

Insights

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Accounting

Accounting and Disclosure Considerations Related to Certain Loan Products

The staff of the Financial Accounting Standards Board (FASB) has issued FASB Staff Position (FSP) No. SOP 94-6-1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk*, to emphasize the requirement to assess the adequacy of disclosures for all lending products (including both secured and unsecured loans) and the effect of changes in market or economic conditions on the adequacy of those disclosures. This FSP has been issued as a result of comments received on a proposed FSP titled "Nontraditional Loan Products."

This FSP first discusses in what circumstances the terms of loan products give rise to a *concentration of credit risk* as that term is used in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. Contractual features that loan products may have, which increase the exposure of the originator, holder, investor, guarantor, or servicer to increased credit risk include, but are not limited to:

- Terms that permit principal payment deferral or payments smaller than interest accruals (negative amortization);
- A high loan-to-value ratio;
- Multiple loans on the same collateral that when combined result in a high loan-to-value ratio;
- Option adjustable-rate mortgages or similar products that may expose the borrower to future increases in repayments in excess of increases that result solely from increases in the market interest rate;
- An initial interest rate that is below the market interest rate for the initial period of the loan term and that may increase significantly when that period ends; and
- Interest-only loans.

The FSP concludes that terms of certain loan products may increase a reporting entity's exposure to credit risk and thereby may result in a concentration of credit risk, which requires disclosures about each significant concentration, including information about the (shared) activity, region, or economic characteristic that identifies the concentration. An entity must provide the disclosures required by Statement No. 107 for products that are determined to represent a concentration of credit risk for all periods presented. This guidance is effective for interim and annual periods ending after December 19, 2005.

The FSP also discusses the following required disclosures and other accounting considerations for entities that originate, hold, guarantee, service, or invest in loan products whose terms may give rise to a concentration of credit risk:

- Certain loan products have contractual terms that expose entities to risks and uncertainties that must be disclosed per AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. Additionally, concentrations should be disclosed if they meet the following requirements:
 - A concentration exists at the date of the financial statements;
 - The concentration makes the entity vulnerable to the risk of a near-term severe impact; and
 - It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.
- Negative amortization results in the recognition of interest income that is not received in cash, but rather, is added to the principal balance of an outstanding loan. To the extent that this non-cash interest income is significant, it is required to be included in the reconciliation of net income to net cash flows from operating activities as required by FASB Statement No. 95, *Statement of Cash Flows*.
- An entity that has recognized a servicing asset relating to loan products whose terms may give rise to a concentration of credit risk is required to consider whether the predominant risk characteristics of the specific product type result in a separate stratum when determining impairment. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires the disclosure of the risk characteristics used to stratify recognized servicing assets for purposes of measuring impairment. Additionally, originators and servicers that have provided guarantees on these loan products should consider the specific risk characteristics when assessing the fair value of those guarantees. The characteristics of each product also must be considered when assessing the fair value of loan products that an entity classifies as held for sale.
- When recognizing interest income on loans with interest rates that increase during the term of the loan, an entity must apply the guidance in paragraph 18(a) of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.
- For public entities, additional disclosures may be required by applicable SEC Rules and Regulations (for example, Item 303 of Regulation S-K, *Management's Discussion and Analysis of Financial Condition and Results of Operations*).
- For banks and bank holding companies subject to the requirements of SEC Regulation S-X, Rule 9-03, and the Securities Act Industry Guide 3, additional disclosures may be required. For example, Rule 9-03 requires an entity to state separately any other loan category regardless of relative size if necessary to reflect any unusual risk concentration.

These required disclosures reflect existing effective literature; therefore, no effective date or transition guidance is given.

While the FSP applies to all entities that make loans having the characteristics described above, entities most affected by the FSP are financial institutions.

FSP No. SOP 94-6-1 is available at http://www.fasb.org/fasb_staff_positions/fsp_sop94-6-1.pdf.

Proposed Guidance on Accounting for Renewable Intangible Assets

FASB Statement No. 142, *Goodwill and Other Intangible Assets*, provides guidance for the accounting of acquired goodwill and other intangible assets. However, in applying Statement No. 142 to account for renewable intangible assets (intangible assets that contain legal, regulatory, or contractual provisions that enable renewal or extension of the asset's legal or contractual life), companies have noticed that such intangible assets often end up with a useful life that is shorter than the period of cash flows that were used in determining their fair value in accordance with FASB Statement No. 141, *Business Combinations*. The FASB Staff, therefore, has proposed FASB Staff Position (FSP) No. FAS 142-d, *Amortization and Impairment of Acquired Renewable Intangible Assets*, to address how finite-lived renewable intangible assets should be amortized and tested for impairment.

