

Insights

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Accounting

Reporting of Fully Benefit-Responsive Investment Contracts

The staff of the Financial Accounting Standards Board (FASB) has issued FASB Staff Position (FSP) No. AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans*. The guidance in the FSP is applicable to certain investment companies subject to the AICPA Audit and Accounting Guide, *Investment Companies*. This FSP amends the guidance in AICPA Statement of Position (SOP) 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, with respect to the definition of *fully benefit-responsive* and the presentation and disclosure of fully benefit-responsive investment contracts. The FSP also amends SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, and amends paragraph 10(h) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to remove the scope exception provided for fully benefit-responsive investment contracts reported at contract value in accordance with SOP 94-4.

An investment contract is considered fully benefit-responsive for purposes of this FSP, if *all* of the following criteria are met for that contract, analyzed on an individual basis:

- The investment contract is affected directly between the fund and the issuer and prohibits the fund from assigning or selling the contract or its proceeds to another party without the consent of the issuer.
- Either (1) the repayment of principal and interest credited to participants in the fund is a financial obligation of the issuer of the investment contract or (2) prospective interest crediting rate adjustments are provided to participants in the fund on a designated pool of investments held by the fund or the contract issuer whereby a financially responsible third party, through a contract generally referred to as a wrapper, must provide assurance that the adjustments to the interest crediting rate will not result in a future interest crediting rate that is less than zero.
- The terms of the investment contract require all permitted participant-initiated transactions with the fund to occur at contract value with no conditions, limits, or restrictions.
- An event that limits the ability of the fund to transact at contract value with the issuer and that also limits the ability of the fund to transact at contract value with the participants in the fund must be probable of not occurring.
- The fund itself must allow participants reasonable access to their funds.

Investments held by an investment company are reported at fair value, except this FSP stipulates that contract value is the relevant measurement attribute for that portion of the net assets of an investment company attributable to fully benefit-responsive investment contracts, provided that the investment company is established

under a trust whereby the trust itself is adopted as part of one or more qualified employer-sponsored defined-contribution plans. Contract value generally equals the principal balance plus accrued interest. The extensive financial statement presentation and disclosure requirements for such funds are detailed and illustrated in the FSP.

The financial statement presentation and disclosure guidance in this FSP is effective for financial statements for annual periods ending after December 15, 2006. The revised definition of *fully benefit-responsive* is effective for all investment contracts as of the last day of the annual period ending after December 15, 2006.

The FSP is available in full at http://www.fasb.org/fasb_staff_positions/fsp_aag_inv-1&sop_94-4-1.pdf.

Guidance Issued for Nonregistered Investment Partnerships

The Accounting Standards Division of the American Institute of Certified Public Accountants has released five technical practice aids (TPAs), which provide guidance to nonregistered investment partnerships and are summarized below:

- TPA 6910.16, *Presentation of Boxed Investment Positions in the Condensed Schedule of Investments of Nonregistered Investment Partnerships*

This TPA concludes that long and short positions in the same security should be individually evaluated on a gross basis when determining whether disclosure is required in the condensed schedule of investments based on the 5% of net asset rule.

- TPA 6910.17, *Disclosure of Long and Short Positions – Nonregistered Investment Partnerships*

In applying the five percent test to determine the investments to be disclosed in the condensed schedule of investments, this guidance concludes that if one security position (e.g. a long position) exceeds 5% of net assets and another position in the same security (e.g. a short position) does not exceed the 5% of net assets, only the position that exceeds 5% of net assets is required to be disclosed. Although not required, a nonregistered investment partnership is not precluded from disclosing both positions.

- TPA 6910.18, *Disclosure of an Investment in an Issuer when One of More Securities and/or One or more Derivative Contracts are Held – Nonregistered Investment Partnerships*

This TPA concludes that in situations where a nonregistered investment partnership holds one or more securities of the same issuer and one or more derivative contracts for which the underlying is a security of the same issuer, the disclosure of securities and derivative contracts on the condensed schedule of investments should be consistent with the classification of the securities or contracts on the statement of assets and liabilities. Those securities and derivatives that are classified as assets should be aggregated, and those securities and derivatives that are classified as liabilities should be aggregated. The TPA includes examples of how to apply these guidelines.

- TPA 6910.19, *Information Required to be Disclosed in Financial Statements when Comparative Financial Statements of Nonregistered Investments Partnerships are Presented*

This guidance states that comparative schedules of investments are required to be presented when comparative statements of assets and liabilities are reported. Also, comparative financial highlights should be presented when comparative statements of operations are provided.

- TPA 6910.20, *Presentation of Purchases and Sales/Maturities of Investments in the Statement of Cash Flows – Nonregistered Investment Partnerships*

This TPA provides guidance on the presentation of purchases and sales/maturities of long-term investments, short-term investments, and transactions in short positions in the statement of cash flows.

The TPAs are available in full at http://www.aicpa.org/download/acctstd/IC_TPAs.pdf.

Auditing

Audit Risk Alert Issued

The American Institute of Certified Public Accountants (AICPA) has issued an Audit Risk Alert, *General Alert: Strengthening Audit Integrity, Safeguarding Financial Reporting - 2005/2006*. This document discusses the economy, general business developments, current accounting issues, auditing issues, and regulatory developments. The AICPA Audit Risk Alert may be purchased through the AICPA at <https://www.cpa2biz.com/default.htm>.

