, time and effort to convert to *IFRS for SMEs*.

**.267** Information about *IFRS for SMEs* and about the activities of the IASB can be found at [www.ifrs.com](http://www.ifrs.com).

### **The AICPA Launches IFRS.com Web Site**

**.268** To assist in both awareness building and education, the AICPA launched the Web site [www.ifrs.com](http://www.ifrs.com) in May 2008. The site provides current information about developments in international convergence. Developed by the AICPA, in partnership with its marketing and technology subsidiary, CPA2Biz, [www.ifrs.com](http://www.ifrs.com) provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

**.269** The Web site features tools and resources to help CPAs get acquainted with IFRSs, the surrounding issues, and available support. Resources include a history of convergence, a high level overview of the differences between IFRSs and U.S. GAAP, frequently asked questions, articles, textbooks, CPE courses and live conference training, helpful links, and assistance for audit committee members.

## **Recent Pronouncements**

**.270** AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA Web site at [www.aicpa.org](http://www.aicpa.org), the FASB Web site at [www.fasb.org](http://www.fasb.org), and the PCAOB Web site at [www.pcaob.org](http://www.pcaob.org). You also may look for announcements of newly issued accounting standards in the *CPA Letter* and the *Journal of Accountancy*.

## **Recent Auditing and Attestation Pronouncements and Related Guidance**

**.271** The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

***Recent Auditing and Attestation Pronouncements  
and Related Guidance***

Statement on Auditing Standards (SAS) No. 116, <i>Interim Financial Information</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 722) Issue Date: February 2009 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard amends AU section 722 to accommodate reviews of interim financial information of nonissuers, including companies offering securities pursuant to Securities and Exchange Commission (SEC) Rule 144A or participating in private equity exchanges. It is effective for reviews of interim financial information for interim periods beginning after December 15, 2009. Earlier application is permitted.
SAS No. 115, <i>Communicating Internal Control Related Matters Identified in an Audit</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 325) Issue Date: October 2008 (Applicable to audits conducted in accordance with GAAS)	Replacing SAS No. 112, <i>Communicating Internal Control Related Matters Identified in an Audit</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 325A), this standard defines the terms <i>deficiency in internal control</i> , <i>significant deficiency</i> , and <i>material weakness</i> ; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.
Statement on Standards for Attestation Engagements (SSAE) No. 15, <i>An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements</i> (AICPA, <i>Professional Standards</i> , vol. 1, AT sec. 501) Issue Date: October 2008	This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity's internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted.

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***Recent Auditing and Attestation Pronouncements  
and Related Guidance***

<p>Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330, <i>The Confirmation Process</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 9330 par. .01–.08)          Issue Date: April 2007 Revised Date: November 2008          (Interpretive publication)</p>	<p>This interpretation of AU section 330 addresses the use of electronic confirmations.</p>
<p>Interpretation No. 7, "Reporting on the Design of Internal Control," of AT section 101, <i>Attest Engagements</i> (AICPA, <i>Professional Standards</i>, vol. 1, AT sec. 9101 par. .59–.69)          Issue Date: December 2008          (Interpretive publication)</p>	<p>This interpretation of AT section 101 addresses how a practitioner may report on the suitability of the design of an entity's internal control over financial reporting for preventing or detecting and correcting material misstatements of the entity's financial statements on a timely basis.</p>
<p>Technical Questions and Answers (TIS) section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, <i>Technical Practice Aids</i>)          Issue Date: September 2009          (Nonauthoritative)</p>	<p>This question and answer addresses whether the accounting guidance in AU section 560, <i>Subsequent Events</i> (AICPA, <i>Professional Standards</i>, vol. 1), is effected by the issuance of Financial Accounting Standards Board (FASB) <i>Accounting Standards Codification</i> (ASC) 855, <i>Subsequent Events</i>.</p>
<p>TIS section 8700.02, "Auditor Responsibilities for Subsequent Events" (AICPA, <i>Technical Practice Aids</i>)          Issue Date: September 2009          (Nonauthoritative)</p>	<p>This question and answer discusses whether the auditor's responsibilities under AU section 560 are changed as a result of the issuance of FASB ASC 855.</p>
<p>TIS section 9150.25, "Determining Whether Financial Statements Have Been Prepared by the Accountant" (AICPA, <i>Technical Practice Aids</i>)          Issue Date: December 2008          (Nonauthoritative)</p>	<p>This question and answer discusses what an accountant should consider in determining whether he or she has prepared the financial statements of a nonissuer.</p>
<p>TIS section 1100.15, "Liquidity Restrictions" (AICPA, <i>Technical Practice Aids</i>)          Issue Date: October 2008          (Nonauthoritative)</p>	<p>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.</p>

