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Guest Commentary: Valuing ARS Now that Dealers Are Supporting Fewer Auctions

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As many readers are likely aware, the list of failed auctions for auction rate securities and for dealers who seem to have been left with no choice but to abandon them (as is their choice), grows ever longer. And all forms of ARS have now failed, including CDO-backed, student loan backed, municipal debt, and auction rate preferreds....

Next up for holders of auction rates will be how do companies treat them on their balance sheet. Bristol Myers has given us an example by marking theirs down to about fifty cents on the dollar. From what I can glean from that company's comments and their filings, their ARS were all the "yucky" variety, tied to sub-prime or other weak loans through some mind-numbing, elaborate "structure." Fine, then. Fifty cents on the dollar seems like a reasonable valuation to settle upon. If the ultimate asset that supports repayment is a mortgage loan pool and the mortgaged houses sold through repossession net the lender, say, sixty percent of the loan value, then there's ten percentage points of money that loan servicers and lawyers can dip into.

Not so easy for holders of student loan backed or municipal debt ARS or even ARPs. In these cases, the underlying asset is something much more solid than a disintegrating pool of mortgages. These varieties have failed simply because their broker sponsors do not have or are unwilling to commit the money to serve as the back-stop investor. So what is the value of such ARS?

Student loan-backed ARS first. These are backed by pools of federally guaranteed student loans. The U.S. Department of Education, funded directly from the U.S. Treasury, partially guarantees these loans, from ninety-five to ninety-eight percent. So, would it be safe to put their value at ninety-five or ninety-eight cents on the dollar? Arguably, maybe.

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As for municipal debt ARS, these are just that, municipal debt or municipal bonds. As such, they are now long-term investments that are mostly paying well above market rates, even for long-term bonds. And they are really no less creditworthy, based on their true, stand-alone credit ratings, than they were before all this mess.

So what if the market were to value student loan-backed and municipal debt ARS for exactly what they are now - a long term municipal bond that is callable every seven, twenty-eight, or thirty five days (if an auction resumes) that pays a not-so-unattractive interest rate (some "failed" tax-exempt rates are in the neighborhood of 3.80%, but many are at 6% and higher)? Well, if such a failed auction rate were paying about 4.50% or higher, it would be

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yielding more than plain vanilla, long term, high-grade municipal bonds. One might say “But these are failed auctions - they should be paying more.” Indeed, but they are no less creditworthy over their life so if you’re a long-term municipal bond investor (not you, corporate America), these look like a pretty good buy.

That’s because the possibility that an auction may resume effectively means that failed ARS are callable at every auction date, at par, or one hundred cents on the dollar. So, just like with regular callable bonds, their valuation takes that into account. What all this means is that, theoretically (that being the state of just about all of the fixed income markets these days) a long term investor could buy a long term, high quality municipal bond that pays one or two hundred basis points above market rates for a hundred cents on the dollar or less, instead of the premium prices of 110 or 115 that non-callable, high-coupon (“premium”) bonds would cost.

Downside? The bonds get called away from you seven days later! Probability of that: A lot lower than many ARS investors would like!

But back to the real world. Two things are much more likely to occur before any failed auctions are resuscitated and holders can liquidate at par: (1) Failed auctions will continue to fail indefinitely and issuers will keep paying interest, or (2) Issuers will redeem them through refinancing.

This latter case seems more likely and imminent. Indeed, municipal finance bankers and issuers are hunkering down well past dinnertime these days working away at structuring just such deals. It will take a few months, maybe a few quarters but eventually the refinancing will begin and some auctions will be revived only long enough morph into straight tender windows, where ARS holders can cash out.

The yucky variety of ARS though will very likely end up as the subject of what’s known as a “work-out” market. This has nothing

to do with sweating or legwarmers - a work-out market is one in which transactions take place within a very wide range of prices, mostly speculative guesses as to what the securities’ value is or will be. A resolution will likely pan out this way for yucky ARS because it will be a rather long time before anyone knows what the aggregate value of a pool of mortgage loans will be. And here’s a wild guess at where prices will cluster: Because the ultimate source of repayment for the ARS could be the net proceeds of loan pay-offs after all of the decline in value that will be experienced in the U.S. residential real estate market is realized, and because conjecture on this notion seems to be about 25%, I figure work-out prices in the fifties will be common. Yes, theoretically a 25% discount on home prices yields a price in the seventies, but you must allow for collection fees, attorney’s fees, etc., and even then the bidders will want to build in a risk-cushion and some possible reward for their gamble.

For now, I think it would be most prudent for non-yucky ARS holders to continue to be holders, if cash flow allows. Holders will be getting paid interest and for all but the case of yucky types of ARS, there could very likely be a refinancing wave that will bail them out. One obstacle to this is that hundreds of issuers will be trying to get to market at the same time, possibly pushing rates up to a point beyond the savings rate for issuers. In any event, look for news that substantiates this prediction and in the meantime, don’t be shy about pressing your brokers to see if this is their intention.

As for yucky ARS holders, again, take a very close look at how you came to own them.

