

Accounting

Understanding and Applying FSP FAS 126-1 – Is That Nonpublic Entity Really Nonpublic?

Does your company have an industrial revenue bond obligation or a “municipal bond” obligation? This is the second of two articles on FASB Staff Position (FSP) No. FAS 126-1, *Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities*, to be published in Insights. The first article in this series addressed situations in which an entity is a “conduit bond obligor”. This article addresses the determination of whether those conduit debt securities are traded in a public market.

While FSP No. FAS 126-1 and its potential impact for nonpublic entities was previously addressed in the January 23, 2007, issue of Insights, the intent of these articles is to further assist in identifying situations in which an entity is an obligor for conduit debt securities that are traded in a public market, and accordingly, under FSP No. FAS 126-1 met the definition of a public entity. A nonpublic or not-for-profit entity that meets the definition of public entity under FSP No. FAS 126-1 must include certain additional financial statement disclosures from which it had previously been exempt. This updated definition, as it amends FASB Statement No. 109, will also be used in determining whether an entity will qualify for the pending deferral of FASB Interpretation No. 48.

Are Those Conduit Debt Securities Publicly Traded?

In late 2006, the Financial Accounting Standards Board (FASB) issued FSP No. FAS 126-1, which extended the reach of the definition of a public entity. The FSP amended several FASB Statements, an APB Opinion, and two AICPA Audit and Accounting Guides to “clarify” the definition of a public entity. This updated definition now includes an entity which is an obligor for conduit debt securities that are traded in a public market. Entities which meet this new definition would be considered public for purposes of applying the amended FASB and AICPA pronouncements. This FSP necessitates that management may need to assess whether their entity is, indeed, not public.

Once a determination has been made that an entity is a conduit bond obligor, an assessment must be made as to whether those conduit debt securities are traded in a public market. The FSP specifies that a public market is a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets. The evaluation of whether a conduit debt security is being traded in a public market can often be difficult and will likely require additional investigation and use of judgment. The following are procedures and considerations which may be helpful in determining whether conduit bond securities are traded in a public market:

- Conversations with trustees or attorneys involved with the securities to inquire about the following:
 - ♦ Were the bonds issued in a private placement? If so, the bonds are not likely to be publicly traded.
 - ♦ Do the bonds trade in a public market? If so, which market(s)?
 - ♦ Are there any on-going reporting requirements such as providing annual audited financial statements to a municipal securities information repository? If there are no reporting requirements, it is unlikely the obligations trade in a public market.

- Review of the offering document or prospectus. The prospectus should indicate whether the securities trade or not.
- Additional information on conduit bonds which are sold in secondary markets to institutional investors and to accredited investors can be found at Web sites such as www.investinginbonds.com which indicate trading activity, if any, for municipal bonds with CUSIP numbers. A CUSIP number is an identification number assigned to help facilitate the identification and clearance of securities. The CUSIP number may be found in the information return that is filed with the IRS for the bond issue. To be considered traded in a public market, we would expect there to actually be trading activity, since the criteria of the FSP is whether the bonds are traded.

The January 23, 2007, issue of Insights provides a list of the pronouncements for which the definition of a public company was amended by the FSP and for which additional disclosures may now be required together with a brief explanation of how those disclosures would affect the entity. The FSP is also available in full at http://www.fasb.org/pdf/fsp_fas126-1.pdf.

The FSP is effective for fiscal periods, including interim periods, beginning after December 15, 2006.

SEC Staff Issues Views Regarding Certain Applications of FASB Statement No. 140

On December 6, 2007, the American Securitization Forum issued the Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans. This Framework provides recommended guidance for servicers to streamline borrower evaluation procedures and to facilitate the effective use of all forms of foreclosure and loss prevention efforts. The Framework is focused on subprime first-lien adjustable-rate residential mortgages that have an initial fixed interest rate period of 36 months or less, are included in securitized pools, were originated between January 1, 2005 and July 31, 2007, and have an initial interest rate reset date between January 1, 2008 and July 31, 2010 (subprime ARM loans).

The Framework categorizes the population of subprime ARM loans into three segments. Subprime ARM loans that meet the screening criteria in Segment 2 of the ASF Framework are eligible for a fast-track loan modification under which the interest rate will be kept at the existing initial rate, generally for five years following the upcoming reset. The Framework indicates that for Segment 2 subprime ARM loans, the servicer can presume that the borrower would be unable to pay pursuant to the original terms of the loan after the interest rate reset, and thus, the loan is “reasonably foreseeable” of default in absence of a modification.

The SEC’s Office of the Chief Accountant has issued a letter providing guidance about whether modifications of Segment 2 subprime ARM loans that occur pursuant to the Framework would result in a change in the status of a transferee as a qualifying special-purpose-entity (QSPE) under FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. The letter addresses the following:

- Application of Statement No. 140 to modifications of mortgages held by QSPEs when default is “reasonably foreseeable”
- Application of Statement No. 140 to modifications of subprime ARM loans pursuant to Segment 2 of the Framework
- Reconsideration of Statement No. 140 on QSPEs

The letter is available in full at <http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf>. The letter’s limited application should not be extended by analogy or relied upon for any mortgage modification other than one occurring pursuant to the specific screening criteria in Segment 2 of the Framework.