***Recent Auditing and Attestation Pronouncements  
and Related Guidance***

<p>Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, <i>Evaluating Consistency of Financial Statements</i> (AICPA, <i>PCAOB Standards and Related Rules</i>, Auditing Standards) Issue Date: September 2008 (Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>This standard and its related amendments update the auditor's responsibilities to evaluate and report on the consistency of a company's financial statements and align the auditor's responsibilities with FASB Statement No. 154, <i>Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3</i>, which is codified in FASB ASC 250, <i>Accounting Changes and Error Corrections</i>. This standard also improves the auditor reporting requirements by clarifying that the auditor's report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement. It is effective November 15, 2008.</p>
<p>PCAOB Rule 3526, <i>Communication with Audit Committees Concerning Independence</i> (AICPA, <i>PCAOB Standards and Related Rules</i>, Select Rules of the Board) Issue Date: August 2008 (Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>Rule 3526 requires the registered public accounting firm to</p> <ul style="list-style-type: none"> <li>• describe in writing, to the audit committee of the issuer (both prior to accepting an initial engagement and annually), all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence.</li> <li>• discuss with the audit committee of the issuer the potential effects of any relationships that could affect independence, should they be appointed as the issuer's auditor.</li> <li>• document the substance of these discussions. These discussions should occur at least annually.</li> </ul> <p>The board also adjusted the implementation schedule for Rule 3523, <i>Tax Services for Persons in Financial Reporting Oversight Roles</i> (AICPA, <i>PCAOB Standards and Related Rules</i>, Select Rules of the Board), as it applies</p>

(continued)

***Recent Auditing and Attestation Pronouncements  
and Related Guidance***

	to tax services. The board agreed not to 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. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions of Rule 3526 became effective on September 30, 2008.
PCAOB Conforming Amendments to the Interim Auditing Standards (AICPA, <i>PCAOB Standards and Related Rules</i> , Select PCAOB Releases, Release No. 2008-001) Issue Date: November 15, 2008 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 6, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 2 of PCAOB Release No. 2008-001 at <a href="http://www.pcaobus.org/Rules/Docket_023/PCAOB_2008-01-19b-4-AS_No_6.pdf">www.pcaobus.org/Rules/Docket_023/PCAOB_2008-01-19b-4-AS_No_6.pdf</a> .
PCAOB Staff Audit Practice Alert (PA) No. 4, <i>Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments</i> (AICPA, <i>PCAOB Standards and Related Rules</i> , PCAOB Staff Guidance, sec. 400.04) Issue Date: April 2009 (Applicable to audits conducted in accordance with PCAOB standards)	This PA is designed to inform auditors about potential implications of the FASB Staff Positions on reviews of interim financial information and annual audits. This alert addresses the following topics: <ul style="list-style-type: none"> <li>• Reviews of interim financial information</li> <li>• Audits of financial statements, including integrated audits</li> <li>• Disclosures</li> <li>• Auditor reporting considerations</li> </ul>
PCAOB Staff Audit PA No. 3, <i>Audit Considerations in the Current Economic Environment</i> (AICPA, <i>PCAOB Standards and Related Rules</i> , PCAOB Staff Guidance, sec. 400.03) Issue Date: December 2008 (Applicable to audits conducted in accordance with PCAOB standards)	This PA is designed to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. The PA addresses the following six main areas: overall audit considerations, auditing fair value measurements, auditing accounting estimates, auditing the adequacy of disclosures, auditor's consideration of a company's ability to continue as a going concern, and additional audit considerations for selected financial reporting areas.



## Recent Accounting Pronouncements and Related Guidance

.272 The following table presents a list of recently issued accounting pronouncements and related guidance.

