

McGladrey & Pullen

Certified Public Accountants

April 6, 2007

FAS 159's "Free Pass" Myth

In the past few weeks we have become aware that entities are considering early adoption of Financial Accounting Standards Board Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, (FAS 159) to take advantage of a perceived "free pass" opportunity located in FAS 159's transition provisions to restructure their investment portfolio. This perceived free pass is based on the belief that entities are able to "reclassify" held to maturity (HTM) or available for sale (AFS) investments that are currently valued at less than their cost basis (or "underwater") to the trading category and then sell such securities without recording a loss in the income statement. In some cases the next step in this strategy would be to repurchase securities that are identical or very similar to the ones sold but with a higher yield. Current market conditions appear to make early adoption of FAS 159 even more advantageous.

If this is indeed possible, why aren't all entities rushing to take advantage of this strategy? There are several reasons, including:

- Consideration of the principle objective of FAS 159;
- Early adoption requirements of FAS 159, including concurrent required early adoption of Financial Accounting Standards Board Statement No. 157, *Fair Value Measurements* (FAS 157); and
- Previous assertions made by entities as to their intent and ability to hold underwater HTM and AFS securities to maturity or recovery.

Discussion of these reasons can't take place without first recapping the provisions of FAS 159.

Summary of FAS 159's Provisions

FAS 159 allows entities to account for most financial instruments at fair value rather than under other applicable generally accepted accounting principles (GAAP), such as historical cost. The accounting results in the instrument being marked to fair value every reporting period with the gain/loss from a change in fair value recorded in the income statement. This accounting treatment is an election made by the entity, on an instrument-by-instrument basis, when the financial instrument first becomes eligible for the election (generally upon entering such instrument, but see paragraph 9 of FAS 159 for further details). However, once the election is made, it is irrevocable.

In addition, upon adoption, entities can reconsider the accounting for eligible financial instruments existing at that date. Eligible financial instruments include HTM and AFS securities. Entities report the effect of the remeasurement to fair value at adoption as a cumulative-effect adjustment to the opening balance of retained earnings.

Keep in mind - this is a one-time reconsideration. In other words, if upon adoption, the entity "misses" or chooses not to elect the fair value option for an existing eligible financial instrument, there is no ability to elect it at a later date unless a reconsideration event (as defined in paragraph 10 of FAS 159) occurs.

Evaluating the "Free Pass" Strategy

FAS 159's Objective

FAS 159 is part of the current trend toward the issuance of principles-based standards. In a principles-based standard all provisions within the Statement must be considered in the context of its objective. Paragraph 1 of FAS 159 states, "The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions." To appropriately apply this principles-based standard, it is therefore expected that entities applying the fair value option are doing so to take advantage of obtaining accounting in their financial statements that corresponds to economic hedges in their activities. The fair value option should not be elected merely to achieve an accounting result.

When considering the "free pass" strategy as discussed in the first paragraph, an entity must consider whether the "free pass" strategy is being done to meet the objective of FAS 159. This requires professional judgment by various people including management and members of the board of directors responsible for monitoring the entity's investment policies and strategies. In addition, there may be governance issues that would require an entity to modify its asset/liability management policies in order to execute this "free pass" strategy.

Early Adoption Conditions

The effective date of FAS 159 is for fiscal years beginning after November 15, 2007. There is an opportunity to early adopt FAS 159 as of the beginning of a fiscal year that begins on or before November 15, 2007, however it comes with conditions in addition to the others required at the stated adoption date. These include:

1. The choice to adopt early must be within 120 days of the beginning of the fiscal year of adoption, so for calendar-year end entities, this would be prior to April 30, 2007.
2. An entity must also early adopt all of the requirements of FAS 157 as of the early adoption date.
3. No financial statements that include required notes for any interim period within the year of early adoption have been issued.
4. The choice to apply the fair value option to eligible items existing at the early adoption date is retroactive to the early adoption date.
5. The choice to apply the fair value option to items that became eligible during the period is retroactive to the date they became eligible.

Because of condition 1 above, calendar-year end entities do not have much time left to decide whether to early adopt FAS 159. This means some entities are quickly trying to determine the value of early adoption. The ability to elect the fair value option for eligible items existing at adoption date is a one-time opportunity - so early adoption just to apply the "free-pass" strategy could mean an entity has not taken full advantage of FAS 159's provisions. We believe an entity should not early adopt FAS 159 without a thorough consideration of how their adoption achieves the objectives of FAS 159.

Condition 2 above should not be underestimated in this process. FAS 157 has established requirements for how to measure fair value when it is required under existing GAAP. The provisions of FAS 157 have changed fair value measurement from an "entrance price" approach to an "exit price" approach based on transactions between market participants. In addition, there are substantial new disclosure requirements. Entities should carefully consider whether they have analyzed the provisions of FAS 157 in order to comply with their early adoption of FAS 159. Public entities will need to apply the measurement principles as well as present FAS 157's substantial new disclosures in their first quarterly filing. We believe if FAS 157 is not applied correctly upon adoption, an entity's early adoption of FAS 159 would be called into question.

Previous Assertions

Under Financial Accounting Standards Board Statement No.115, *Accounting for Certain Investments in Debt and Equity Securities*, as amended and interpreted, entities are required to evaluate those HTM and AFS securities whose current fair value is less than cost to determine whether such decline is considered "other than temporary" (OTT). To avoid an OTT impairment charge, one of the requirements is that an entity must be able to assert that it has the "intent and ability" to hold such a security to a point in time at which the value is recovered, often to maturity. Therefore, if management has made such an assertion in the entity's financial statements prior to adopting FAS 159 and then adopts FAS 159 with the intent to sell such securities as stated in the "free pass" strategy, such original assertion would be questioned. All the facts and circumstances other than the adoption of FAS 159 should be considered in evaluating the prior assertions. It may be necessary to take an OTT impairment charge prior to applying the adoption provisions of FAS 159 before employing the "free pass" strategy. FAS 159 should not be used to avoid an income statement charge or for objectives that are not consistent with its stated objectives.

Other Considerations

As of the release date of this white paper, the staff of the U.S. Securities and Exchange Commission has not provided any formal guidance as to how it will evaluate this "free pass" strategy for public companies. However, James L. Kroeker, Deputy Chief Accountant with the SEC, stated at an April 4, 2007 conference, "Regardless of whether these engineered transactions achieve your accounting goal...you can expect the SEC to have a continued interest in this topic." Based on this comment and ongoing discussions with the SEC staff, it is obvious that the SEC will be paying special attention to those entities that early adopt FAS 159 and employ such strategies.

In addition, this white paper addresses only the accounting issues associated with the "free pass" strategy. Entities are cautioned to also consider any other implications the adoption of FAS 159 or

FAS 157 may raise with other regulators, and the effects on contractual arrangements such as loan covenants or book value stock purchase plans.

Conclusion

It should now be clear the “free pass” strategy is not truly a “free pass.” Entities need to proceed with caution before employing such a strategy. How this strategy would impact any previous assertions made by the entity needs to be evaluated. Consideration must also be given to how the adoption of FAS 159, whether adopted early or not, fits into the entity’s investment and risk management strategy. In addition, time must be allocated to determine the impact to the financial statements of adopting FAS 157, including the required disclosures. We believe structuring a transaction solely to achieve an accounting result is not an appropriate application.

Interpretations of FAS 159 are evolving daily. McGladrey & Pullen, LLP’s National Office is in contact with other firms and the staff of the AICPA and SEC. McGladrey & Pullen clients should stay in touch with their service team for new developments.

Statement No. 159 may be found in its entirety on the Financial Accounting Standards Board web site (www.fasb.org).