

Insights

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Accounting

BEWARE: That Nonpublic Entity Might Not Be Nonpublic

In late 2006, the Financial Accounting Standards Board (FASB) issued a FASB Staff Position (FSP) that extended the reach of the definition of a public entity. FSP No. FAS 126-1, *Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities*, amended several FASB Statements, an APB Opinion and two AICPA Audit and Accounting Guides to “clarify” the definition of a public entity. (The November 8, 2006 issue of Insights provides a more complete summary of the FSP along with a link to the FASB Web site to view the document.) This FSP necessitates that management may need to assess whether their entity is, indeed, not public.

But, first, a little background information. A not-for-profit entity (for example, a hospital or museum), or a for-profit entity (of any size, ownership structure, or type of business), may raise cash through a governmental entity. A state or unit of a local government or an agency or instrumentality of a state or local government (governmental entity) can raise funds in the capital markets by issuing municipal bonds. As permitted by the Internal Revenue Code, a governmental entity can issue conduit debt securities, which are frequently called municipal bonds or industrial revenue bonds. A conduit debt security is an offering by a governmental entity that is not for its own use but for the use of a private party who becomes a conduit bond obligor. In these types of transactions, the governmental entity is the issuer of the security but normally has no subsequent liability or continuing involvement. The private party who receives the proceeds in the transaction is the obligor and is required to make or fund all interest and principal payments as they come due and also is required to satisfy future financial reporting requirements.

In the financing transactions described in the preceding paragraph the entity that receives the proceeds make no filing with a state or federal regulatory agency, such as the Securities and Exchange Commission, nor does it need to meet any of the requirements for an exempt transaction, such as the sale of securities to accredited investors. Nevertheless, the FSP concludes that an entity that is an obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets) meets the definition of a public entity. Thus, if an entity (either a for-profit or a not-for-profit) is involved in a financing transaction as an obligor for conduit debt securities that are traded in a public market, it must include certain additional disclosures in its financial statements from which it had previously been exempt.

In extending the reach of the definition of a public entity, the FSP amends the following pronouncements (followed by a brief explanation of how the amendment would affect the entity):

- APB Opinion No. 28, *Interim Financial Reporting* (requires certain disclosures in interim financial statements)
- FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities* (requires certain disclosures about oil and gas reserve quantities and capitalized costs related to oil and gas activities)
- FASB Statement No. 109, *Accounting for Income Taxes* (requires additional disclosures about the types of temporary differences and a reconciliation from the reported tax expense to the expected tax expense)
- FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities* (requires disclosure about the fair value of financial instruments)

- FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (requires disclosure about an entity's reportable operating segments)
- FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits* (requires additional disclosures about an employer's defined benefit pension plans and defined benefit postretirement plans)
- FASB Statement No. 141, *Business Combinations* (requires certain pro forma disclosures about business combinations)
- AICPA Audit and Accounting Guides, *Not-for-Profit Organizations and Health Care Organizations* (requires those entities to disclose information required by the above mentioned APB Opinion and FASB Statements)

The FSP is effective for fiscal periods, including interim periods, beginning after December 15, 2006. Therefore it is important that management begin to (i) consider whether it is an obligor on a debt security issued by a governmental entity that is traded in a public market, and, if so (ii) develop a plan for gathering the additional disclosures that were previously not required of a nonpublic entity.

Guidance Related to Certain Cash Flow Hedges

Financial Accounting Standards Board (FASB) Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, provides that an entity can specify that it is hedging the interest rate risk in a cash flow hedge of a variable-rate financial asset or liability (either existing or forecasted) as long as the interest rate is considered a benchmark interest rate. In addition, Statement No. 133 defines a benchmark interest rate as rates on direct Treasury obligations of the U.S. government and interest rates based on the London Interbank Offered Rate (LIBOR). The ability to hedge a benchmark interest rate often simplifies the effectiveness testing of hedge accounting; therefore entities often strive to qualify for this provision.

As a result of the desire to qualify, entities have raised questions as to whether rates determined based on an auction process qualify as a benchmark interest rate. Auction rate notes generally have interest rates that reset periodically through a Dutch auction process, typically every 7, 28 or 35 days. Because the rates reset so frequently in a market situation, arguments have been made that rates on such instruments should be treated as a benchmark interest rate under Statement No. 133.