<i>Recent Accounting Pronouncements and Related Guidance</i>	
Financial Accounting Standards Board (FASB) <i>Accounting Standards Codification</i> (ASC) Accounting Standards Update (ASU) No. 2009-15 (October 2009)	<i>Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing</i>
FASB ASC ASU No. 2009-14 (October 2009)	<i>Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force (EITF)</i>
FASB ASC ASU No. 2009-13 (October 2009)	<i>Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB EITF</i>
FASB ASC ASU No. 2009-12 (September 2009)	<i>Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)</i>
FASB ASC ASU No. 2009-11 (September 2009)	<i>Extractive Activities—Oil and Gas—Amendment to Section 932-10-S99 (SEC Update)</i>
FASB ASC ASU No. 2009-10 (September 2009)	<i>Financial Services—Broker and Dealers: Investments—Other—Amendment to Subtopic 940-325 (SEC Update)</i>
FASB ASC ASU No. 2009-09 (September 2009)	<i>Accounting for Investments—Equity Method and Joint Ventures and Accounting for Equity-Based Payments to Non-Employees—Amendments to Sections 323-10-S99 and 505-50-S99 (SEC Update)</i>
FASB ASC ASU No. 2009-08 (September 2009)	<i>Earnings per Share—Amendments to Section 260-10-S99 (SEC Update)</i>
FASB ASC ASU No. 2009-07 (September 2009)	<i>Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)</i>
FASB ASC ASU No. 2009-06 (September 2009)	<i>Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities</i>

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<b><i>Recent Accounting Pronouncements and Related Guidance</i></b>	
FASB ASC ASU No. 2009-05 (August 2009)	<i>Fair Value Measurements and Disclosures (Topic 820)—Measuring Liabilities at Fair Value</i>
FASB ASC ASU No. 2009-04 (August 2009)	<i>Accounting for Redeemable Equity Instruments—Amendment to Section 480-10-S99</i>
FASB ASC ASU No. 2009-03 (August 2009)	<i>SEC Update—Amendments to Various Topics Containing SEC Staff Accounting Bulletins</i>
FASB ASC ASU No. 2009-02 (June 2009)	<i>Omnibus Update—Amendments to Various Topics for Technical Corrections</i>
FASB ASC ASU No. 2009-01 (June 2009)	<i>Topic 105—Generally Accepted Accounting Principles—amendments based on—Statement of Financial Accounting Standards No. 168—The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles</i>
FASB Statement No. 168 (June 2009) (Codified in FASB ASC 105, <i>Generally Accepted Accounting Principles</i> )	<i>The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162</i>
FASB Statement No. 167 <sup>5</sup> (June 2009)	<i>Amendments to FASB Interpretation No. 46(R)</i>
FASB Statement No. 166 <sup>6</sup> (June 2009)	<i>Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140</i>
FASB Statement No. 165 (May 2009) (Codified in FASB ASC 855, <i>Subsequent Events</i> )	<i>Subsequent Events</i>
FASB Statement No. 164 <sup>7</sup> (April 2009)	<i>Not-for-Profit Entities: Mergers and Acquisitions</i>
FASB Statement No. 163 (May 2008) (Codified in FASB ASC 944, <i>Financial Services—Insurance</i> )	<i>Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60</i>

<sup>5</sup> See footnote 2.

<sup>6</sup> See footnote 2.

<sup>7</sup> See footnote 2.

***Recent Accounting Pronouncements and Related Guidance***

EITF Issues (Various dates)	Go to <a href="http://www.fasb.org/eitf/agenda.shtml">www.fasb.org/eitf/agenda.shtml</a> for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to <a href="http://www.fasb.org">www.fasb.org</a> for a complete list of FSPs.
Technical Questions and Answers (TIS) section 1500.07, "Disclosure Concerning Subsequent Events in OCBOA Financial Statements" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: July 2009 (Nonauthoritative)	This question and answer addresses whether full disclosure financial statements prepared on an other comprehensive basis of accounting should contain the disclosures set forth in Financial Accounting Standards Board (FASB) <i>Accounting Standards Codification</i> (ASC) 855, <i>Subsequent Events</i> .
TIS section 6931.11, "Fair Value Measurement Disclosures for Master Trusts" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: March 2009 (Nonauthoritative)	This question and answer indicates that the disclosures required by paragraphs 32–34 of FASB Statement No. 157, <i>Fair Value Measurements</i> , are required for individual investments under a master trust arrangement and are not required for the plan's total interest in the master trust.
TIS section 1900.01, "Condensed Interim Financial Reporting by Nonissuers" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: January 2009 (Nonauthoritative)	This question and answer indicates that when preparing condensed interim financial statements, nonissuers may analogize to the guidance in Article 10 of SEC Regulation S-X regarding form and content because Accounting Principles Board (APB) Opinion No. 28, <i>Interim Financial Reporting</i> , does not provide a reporting framework. APB Opinion No. 28 is codified primarily at FASB ASC 270, <i>Interim Reporting</i> .
TIS section 6910.29, "Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: January 2009 (Nonauthoritative)	This question and answer discusses how cumulative unrealized gains (losses), carried interest, and clawback should be reflected in the equity balances of each class of shareholder or partner at the balance sheet date when preparing financial statements of an investment partnership, in accordance with U.S. generally accepted accounting principles, in which capital is reported by investor class. In particular, this question and answer asks if cumulative period-end unrealized gains and losses should be allocated as if realized in accordance with the partnership's governing documents prior to the date, time, or event specified in the partnership agreement.