Per the proposed FSP, the fair value of the renewable intangible asset upon acquisition should be attributed to (a) the initial contractual period of use and (b) each future renewal period based on the relative value of the discounted cash flows of each period compared with the total discounted cash flows. The amount attributed to the initial contractual period of use and all future renewal periods should be amortized over each respective period. Incremental and direct costs of renewal should be capitalized and amortized over the respective renewal period. (Under existing practice, renewal costs are charged to expense in the period incurred.) The application of the amortization methodology described in the proposed FSP results in a declining amount of amortization expense during each of the renewal periods.

The proposed FSP also states that renewable intangible assets must be tested for impairment using the same methodology as indefinite-lived intangible assets. That is, the asset must be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test must consist of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss must be recognized in an amount equal to that excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset would be its new accounting basis. The updated cash flow information would be used for purposes of attributing amortization to the contractual period of use and all future renewal periods. In the unusual situation that cash flow information is not available without undue cost and effort, an entity should use a methodology that is reasonable and supportable for purposes of attributing amortization to the contractual period of use and all future renewal periods.

If adopted, this FSP would be applied prospectively to newly acquired renewable intangible assets, and preexisting renewable intangible assets that are renewed after June 15, 2006. A perpetually renewable intangible asset that was previously deemed to have a finite useful life due to material modifications at renewal, but renewal was reasonably assured for the foreseeable future, would be accounted for as an indefinite-lived intangible asset in interim and annual periods beginning after June 15, 2006.

The proposed FSP is available for comment until March 27, 2006 at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas142-d.pdf.

Financial Institutions

Guide to Help Financial Institutions Comply with Information Security Guidelines

The federal bank and thrift regulatory agencies have published a *Small-Entity Compliance Guide* to address financial institutions' obligations under the *Interagency Guidelines Establishing Information Security Standards* (Security Guidelines). The Compliance Guide summarizes the obligations of financial institutions to protect customer information and illustrates how certain provisions of the Security Guidelines apply to specific situations, but is not a substitute for the Security Guidelines. The compliance guide provides information to help financial institutions assess risks, design and implement an information

security program, properly dispose of customer and consumer information, respond to incidents of unauthorized access to customer information, and oversee service providers that have access to customer information. The compliance guide also lists resources that may be helpful in assessing risks and designing and implementing information security programs.

A copy of the Compliance Guide is available at [FDIC: Press Releases - PR-127-2005 12/14/2005](#).

Public Sector

Temporary Exemptions Resulting from Hurricanes

The Comptroller General of the United States has issued temporary exemptions from certain provisions of the 2003 revision of *Government Auditing Standards* for auditors and audit organizations impacted by Hurricanes Katrina and Rita, and is providing additional guidance to protect the public interest related to accountability for public funds in the relief efforts.

Government audit organizations that have audit responsibilities for entities affected by Hurricanes Katrina and Rita may be temporarily exempt from certain independence requirements of *Government Auditing Standards* that prohibit or place restrictions on providing non-audit services that involve performing management functions other than accounting and bookkeeping services if certain conditions exist. The temporary exemption applies for financial statement audits of periods ending through September 30, 2006 and for performance audits and attestation engagements of activity through September 30, 2006.

Government audit organizations that have audit responsibilities for entities whose records were lost or destroyed in Hurricanes Katrina and Rita also may be exempt from the independence requirements of *Government Auditing Standards* that prohibit or place restrictions on accounting and bookkeeping services if certain conditions exist.

In the wake of the hurricanes, there may be situations in which an audited entity's financial records, program records, or supporting documentation needed to conduct or complete an audit have been lost or destroyed. Also, audit organizations may encounter situations in which the audit work and audit documentation were completed but the audit documentation was lost or destroyed before issuance of the audit report, or in which the audit work was partially completed and the audit documentation was lost or destroyed. In these situations, audited entities and their auditors will need to use professional judgment to weigh the costs and benefits of completing audits with the need for public accountability for the use of funds. The Comptroller General's guidance outlines steps that audit organizations should take in these situations. Consultations will also be needed with external oversight organizations to determine whether there is a legal or regulatory requirement for the audit, and if so, how to meet those requirements.

The complete text of the Comptroller General's temporary exemptions and guidance is available at <http://www.gao.gov/govaud/hurricanedocument.pdf> and should be read in its entirety prior to relying on any of the exemptions.

SEC

When Is Form 10-K Due?