To address these questions, the FASB issued guidance in Derivatives Implementation Group Statement 133 Implementation Issue No. G26 (DIG Issue No. G26), *Cash Flow Hedges: Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That Are Not Based on a Benchmark Interest Rate*. Although the Dutch auction process to set the interest rate is similar to why they concluded that LIBOR is a benchmark interest rate, the FASB concluded that the bidding process does not provide for transparent separation of interest rate risk and credit risk. Therefore such auction interest rates cannot be considered a benchmark interest rate. However this does not mean that entities with such instruments cannot elect and qualify for hedge accounting. In situations where an interest rate is reset through an auction process, an entity may hedge the variability in cash flows by designating the hedged risk as the risk of overall changes in cash flows, provided all of the other cash flow hedging criteria in Statement No. 133 are met. The entity may not indicate that the risk being hedged is interest rate risk (that is, the risk of changes in cash flows attributable to changes in the designated benchmark interest rate) unless the cash flows of the hedged transaction are explicitly based on that same benchmark interest rate.

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after January 8, 2007. Entities that have previously designated an otherwise qualifying hedging relationship that no longer qualifies for hedge accounting based on the guidance in this Issue, must dedesignate the hedging relationships prospectively as of the effective date of the Issue.

DIG Issue No. G26 is available in full at http://www.fasb.org/derivatives/01-08-07_G26pdf.

Who Should Be Designated to Issue Valuation Guidance for Financial Reporting?

Currently, a number of organizations issue valuation standards for different classes of assets and liabilities and for different purposes. On January 15, 2007, the Financial Accounting Standards Board (FASB) issued an Invitation to Comment, *Valuation Guidance for Financial Reporting*, to begin public discussion about whether the FASB should be solely responsible for providing valuation guidance to determine a value that would satisfy a measurement attribute for financial reporting purposes. The Invitation to Comment also requests comments on whether such valuation guidance is needed, the specificity of this valuation guidance, and the process that should be used to issue valuation guidance for financial reporting. The Invitation to Comment includes the following four main questions, plus sub issues and other related questions:

- Is there a need for valuation guidance specifically for financial reporting?
- What level of participation should existing appraisal organizations have in establishing valuation guidance for financial reporting?
- What process should be used for issuing valuation guidance for financial reporting?
- Should the process of valuation guidance be on an international or national level?

The Invitation to Comment is available at http://www.fasb.org/draft/ITC_Val_Guide_for_Financial_Reporting.pdf. Responses from interested parties must be received by the FASB prior to April 15, 2007.

Auditing

Proposed International Ethics Standards May Have Implications for U.S. Auditors

The International Ethics Standards Board for Accountants, an independent standard-setting board within the International Federation of Accountants (IFAC), recently released an Exposure Draft that is intended to strengthen auditor independence. The Exposure Draft revises Section 290, *Independence - Audit and Review Engagements*, of the IFAC Code for Ethics for Professional Accountants and proposes a new Section 291, *Independence - Other Assurance Engagements*. Significant proposed modifications to the Code include:

- Extending the more restrictive listed-entity independence requirements (e.g., partner rotation, cooling-off period, non-audit services restrictions) to “all entities of significant public interest.” Such entities are described in proposed revised Section 290 as listed entities and certain other entities which, because of their business, size or number of employees, have a large number and wide range of stakeholders. While the proposal allows some flexibility for each member body to determine which entities should be considered to be entities of significant public interest for purposes of their particular jurisdiction, there is a presumption that regulated financial institutions would be considered to be entities of significant public interest, and depending on the facts and circumstances, pension funds, government agencies, government-controlled entities and not-for-profit entities may be included.
- Removing the existing flexibility that permits firms without a large number of partners to apply other safeguards, instead of partner rotation, to address the familiarity threat. The proposal is therefore more restrictive than the SEC requirement that provides an exception for firms with fewer than five SEC audit clients and fewer than ten partners.
- Strengthening guidance related to the provision of non-assurance services, including setting out additional guidance on the provision of tax services to audit clients. The proposal states that performing certain tax services may create threats to independence and contains guidance on four broad categories of tax services - tax return preparation, preparation of tax calculations, tax planning and other tax advisory services, and assistance in the resolution of tax disputes.