Credit Ratings of Counterparties in Derivative Transactions

In recent weeks, it has become more and more obvious that the “liquidity crisis” has spread to other corners of the credit markets as we have seen credit ratings of certain bonds plummet to “junk” status. Among other audit and accounting issues, this severe price volatility, together with increased credit risk and reduced liquidity in the market place, can give rise to questions about the ability of a counterparty to perform in a derivative transaction. The ability of the counterparty to perform on its obligation in a derivative transaction should be carefully analyzed by management. The creditworthiness of a counterparty to a derivative transaction affects the fair value of the derivative. This impact on the fair value may affect both the effectiveness of a hedge and the disclosures about the derivative transaction.

Hedge ineffectiveness can result when part of the change in the fair value of a derivative is attributable to a change in the counterparty’s creditworthiness. In addition, the financial statements should disclose that the company has a risk of loss if the counterparty does not perform on its obligation. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires significant concentrations of credit risk to be disclosed. Therefore, such disclosures may need to be enhanced, especially if the credit rating of the counterparty has been downgraded to less than investment grade status.

Guidance Issued for Consistent Application of Shortcut Method

One technique for computing hedge effectiveness in hedge accounting under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, is the shortcut method. This method prescribes a set of conditions that must be met in order for a reporting entity to assume that certain hedging relationships of interest rate swaps result in no ineffectiveness. Using the shortcut method simplifies the necessary calculations involved in hedge accounting, as it assumes that the change in value of the swap is a “perfect proxy” for the change in value of the hedged item, thereby resulting in no income statement volatility (or “ineffectiveness”). However, there has been diversity in the way the shortcut method is applied by preparers of financial statements.

In response to this diversity, the Financial Accounting Standards Board has issued Statement 133 Implementation Issue No. E23, “Issues Involving the Application of the Shortcut Method under Paragraph 68.” This guidance is designed to promote consistency and reduce complexity in the practice of determining when an entity qualifies for the shortcut method. Specifically, the guidance is expanded for the conditions in paragraph 68 of Statement No. 133 that must be met for a reporting entity to use the shortcut method.

The implementation guidance in this Issue is effective for hedging relationships designated on or after January 1, 2008. Implementation Issue No. E23 is available in full at http://www.fasb.org/derivatives/01-10-08_E23.pdf.

Accounting for Auction Rate Securities in Today’s Market

Does your company have investments in auction rate securities? Auction rate securities (ARS) are securities whose rate is reset periodically based on an auction. Auction rate notes generally have long-term nominal maturities and interest rates that reset periodically through a “Dutch auction” process, typically every 7, 28, or 35 days. At an auction, existing holders of auction rate notes and potential buyers enter a competitive bidding process through a broker-dealer, specifying the number of shares (units) to purchase with the lowest interest rate they are willing to accept. A failed auction may occur if there is not sufficient demand for the ARS to allow existing ARS investors to liquidate their holdings in the auction process.

While the accounting and review for impairment for many types of investments needs greater attention given today’s credit markets, the accounting for ARS should be even more carefully scrutinized. Similar to other securities classified as available-for-sale, ARS should be analyzed for other-than-temporary impairment. If it is probable that the company will not collect all amounts due or realize the investment from a disposal, an other-than-temporary impairment may have occurred. A failed auction is a strong indicator of a credit deterioration in the issuer or the underlying assets collateralizing the ARS. Regardless of whether there will be an actual credit loss, the severity of a decline in value is an important factor in evaluating whether a security is other-than-temporarily impaired.

When a determination has been made that a decline in fair value is other than temporary, the cost of the impaired security should be adjusted down to fair value by a charge to income. Because the terms of ARS are complex, companies must carefully evaluate them when determining fair value. In a more complex ARS, the security can be backed by other investments. To fully understand the severity of a credit deterioration and to determine the fair value of the security, a company may need to analyze the underlying collateral and cash flows.

It also should be noted that ARS should not be classified as cash equivalents. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash, and are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. ARS do not meet this definition.

International

Standards Issued for Accounting for Business Combinations

The International Accounting Standards Board (IASB) has issued a revised version of International Financial Reporting Standard (IFRS) 3, *Business Combinations*, and an amended version of International Accounting Standard (IAS) 27, *Consolidated and Separate Financial Statements*. There are also consequential amendments to other standards, including IAS 28, *Investments in Associates*, and IAS 31, *Interests in Joint Ventures*. These revised and amended standards represent the completion of the IASB's first major joint project with the Financial Accounting Standards Board (FASB). The IASB and the FASB first initiated the joint project that resulted in the new standards because U.S. generally accepted accounting principles and IFRS differed widely in their approach to accounting for business combinations. In December, 2007, the FASB issued Statements No. 141 (revised 2007), *Business Combinations*, and No. 160, *Noncontrolling Interests in Consolidated Financial Statements*.

The changes to the international standards have been relatively minor in contrast to the recent changes in U.S. standards. The revised IFRS 3 reinforces the existing IFRS 3 model, but remedies problems that have emerged in its application. The new requirements in revised IFRS 3 and amended IAS 27 are effective for annual periods beginning on or after July 1, 2009. Early adoption is permitted, but only back to an annual reporting period that begins on or after June 30, 2007.

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