(continued)

<b><i>Recent Accounting Pronouncements and Related Guidance</i></b>	
TIS section 6910.30, "Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: August 2009 (Nonauthoritative)	This question and answer discusses if a nonregistered investment partnership should apply the guidance in paragraphs 8–9 of FASB ASC 946-210-50 if it owns an interest in an investee fund that constitutes less than 5 percent of the nonregistered investment partnership's net assets.
TIS section 6910.31, "The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the "5 Percent Test" Described in TIS Section 6910.30" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: August 2009 (Nonauthoritative)	This question and answer discusses the method and the location for the disclosure in the financial statements when a nonregistered reporting investment company calculates its proportional share of any investments owned by an investee fund in applying the "5 percent test" described in TIS section 6910.30, "Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets".
TIS section 6910.32, "Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund's Debt" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: August 2009 (Nonauthoritative)	This question and answer discusses what additional disclosures a nonregistered reporting investment partnership should consider within the financial statements when the reporting investment partnership has provided guarantees related to the investee fund's debt.
TIS section 1900.01, "Condensed Interim Financial Reporting by Nonissuers" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: January 2009 (Nonauthoritative)	This question and answer indicates that when preparing condensed interim financial statements, nonissuers may analogize to the guidance in Article 10 of SEC Regulation S-X regarding form and content because Accounting Principles Board (APB) Opinion No. 28, <i>Interim Financial Reporting</i> , does not provide a reporting framework. APB Opinion No. 28 is codified primarily at FASB ASC 270, <i>Interim Reporting</i> .

***Recent Accounting Pronouncements and Related Guidance***

TIS section 1100.15, "Liquidity Restrictions" (AICPA, <i>Technical Practice Aids</i> ) Issue Date: October 2008 (Nonauthoritative)	This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.
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## Recent AICPA Independence and Ethics Pronouncements

**.273** Audit Risk Alert *Independence and Ethics Developments—2009* (product no. 0224709) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting [www.cpa2biz.com](http://www.cpa2biz.com).

## On the Horizon

**.274** Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the investment company industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

**.275** The following table lists the various standard setting bodies' Web sites, through which information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

<b><i>Standard Setting Body</i></b>	<b><i>Web Site</i></b>
AICPA Auditing Standards Board	<a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a>
Financial Accounting Standards Board	<a href="http://www.fasb.org">www.fasb.org</a>
Professional Ethics Executive Committee	<a href="http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/">www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/</a>
Public Company Accounting Oversight Board	<a href="http://www.pcaob.org">www.pcaob.org</a>
Securities and Exchange Commission	<a href="http://www.sec.gov">www.sec.gov</a>

## Auditing and Attestation Pipeline—Nonissuers

### *Auditing Standards Board Clarity Project*

.276 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the ISAs issued by the International Auditing and Assurance Standards Board (IAASB). The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made and will be amended, should that prove necessary. See the explanatory memorandum "Clarification and Convergence" and the discussion paper *Improving the Clarity of ASB Standards* at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm).

### *Exposure Drafts on Service Organizations*

.277 The ASB issued an exposure draft (using clarity drafting conventions) that would supersede AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), which contains guidance for auditors auditing the financial statements of entities that use a service organization (user auditors) and for auditors reporting on controls at a service organization (service auditors). The proposed SAS only contains guidance for user auditors and is based on the December 2007 exposure draft of ISA 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Third Party Service Organization*. Guidance for service auditors will be contained in a new Statement on Standards for Attestation Engagements (SSAE), *Reporting on Controls at a Service Organization*, which was exposed for comment concurrently with this proposed SAS. AU section 324 would retain this new user auditor guidance and be renamed *Audit Considerations Relating to an Entity Using a Service Organization*. The key provisions of the proposed SAS are as follows:

- In a type 2 report, the service auditor's report would contain an opinion on the fairness of the description of the service organization's system and the suitability of the design of the controls for a period (rather than as of a specified date).
- A user auditor would be permitted to make reference to the work of a service auditor in his or her report to explain a modification of the user auditor's opinion. In those circumstances, the user auditor's report must indicate that such reference does not diminish the user auditor's responsibility for that opinion.
- A user auditor would be required to inquire of management of the user entity about whether the service organization has reported



to the user entity any fraud, noncompliance with laws and regulations, or uncorrected misstatements. If so, the user auditor would be required to evaluate how such matters affect the nature, timing, and extent of the user auditor's further audit procedures.