As a member body of IFAC, the American Institute of Certified Public Accountants (AICPA) must apply ethics standards that are not less stringent than those stated in the IFAC Code of Ethics. Since certain aspects of the IFAC proposed ethics rules will be more restrictive than the AICPA's existing independence rules, it is important that

AICPA members are aware of this proposal. The AICPA's Professional Ethics Executive Committee (PEEC) will be commenting on this proposal on behalf of the AICPA.

The Exposure Draft is available for comment until April 30, 2007 at <http://ifac.org/Guidance/EXD-Details.php?EDID=0075>.

Financial Institutions

Interagency Statement Concerning Complex Structured Finance Activities

The Office of the Comptroller of the Currency, Office of Thrift Supervision, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and SEC have collectively issued a final statement on the complex structured finance activities of financial institutions. The statement describes the types of internal controls and risk-management procedures that should help financial institutions identify, manage and address the heightened legal and reputational risks that may arise from certain complex structured finance transactions.

The statement represents supervisory guidance for institutions supervised by the four banking agencies and a policy statement for institutions supervised by the SEC. Because the statement focuses on sound practices related to elevated risk complex structured finance transactions, which typically are conducted by a limited number of large financial institutions, it will not affect or apply to the vast majority of financial institutions, including most small institutions. The statement is available in full at <http://www.sec.gov/rules/policy/2007/34-55043.pdf>.

International

Four Redrafted Auditing Standards Released

In striving to improve the clarity of its standards, the International Auditing and Assurance Standards Board (IAASB) plans to redraft existing standards and to develop new and revised standards following new drafting conventions. Key elements of the new drafting conventions include: basing each standard on the objective of the auditor with respect to the subject matter of the standard; separating the requirements that the auditor is required to follow from guidance on their application; eliminating the present tense to describe actions by the auditor, which raised ambiguity about whether such actions were required; and other structural and drafting improvements to enhance the overall readability and understandability of the standards. Standards redrafted in this way are described as "redrafted." If further revision has been undertaken, a standard is described as "revised and redrafted."

Recently, the IAASB issued the first four final International Standards on Auditing (ISAs) that were redrafted under this initiative:

- ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*;
- ISA 300, *Planning an Audit of Financial Statements*;
- ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*; and
- ISA 330, *The Auditor's Responses to Assessed Risks*.

The four redrafted ISAs have a provisional effective date for audits of financial statements for periods beginning on or after December 15, 2008. While the final common effective date for all redrafted ISAs will be determined as the IAASB's agenda progresses, it will not be earlier than December 15, 2008. The IAASB also approved amendments to the Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services, which establishes the conventions to be used by the IAASB in drafting future ISAs and the obligations of auditors who follow those standards.

The amended preface and redrafted standards are available in full at <http://www.ifac.org/store/Category.tmpl?Category=Auditing%2C%20Assurance%20%26%20Related%20Services&Cart=11684559485763240>.

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Title:	Cash Flow Hedges: Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That Are Not Based on a Benchmark Interest Rate
Paragraph references:	29(h)
Date cleared by Board:	December 13, 2006
Date posted to website	January 8, 2007

QUESTIONS

In a cash flow hedge of a variable-rate financial asset or liability for which the interest rate is not based solely on an index, including situations in which an interest rate is reset through an auction process, can the designated risk being hedged be:

1. The risk of overall changes in the hedged cash flows related to the variable-rate financial asset or liability?
2. The risk of changes attributable to *interest rate risk* as defined in Statement 133 (that is, the risk of changes in cash flows attributable to changes in a specifically designated benchmark interest rate) even though the cash flows of the hedged transaction are not explicitly based on that designated benchmark interest rate?

BACKGROUND

Auction rate notes are an example of a variable-rate financial instrument whose interest rate is not explicitly based on a benchmark rate. 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. Generally, the lowest bid rate at which all shares can be sold at the notes' par value establishes the interest rate, also known as the "clearing rate," to be applied until the next auction.

Paragraph 29(h) of Statement 133 defines *interest rate risk* for an existing financial asset or liability as "the risk of changes in cash flows attributable to changes in the designated benchmark rate." That paragraph further requires the following:

In a cash flow hedge of a variable-rate financial asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are **explicitly** based on a different index, for example, based on a specific bank's prime rate, which cannot qualify as the benchmark rate. [Emphasis added.]