Note: Views expressed are those of the author alone and not necessarily those of AFP. This is excerpted from AFP’s online discussion lists, reprinted with permission. Full article available to AFP members: http://www.afponline.org/mbr/res/mbr_news/ns_20080212_ars.html ▲

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Hedge Effectiveness: The Wild Card in Accounting for Derivatives

Ira G. Kawaller, President of Kawaller & Co., Managing Director of the Kawaller Fund

The implementation of FAS 133 made accounting for derivative fair market value a requirement.

The appeal of hedge accounting for public companies is understandable. Because well performing derivatives typically generate offsetting gains or losses relative to the risks being hedged, recognizing both effects in the same accounting period will necessarily serve to dampen reported income volatility; and it's commonly appreciated that firms with lower income volatility tend to be rewarded with higher stock prices, all else remaining equal.

Critically, to qualify for hedge accounting the hedge need not perform perfectly; but it does have to be "highly effective." This condition is certainly satisfied when the hedger can credibly assert that the derivative perfectly offsets the gain or loss due to the risk being hedged. In this instance, that derivative could be said to be the hypothetical derivative. If that's the situation, the documentation should simply assert that the actual derivative is one-and-the-same as the hypothetical derivative.

The most basic test of effectiveness is a dollar offset ratio which compares the results of the derivative to the gain or loss associated with the risk being hedged – or, alternatively relative to that which would be generated by the hypothetical derivative. Passing this test requires that this ratio to fall within the bounds of 0.80 to 1.25. Clearly, these requirements become trivial if the actual derivative is the hypothetical derivative. If this is the case, the dollar offset ratio will necessarily be equal to unity, irrespective of the time period being assessed. Thus, the mere assertion that the actual derivative and the hypothetical derivative are identical should be sufficient for passing these effectiveness tests – assuming the assertion can be demonstrated to be true.

Full article: http://www.afponline.org/mbr/res/mbr_news/ns_20080131_hedge.html ▲

SEC Chairman Issues Statement on Improvements in Financial Reporting

Securities and Exchange Commission Chairman Christopher Cox in February issued the following statement regarding the progress report presented by the Advisory Committee on Improvements to Financial Reporting:

"The Advisory Committee on Improvements to Financial Reporting today presented to the Commission a progress report on the Committee's work to date. This is an important step toward making financial information more useful for investors and reducing unnecessary complexity. I have asked the SEC's professional staff to analyze the report and its proposals, and to provide recommendations to the Commission for possible consideration later this year. I thank the Committee members for their diligent work to date and look forward to additional proposals and recommendations as the Committee continues its important work over the next few months."

The full report (111 pages) is available in PDF format through the SEC's Web site: <http://sec.gov/about/offices/oca/acifr/acifr-pr-021408-final.pdf>. ▲

FASB Wants More Disclosure of Asset Allocation in Corporate Pension Funds

FASB in February approved a proposal requiring corporate pension funds and other types of post-employment benefit funds to elucidate their risk concentrations, including derivatives exposure. According to statements issued by FASB, the proposal is expected to be issued March 6, go through a comment period, and then become effective in December.

The proposal requires breakout of percentages in debt securities issued by federal, state and local governments, plus corporate debt, mortgage-backed debt and derivatives. ▲



Professional Whitepapers

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FASB Annual Survey to Ask GAAP vs. IFRS Question

The Financial Accounting Standards Board (FASB) is collecting responses to its annual survey on the role and future direction of the organization, current agenda and priorities, and future and past reporting issues. This year, responses are being collected online. A preview of the survey reveals that respondents are asked to choose which set of accounting standards they believe should be used for U.S. public companies:

- Mutual recognition for foreign issuers only
- Two-GAAP system for U.S. issuers
- A single set of high-quality international accounting standards
- Other

Responses are being collected by FASB until March 3. Further information is available on the organization's Web site:

www.fasb.org ▲

AICPA Submits Comments on Proposed Changes to FAF, FASB and GASB

The AICPA has submitted comments to the Financial Accounting Foundation (FAF) on proposed changes to Oversight, Structure, and Operations of the FAF, FASB and the Governmental Accounting Standards Board (GASB). Full text is available for download in PDF format: <http://www.aicpa.org/download/news/2008/FAF-Board-Comment-Letter.pdf> ▲

AFP Launches Newsletters on Transition to IFRS, Impact of Credit Crisis

AFP is launching two e-mail newsletters to help financial professionals stay on top of issues important to the profession:

- AFP Update: IFRS – Provides longer articles on the transition to International Financial Reporting Standards from a North American perspective.
- AFP Update: Credit Crisis - Covers the broad impact of the subprime mortgage crisis on treasury and finance, including the issues related to ARS and other short-term securities.

Both are delivered via e-mail on a complimentary basis with links to the latest AFP content: www.afponline.org/newsletters ▲

Dates to Remember:

Forums/Webinars/Conferences

March 9-11, 2008

AFP Payments Forum
Phoenix, Arizona

April 6-8, 2008

AFP Retail Forum
Atlanta, GA
(Includes Accounting Update for Retailers)

May 19-21, 2008

AFP Global Corporate Treasurers Forum
Chicago, IL

June 10, 2008

Challenges with Derivative Hedge Accounting under Canadian GAAP (CICA 3865)
AFP Webinar
<http://www.AFPonline.org/pub/store/ves.html>

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