- The proposed SAS also would be applicable to situations in which an entity uses a shared service organization that provides services to a group of related entities.

**.278** The proposed SSAE would supersede the requirements and guidance in AU section 324 for auditors reporting on controls at service organizations. It is based on the December 2007 exposure draft of International Standard on Assurance Engagements 3402, *Assurance Reports on Controls at a Third Party Service Organization*. The proposed SSAE has six key provisions:

- First, as a condition of engagement performance, management of the service organization would be required to provide the service auditor with certain written assertions related to their system and design of controls.
- Second, a service auditor would be able to report on controls at a service organization other than controls that are relevant to user entities' financial reporting (such as controls related to regulatory compliance).
- The third key provision mirrors the provision of the proposed SAS, which discusses the service auditor's opinion in a type 2 report.
- Fourth, when obtaining an understanding of the service organization's system, the service auditor would be required to obtain information to identify risks that the description of the service organization's system is not fairly presented or that the control objectives stated in the description were not achieved due to intentional acts by service organization personnel.
- Next, when assessing the operating effectiveness of controls in a type 2 engagement, evidence obtained in prior engagements about the satisfactory operation of controls in prior periods does not provide a basis for a reduction in testing, even if supplemented with evidence obtained during the current period.
- Lastly, the proposed SSAE specifies the wording to be used in a service auditor's type 1 or 2 report to describe the customers to whom use of the report is restricted.

**.279** The exposure draft indicates that the proposed SAS would be effective for audits of financial statements for periods beginning on or after December 15, 2010. This is a provisional effective date; however, the actual effective date will not be any earlier. The ASB requested feedback on the effective date of the proposed SSAE. The comment period for both ended on February 17, 2009. The exposure drafts, a disposition of AU section 324 in the proposed SSAE, and a disposition of AU section 324 in the proposed SAS can all be accessed at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/). Constituents should be alert for developments.

### ***Exposure Draft on Auditing Accounting Estimates***

**.280** The ASB recently issued an exposure draft with clarity drafting conventions, *Auditing Accounting Estimates, Including Fair Value Accounting*

*Estimates and Related Disclosures* (Redrafted), which would supersede AU sections 342 and 328. This proposed SAS is based on ISA 540, *Auditing Accounting Estimates, Including Fair Value Estimates and Related Disclosures*. This exposure draft does not significantly change or expand the guidance in AU sections 342 or 328; however, it does combine the two sections.

.281 Comments on the proposed SAS are due on November 30, 2009. The ASB was specifically seeking comments on changes resulting from applying the clarity conventions and converging with the ISA. This proposed SAS would be effective for audits of financial statements for periods beginning on or after December 15, 2010. This effective date is provisional, but will not be any earlier. The proposed SAS can be accessed at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/Proposed+Statement+on+Auditing+Standards+Estimates.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/Proposed+Statement+on+Auditing+Standards+Estimates.htm).

### ***Exposure Draft to Revise Standards for Compilation and Review Engagements***

.282 The Accounting and Review Services Committee (ARSC) issued an exposure draft that would revise the standards for compilation and review engagements. The changes would affect the interplay between the standards and independence Rules, permitting an accountant to issue a review report on financial statements when the accountant's independence is impaired by performing certain nonattest services (described in the exposure draft as internal control services) that were designed to improve the reliability of the client's financial information.

.283 The exposure draft includes a trio of proposed standards: *Framework and Objectives for Performing and Reporting on Compilation and Review Engagements*, *Compilation of Financial Statements*, and *Review of Financial Statements*. In drafting the proposed standards, the ARSC considered recommendations from the Private Company Practice Section (PCPS) Reliability Task Force. The ARSC and PCPS believe the proposed standards will respond to many concerns of smaller business owners, users of small business financial statements, and CPAs who serve smaller entities.

.284 The PCPS task force recommended that the ARSC consider revising its standards for situations in which an accountant's independence is impaired in connection with the performance of a nonattest service relating to the design or operation of an aspect of internal control over financial reporting. These nonattest services help management prepare higher quality or more reliable financial statements.