Statement 133, as amended by FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, identifies rates on direct Treasury obligations of the U.S. government and the interest rate swap rates based on the London Interbank Offered Rate (LIBOR) as the only rates that can be designated as benchmark interest rates in the United States for purposes of applying the definition of *interest rate risk*. Some have suggested that because an auction rate is not an index, it is not subject to the limitation in paragraph 29(h).

Statement 133 Implementation Issue No. G19, “Cash Flow Hedges: Hedging Interest Rate Risk for the Forecasted Issuances of Fixed-Rate Debt Arising from a Rollover Strategy,” provides guidance for the planned issuance of a series of fixed-rate debt instruments, such as commercial paper (thereby resulting in a variable interest expense pattern) and states:

The restriction against hedging interest rate risk in paragraph 29(h) of Statement 133 is not intended to apply to scenarios whereby the cash flow hedging model is being applied to the forecasted issuance of fixed-rate debt. Provided the entity meets all the other cash flow hedging criteria, an entity may hedge the risk of changes in either (a) the coupon payments (or the interest element of the final cash flow if interest is paid only at maturity) or (b) the total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate debt. It should be noted that the derivative used to hedge either of these risks must provide offsetting cash flows in order for the hedging relationship to be effective in accordance with paragraph 30 of Statement 133.

Issue G19 addresses its applicability to variable-rate debt as follows:

Although the variable-rate debt does, after each reset, have a fixed rate for each monthly period, it is inappropriate to characterize that debt as a series of fixed-rate debt instruments whose issuances would not be subject to the restriction against hedging interest rate risk in paragraph 29(h). When each reset occurs, it is not a new issuance of fixed-rate debt based on current market interest rates for that debtor; instead, it is a contractual continuation of a debtor-creditor relationship and the “fixed rate” for each month is explicitly (and contractually) based on a specific index (a specified bank’s Prime rate) that is different from a designated benchmark interest rate. Thus, the restriction against hedging interest rate risk in paragraph 29(h) must be applied to the variable-rate debt instrument.

In conjunction with resolving this Issue, the last sentence of the third paragraph under the Commercial Paper heading in the Background section of Issue G19, “Those short-term instruments are not ‘indexed’ to any market rate,” has been deleted because it has caused confusion in practice.

RESPONSE**Question 1**

Yes. Provided all of the other cash flow hedging criteria in Statement 133 are met, an entity may hedge the variability in cash flows (for example, in auction rate notes) pursuant to paragraph 29(h)(1) of Statement 133 by designating the hedged risk as the risk of overall changes in cash flows.

Question 2

No. In a cash flow hedge of a variable-rate financial asset or liability, the risk being hedged cannot be designated as *interest rate risk* (that is, the risk of changes in cash flows attributable to changes in the designated benchmark interest rate) unless the cash flows of the hedged transaction are **explicitly** based on that same benchmark interest rate. For example, a variable-rate financial asset or liability that is reset through an auction process is not based on a benchmark interest rate. Although the interest rate may be described as a designated benchmark interest rate plus or minus an adjustment specified by the bidder, the “clearing rate” is effectively established by a bidding process that does not provide for transparent separation of *interest rate risk* and *credit risk*. Thus, the designated risk being hedged in an auction rate note cannot be *interest rate risk*. Additionally, Issue G19 explicitly prohibits entities from characterizing their variable-rate debt as fixed-rate debt that, at each interest rate reset, rolls over to another issuance of fixed-rate debt that has a new fixed interest rate until the next reset date.

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after the date that the Board-cleared guidance was posted on the FASB website.

Pursuant to Statement 133 Implementation Issue No. K5, “Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues,” entities that have previously designated an otherwise qualifying hedging relationship that no longer qualifies for hedge accounting based on the guidance in this Issue, must dedesignate the hedging relationships prospectively as of the effective date of this Issue. The derivative’s gain or loss for the period prior to the effective date shall remain in accumulated other comprehensive income and be reclassified into earnings consistent with the provisions of paragraphs 32 and 33 of Statement 133.

The above response has been approved by the Board by written ballot.