Financial Institutions

Audit Risk Alert Issued for Financial Institutions

The American Institute of Certified Public Accountants has issued an Audit Risk Alert, *Strengthening Audit Integrity, Safeguarding Financial Reporting - Banks, Credit Unions, and Other Lenders and Depository Institutions Industry Developments - 2005/2006*. This Alert may be useful to clients and auditors in gaining an understanding of how recent economic, industry, technical, regulatory, and professional developments affect financial institutions and other lenders. The AICPA Audit Risk Alert may be purchased through the AICPA at <https://www.cpa2biz.com/default.htm>.

Proposed Guidance for Management of Non-traditional Mortgage Products

The Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, and the National Credit Union Administration have proposed risk management guidance and consumer protection practices to address heightened risk levels associated with nontraditional residential mortgage products. Nontraditional mortgage products include "interest-only" mortgage loans where a borrower pays no principal for the first few years of the loan and "payment option" adjustable-rate mortgages where a borrower has flexible payment options, including the potential for negative amortization. Concern is elevated with respect to nontraditional products due to the combining of these mortgages with other practices, such as simultaneous second-lien mortgages, and reduced documentation in evaluating an applicant's creditworthiness.

The proposed guidance discusses the importance of carefully managing the potential heightened risk levels created by these loans. The proposal provides guidance regarding the following management practices:

- Assessing current loan terms and underwriting guidelines to ensure prudent lending practices, including consideration of a borrower's ability to repay the loan.
- Recognizing that certain nontraditional mortgage loans warrant strong risk-management policies and internal controls, as well as appropriate capital and loan loss reserves.
- Ensuring that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

When finalized, this guidance will apply to all banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. Institutions that offer nontraditional mortgage products are encouraged to comment prior to February 27, 2006 on their ability to implement the proposed guidance.

The proposed guidance is available in full at

http://www.fdic.gov/news/news/press/2005/Guidance_on_non_traditional_mortgages.pdf.

Public Sector

Implementation Guide for GASB Statement No. 44

The Governmental Accounting Standard Board (GASB) has published a *Guide to Implementation of GASB Statement 44 on the Statistical Section* to assist preparers and auditors of governmental financial statements as they implement GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section*. Statement No. 44 updated and expanded the specific information required by the statistical section, which is the part of a state or local government's comprehensive annual financial report (CAFR) that presents trend information for the last ten years about a government's financial results, major revenue sources, outstanding debt, economic and demographic indicators, and operating activities. Governments that prepare a CAFR are required to implement Statement No. 44 for fiscal years beginning after June 15, 2005.

The Implementation Guide contains over 120 questions and answers on important aspects of Statement No. 44, including:

- Presenting newly required information, such as net assets, changes in net assets, fund balance, and total outstanding debt;
- Identifying a government's most significant own-source revenue and its overlapping governments;
- Calculating total direct rates, debt ratios, overlapping debt, and debt limit information;
- Obtaining and reporting demographic and economic information; and
- Selecting appropriate trend information about government employees, operating indicators, and capital assets.

The questions and answers are accompanied by more than 160 illustrations, including complete sample statistical sections, alternative formats, and optional schedules for nine types of governments—local, county, and state general purpose governments, a school district, a library district, a public university, a water and sewer authority, an airport, and a retirement system.

The Implementation Guide (product code GQA44) can be ordered through the GASB's Web site at <http://store.yahoo.com/gasbpubs/publications-implementation-guides.html>.

SEC

SEC to Consider Executive Comp Disclosures

The SEC has announced that during its meeting on January 17, 2006, it will consider whether to propose amendments to the disclosure requirements for executive and director compensation, related party transactions, director independence and other corporate governance matters, and securities ownership of officers and directors. The SEC also will consider whether to propose amendments to require most of the disclosure in proxy and information statements to be provided in plain English. This announcement comes as no surprise based on

remarks made in December by Chairman Christopher Cox, "When it comes to disclosure documents intended for investors, nothing is more complicated than the description of executive compensation. We aim to simplify it, and make it more meaningful... What we will propose is disclosure that permits a complete and accurate understanding of the compensation package... Investors should get all the information they need — and they should get it in a form they can use."

Executive compensation disclosures are sure to be one of the more prevalent themes in 2006 for discussions within the SEC and the investment community. With proxy season around the corner, you should monitor the SEC's Web site and future editions of *Insights* for potential updates about required proxy disclosures.

International

Exposure Draft Regarding Related Parties

The International Auditing and Assurance Standards Board has issued an exposure draft, proposed International Standard on Auditing 550 (Revised), *Related Parties*. This proposed standard extends the current procedures specified for auditing related-party transactions by requiring the auditor to obtain an understanding of the nature and business rationale of an entity's related-party relationships and transactions. This understanding must be sufficient to identify, assess and respond to the risks of material misstatement resulting from such relationships and transactions. The exposure draft also requires the auditor to perform a minimum set of risk assessment procedures specifically directed toward the identification of related-party relationships and transactions not identified or disclosed by management.

The proposed standard expands the basic related-party disclosure requirements by providing enhanced guidance on auditing the disclosures to determine whether:

- The business rationale and financial effects of the related party transactions are clear;
- The key terms, conditions, or other important elements of the transactions necessary for understanding them have been appropriately disclosed; and
- The disclosure of a related-party transaction as an "arm's length" transaction can be supported by sufficient audit evidence.

The exposure draft is available for comment until April 30, 2006 at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0052>.

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