.285 The proposed standards also would harmonize the AICPA's review standard with the IAASB's review standard, International Standard on Review Engagements No. 2400, *Engagements to Review Financial Statements*.

.286 Significant proposed changes to the Statements on Standards for Accounting and Review Services include the following:

- The introduction of new terms such as *moderate assurance*, *review evidence*, and *review risk*, to the review literature to harmonize with international review standards.
- A discussion of materiality in the context of a review engagement.

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- A requirement that an accountant establish an understanding with management regarding the services to be performed through a written communication (that is, an engagement letter).
- The establishment of enhanced documentation requirements for compilation and review engagements.
- Guidance for practitioners who are engaged to perform a compilation or review engagement when they also have been engaged to perform nonattest services. The guidance includes reporting requirements for instances in which the accountant's independence is impaired due to the performance of these services.
- The ability for an accountant to include a general description in the accountant's compilation report regarding the reason(s) for an independence impairment.

.287 The comment deadline was July 31, 2009. The proposed effective date is for compilations and reviews of financial statements for periods beginning on or after December 15, 2010. Early application would be permitted. For further information on this project, visit [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/ARSC+Reliability+Project.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/ARSC+Reliability+Project.htm).

### *Implementation Guidance for Compilation and Review Standards*

.288 The AICPA is working on two products to further your knowledge of the new compilation and review standards. The first product is the AICPA's annual alert *Compilation and Review Engagements—2009*. This alert provides an annual update on issues affecting compilation and review engagements and will focus on the proposed new standards, among other issues, affecting practitioners performing compilation and review engagements. This alert is scheduled to be released in December 2009, just in time for your 2009 compilation and review engagement planning. The second product is the brand new AICPA Guide *Compilation and Review Engagements*, which will provide additional information on implementing the new compilation and review standards and understanding internal control services. It also will include illustrative letters, sample reports, and case studies. This guide is expected to be available in 2010. See [www.cpa2biz.com](http://www.cpa2biz.com) for further information.

## Auditing and Attestation Pipeline—Issuers

### *PCAOB Risk Assessment Standards*

.289 In October 2008, the PCAOB proposed seven new auditing standards to update and supersede the current risk assessment standards. The PCAOB chairman noted that the proposals demonstrate the view that the risk of fraud is a central part of the audit process and not a separate consideration. The proposed standards integrate the risk assessment standards with the standard for the audit of internal control over financial reporting. Many of the IAASB's risk assessment standards were utilized in creating these proposed standards, and efforts were made to reduce any unnecessary differences. Each of these proposed standards has a statement of objective for the auditor, which was loosely adapted from the ISAs. This is an example of the move in the United States from Rules-based to principles-based accounting and auditing standards

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because these objectives do not state required outcomes. The seven proposed standards are as follows:

- Audit Risk in an Audit of Financial Statements
- Audit Planning and Supervision
- Identifying and Assessing Risks of Material Misstatement
- The Auditor's Responses to the Risks of Material Misstatement
- Evaluating Audit Results
- Consideration of Materiality in Planning and Performing an Audit
- Audit Evidence

.290 In February 2009, the CAQ issued a comment letter on the proposed standards. Readers can review the full text of the comment letter at <http://thecaq.org/newsroom/pdfs/CAQCommentLetter-PCAOBRiskAssessmentAuditStds.pdf>. The comment period for these proposed standards ended in February 2009. As with any new auditing standard or amendment to a PCAOB standard, after adoption by the PCAOB, the standards will be submitted to the SEC for approval.

### ***Signing of the Audit Report by the Engagement Partner***

.291 In July 2009, the PCAOB issued a concept release on requiring the engagement partner to sign the audit report. This requirement would be in addition to the signature of the audit firm on the audit report. The rationale for this concept release is the potential for an improvement of audit quality if the engagement partner signs the audit report due to the following:

- It might increase the engagement partner's sense of accountability to financial statement users, which could lead him or her to exercise greater care in performing the audit.
- It would increase transparency about who is responsible for performing the audit, which could provide useful information to investors and, in turn, provide an additional incentive to firms to improve the quality of all of their engagement partners.

.292 Further, this signature would be the auditor's equivalent for the Section 302 certifications required for the principal executive officer and principal financial officer to essentially remind the signer of their responsibilities. The European Union mandated the signing of the audit report by the engagement partner in 2006. Comments on this proposal were due in September 2009. Readers should be alert for developments on this issue.