As previously reported, the SEC recently adopted amendments to certain periodic report filing deadlines, and, in doing so, amended the definition of an accelerated filer. The term "accelerated filer" now is defined as an issuer after it first meets the following conditions as of the end of its fiscal year:

- The aggregate worldwide market value of the voting and nonvoting common equity held by non-affiliates of the issuer (public float) is \$75 million or more, but less than \$700 million as of the last business day of the issuer's most recently completed second fiscal quarter;

- The issuer has been subject to the Exchange Act's reporting requirements for a period of at least twelve calendar months;
- The issuer has filed at least one annual report; and
- The issuer is not eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports.

The amendments also created a new category of "large accelerated filers" that will include companies with a public float of \$700 million or more.

Using these new definitions, the annual report on Form 10-K must be filed within the following period:

Type of filer	For fiscal years ending prior to December 15, 2006	For fiscal years ending on or after December 15, 2006
Large accelerated filer	75 days after the end of the fiscal year covered by the report	60 days after the end of the fiscal year covered by the report
Accelerated filer	75 days after the end of the fiscal year covered by the report	75 days after the end of the fiscal year covered by the report
All other registrants	90 days after the end of the fiscal year covered by the report	90 days after the end of the fiscal year covered by the report

The SEC requires registrants to file Form 10-Q within the following period after the end of the quarter for each of the first three quarters of the fiscal year:

- 40 days after the end of the fiscal quarter for large accelerated filers and accelerated filers.
- 45 days after the end of the fiscal quarter for all other registrants.

The full text of the final rule detailing the amendments is available at <http://www.sec.gov/rules/final/33-8644.pdf>.

PCAOB Selects New Chief Auditor

The Public Company Accounting Oversight Board (PCAOB) has selected Thomas Ray as Chief Auditor and Director of Professional Standards, succeeding Douglas R. Carmichael, who will leave his post at the end of January for personal reasons. The PCAOB's Chief Auditor is the primary advisor to the PCAOB on policy and technical issues related to auditing of public companies' financial statements. The Chief Auditor reports to the Board on significant issues related to the accounting industry and works with other relevant organizations, including the Securities and Exchange Commission, the Financial Accounting Standards Board and the American Institute of Certified Public Accountants (AICPA). The Chief Auditor also serves as chairman of the Board's Standing Advisory Group.

Mr. Ray, 45, has served as deputy chief auditor since June 2003. Prior to joining the PCAOB, Mr. Ray was a partner in KPMG LLP in the Department of Professional Practice—Assurance, providing advice on the application of professional standards and firm policy to the firm's personnel, audit methodology and professional development groups and assurance product development teams. Prior to joining KPMG in June 2000, Mr. Ray was Director—Audit and Attest Standards at the AICPA, where he was responsible for the administration of the AICPA auditing and attestation standards-setting activities and was the senior technical advisor to the AICPA Auditing Standards Board. Mr. Ray joined the AICPA in 1995 after 13 years with Grant Thornton LLP as an audit professional.

International

Clarification of Certain IAS 21 Requirements

Earlier this year, the International Accounting Standards Board (IASB) received comments about problems in implementing International Accounting Standard (IAS) 21, *The Effects of Changes in Foreign Exchange Rates*, which became mandatory in 2005. In particular, IAS 21 required different accounting depending on the currency in which a monetary item was denominated, specifically where such an item was regarded as part of an entity's investment in a foreign operation. Secondly, IAS 21 was not clear on whether any member of a consolidated group could enter into the monetary transaction with the foreign operation. In response to these concerns, the IASB has issued a limited amendment to clarify the requirements of IAS 21 regarding an entity's investment in foreign operations.

For a monetary item that forms part of an entity's investment in a foreign operation, the IASB concluded that the accounting treatment in consolidated financial statements should not be dependent on the currency of the monetary item, nor on which entity within the group conducts a transaction with the foreign operation. The amendment requires exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation to be recognized initially in a separate component of equity in the consolidated financial statements. This requirement applies irrespective of the currency of the monetary item and irrespective of whether the monetary item results from a transaction with the parent or with any of its subsidiaries.

An entity must apply the amendment for annual periods beginning on or after January 1, 2006. Earlier application is encouraged.

IASB Revises IFRS 4 Implementation Guidance

The International Accounting Standards Board (IASB) has published revised *Guidance on Implementing IFRS 4, "Insurance Contracts"*. This revision reflects the changes made to IFRS 4 in August 2005 by IFRS 7, *Financial Instruments: Disclosures*. IFRS 7 amended and superseded the disclosures about risk that were previously required by IAS 32, *Financial Instruments: Disclosure and Presentation*. Those changes necessitated consequential amendments to IFRS 4, which previously required disclosure of the information about interest rate risk and credit risk that IAS 32 would require if the insurance contracts were within the scope of IAS 32. The revised guidance is available at <http://www.iasb.org/>.

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