## **Accounting Pipeline**

### ***FASB and IASB Memorandum of Understanding***

.293 In September 2008, FASB and the IASB updated their "Memorandum of Understanding" (MoU), originally published in 2006, to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In developing the original MoU, FASB and the IASB agreed on priorities and established milestones as part of a joint work program to develop new common standards that improve the financial information reported to investors. FASB and the IASB agreed that the goal of joint projects is to produce

common, principles-based standards, subject to the required due process. In the MoU, the boards identified the following 11 convergence topics on which to focus:

- Business combinations
- Financial instruments
- Financial statement presentation
- Intangible assets
- Leases
- Liabilities and equity distinctions
- Revenue recognition
- Consolidations
- Derecognition
- Fair value measurement
- Postemployment benefits (including pensions)

**.294** Both FASB and the IASB note that their individual and joint efforts are not limited to the preceding items, but they remain committed to the MoU. FASB and the IASB also have several other joint projects in process, including the conceptual framework project, emissions trading schemes, insurance contracts, and income taxes.

**.295** Readers also are encouraged to monitor developments on the AICPA's Web site, [www.ifrs.com](http://www.ifrs.com), in addition to the FASB, IASB, and SEC Web sites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

### ***Other Accounting Projects***

**.296** Additionally, FASB has the following projects underway:

- Going concern
- Embedded credit derivatives scope exceptions
- Disclosure of certain loss contingencies
- Loan loss disclosures
- Financial instruments with characteristics of equity
- Consolidations: policy and procedures
- Accounting for financial instruments
- Financial statement presentation
- Disclosure framework

**.297** FASB and the IASB established an advisory group, the Financial Crisis Advisory Group (FCAG), which is composed of senior leaders with international experience in financial markets. The FCAG will advise FASB and the IASB about the standard setting implications of the global financial crisis as well as changes to the global regulatory environment. Readers should refer to <http://fasb.org/fcag/index.shtml> for additional information.

### **Resource Central**

**.298** The following are various resources that practitioners engaged in the investment company industry may find beneficial.

## Publications

**.299** Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- Audit and Accounting Guide *Investment Companies* (2009) (product no. 012629 [paperback], WIN-XX12 [online with the associated Audit Risk Alert], or DIN-XX12 [CD Rom with the associated Audit Risk Alert])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback], WAN-XX [online], or DAN-XX [CD-ROM])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Revenue in Certain Industries* (2009) (product no. 012519 [paperback], WAR-XX [online], or DAR-XX [CD-ROM])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback], WAS-XX [online], or DAS-XX [CD-ROM])
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2009) (product no. 012779 [paperback], WSV-XX [online], or DSV-XX [CD-ROM])
- Audit Risk Alert *Compilation and Review Developments—2008* (product no. 022309 [paperback], WCR-XX [online], or DCR-XX [CD-ROM])
- Audit Risk Alert *Current Economic Instability: Accounting and Auditing Considerations—2009* (product no. 0223309 [paperback], WGE-XX [online], or DGE-XX [CD-ROM])
- Audit Risk Alert *Independence and Ethics Developments—2009* (product no. 0224709 [paperback], WIA-XX [online], or DIA-XX [CD-ROM])
- Checklists and Illustrative Financial Statements *Investment Companies* (product no. 0089409 [paperback] or WISCL12 [online])
- *Accounting Trends & Techniques, 62nd Edition* (product no. 009900 [paperback] or WAT-XX [online])
- *Audit and Accounting Manual* (2009) (product no. 0051309 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* (product no. 006639 [paperback])
- Audit and Accounting Practice Aid *Independence Compliance: Checklists and Tools for Complying With AICPA, SEC, and PCAOB Independence Requirements* (product no. 006660 [paperback])

**.300** Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed 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.

- Financial Reporting Alert *Current Economic Crisis: Accounting Issues and Risks for Financial Management and Reporting—2009* (product no. 0292009 [paperback])

### AICPA reSOURCE: Accounting and Auditing Literature

.301 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. To subscribe to this essential online service for accounting professionals, visit [www.cpa2biz.com](http://www.cpa2biz.com).

### AICPA Accounting Guidance Library

.302 AICPA Resource Online now offers FASB ASC. As discussed previously in this alert, FASB ASC significantly changes the structure and hierarchy of accounting and reporting standards into a topically organized format.

.303 In this extraordinary member value, the AICPA is offering online access to FASB ASC along with our most popular Audit and Accounting Guides for only \$659 for a one year subscription (product number WGC-XX).

.304 This new library gives you online access to FASB ASC and the following AICPA Audit and Accounting Guides:

- *Construction Contractors*
- *Depository and Lending Institutions*
- *Employee Benefit Plans*
- *Investment Companies*
- *Life and Health Insurance Entities*
- *Not-for-Profit Entities*
- *Property and Liability Insurance Entities*

.305 The guides have been fully conformed and linked to FASB ASC and will help ease your transition to the new structure. In addition, these guides provide a key entry point to understanding the impact of FASB ASC on your work.

.306 While working in FASB ASC on AICPA reSOURCE Online, you will be able to do the following:

- Perform a full-text search
- Browse by topic
- Use quick go-to navigation to find a specific FASB ASC reference
- Access a cross reference report that identifies where legacy material is now located and link directly to that content
- View the source of the codified content
- Join sections and subsections

- Access an archive function of previous versions of FASB ASC content
- See all FASB ASC content that links to a given paragraph

.307 Subscribe today and make the transition to the new FASB ASC at a member-only value price of \$659. Discounted multiuser subscriptions are available for this library. To order, call (888) 777-7077 or go to [www.cpa2biz.com](http://www.cpa2biz.com).

## Continuing Professional Education

.308 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop (2009–2010 Edition)* (product no. 736185 [text] or 187193 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *SEC Reporting* (product no. 736776 [text] or 186757 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements and gives you examples and tips for ensuring compliance.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731667 [text]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *The International Financial Reporting Standards: An Overview* (product no. 157220 [online] or 739750HS [CD-ROM]). This course captures a live presentation on IFRSs given to the AICPA board of directors.

.309 Visit [www.cpa2biz.com](http://www.cpa2biz.com) for a complete list of CPE courses.

## Online CPE

.310 AICPA CPEExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay \$180 for a new subscription and \$149 for the annual renewal. Nonmembers pay \$435 for a new subscription and \$375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPEExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit [www.cpa2biz.com](http://www.cpa2biz.com).

## Webcasts

.311 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

### ***CFO Quarterly Roundtable Series***

.312 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

### ***SEC Quarterly Update Series***

.313 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

### ***IFRS Quarterly Webcast Series***

.314 The IFRS Quarterly Webcast Series, brought to you each calendar quarter, is part of a multistep educational process to get practitioners, financial managers, and auditors up to speed on all aspects of IFRSs implementation. Over the course of the quarterly series, IFRSs will be covered in depth. International harmonization is quickly approaching, and this series will help both accountants and auditors stay abreast of the developments and changes they will need to implement.

## **Member Service Center**

.315 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

## **Hotlines**

### ***Accounting and Auditing Technical Hotline***

.316 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/).

### ***Ethics Hotline***

.317 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at [ethics@aicpa.org](mailto:ethics@aicpa.org).

## The CAQ

**.318** The CAQ was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

**.319** To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit <http://thecaq.aicpa.org>.

## AICPA Industry Expert Panel—Investment Companies

**.320** For information about the activities of the AICPA Investment Companies Industry Expert Panel, visit the panel's Web page at [www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel\\_investco.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_investco.htm).

## Industry Web Sites

**.321** The Internet covers a vast amount of information that may be valuable to auditors of investment companies, including current industry trends and developments. Some of the more relevant sites for auditors with investment company clients include those shown in the following table:

<i>Organization</i>	<i>Web Site</i>
Commodity Futures Trading Commission	<a href="http://www.cftc.gov/">www.cftc.gov/</a>
Financial Accounting Standards Board	<a href="http://www.fasb.org/">www.fasb.org/</a>
Financial Industry Regulatory Authority	<a href="http://www.finra.org/index.htm">www.finra.org/index.htm</a>
Independent Directors Council	<a href="http://www.idc1.org">www.idc1.org</a>
Investment Company Institute	<a href="http://www.ici.org/">www.ici.org/</a>
Mutual Fund Directors Forum	<a href="http://www.mfdf.com/">www.mfdf.com/</a>
Securities and Exchange Commission	<a href="http://www.sec.gov/">www.sec.gov/</a>

**.322** The investment company practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

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**.323** This Audit Risk Alert replaces *Investment Companies Industry Developments—2008*.

**.324** The Audit Risk Alert *Investment Companies Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to [KLichtenstein@aicpa.org](mailto:KLichtenstein@aicpa.org) or write to

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## Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

<i>Web Site Name</i>	<i>Content</i>	<i>Web Site</i>
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Accounting Standards Executive Committee	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org



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<i><b>Web Site Name</b></i>	<i><b>Content</b></i>	<i><b>Web Site</b></i>
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC Rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov





