

### **Removal of the QSPE: Do You Know Where Your Derivatives Are?**

After years of discussion and debate, on June 12, 2009, the FASB issued two new Standards that significantly impact the way reporting entities account for and consolidate transferred assets: SFAS 166 and 167. The aim is to broadly provide better transparency for investors about a company's activities and risks related to these areas. The objective of this article is to highlight several implementation issues specific to derivatives, because as a result of the issuance of the new standards, many derivatives residing in previously off-balance sheet Special Purpose Entities will now be required to be recorded on balance sheet by the consolidating entity.

### **Consolidation Considerations**

Our experience in working with our client base has shown that many companies may not be fully aware of the valuation challenges that may exist in applying the provisions of SFAS 157 (Topic 820) to derivatives that will be brought on balance sheet as a result of SFAS 166 & 167. Derivative termination valuations alone can be complex, without the additional complexity introduced as a result of the need to consider non-performance risk under SFAS 157. Another possible result of the changes in these accounting standards is that many companies will likely seek to avoid additional earnings volatility that may arise from having mark-to-market derivatives now on balance sheet by applying hedge accounting for these derivatives. It can be easy to overlook complex implementation challenges, such as attempting to designate derivatives with fair values "other than zero" at the inception of newly documented hedging relationships (also known as "off-market hedge accounting").

### **SFAS 157 (FASB ASC Topic 820)**

Once you've gone through the consolidation guidance in SFAS 167 and determined that you must consolidate all or several of your previously off-balance sheet VIEs, you're still left with the fact that you'll actually have to start accounting for the assets, liabilities and activities of these entities on January 1, 2010. So where does one begin?

As if the consolidation accounting was not complicated enough, you have to be sure that valuations of assets and liabilities being carried at fair value are determined in accordance with FASB Statement No. 157, *Fair Value Measurements*. SFAS 157 provides a consistent definition of fair value to be applied to assets and liabilities already required to be reported at fair value by other accounting guidance. Specifically, SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability to another party with similar credit risk (the liability is assumed to continue, not to be settled) at the measurement date. Perhaps the most challenging aspect of the guidance in SFAS 157 is the requirement to consider nonperformance risk (credit risk) in determining fair value. Broadly, SFAS 157 requires fair value be measured assuming an orderly transaction between market participants at the measurement date. In keeping with market participant assumptions, these measurements should include adjustments to nonperformance risk that these participants would make in pricing the derivative contract. Due to the bilateral nature of forward-based derivative contracts (e.g. interest rate swaps) the instrument has the ability to "flip" from either a current asset position to a liability

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position or vice versa, depending on the current and future interest rate environments. Therefore, one must consider the nonperformance risk of both parties to the transaction to the extent the positions would remain uncollateralized. Collateral posted against a transaction serves as a credit guarantee (if a party defaults, the counterparty gets to keep the collateral), and thus limits the nonperformance risk with respect to the counterparty. This issue of incorporating nonperformance risk is further complicated by the fact that there may be multiple derivatives in the securitization that face the same bank counterparty (the party on the other side of the trade) and be subject to a master netting arrangement.

### **Credit Assessment**

Aside from various netting and collateral provisions, it is then necessary to assess the creditworthiness of each party to the transaction, understanding that credit is entity-specific. In thinking about credit, a useful question to ask regarding each party to the derivative might be: Where would this entity borrow, on an unsecured basis (to the extent that an uncollateralized swap position would be a type of unsecured borrowing) for the remaining term of this derivative?

For securitization entities the answer to this question (the assessment of the creditworthiness) is often further complicated by the position of the derivative in the securitization waterfall, which should directly impact the entity specific creditworthiness. Is the swap superior to all credit tranches, or pari passu to a certain tranche? The placement of the swap in the structure will dictate its relative creditworthiness. Needless to say, obtaining the appropriate, unique, entity-specific credit risk information can be quite challenging, and at times highly subjective.

Once you've determined the creditworthiness of your entity you'll need to repeat this process for each of the bank counterparties your entities are facing. Luckily, in some cases traded CDS (credit default swap) data may be available, or rating agencies and other data providers may be able to provide credit risk information.

After determining the credit risk of both parties to the derivative transactions, you'll next need a model to incorporate the impact of each party's nonperformance risk on the fair value of the derivative(s). Best practices, consistent with market pricing, is that the incorporation of nonperformance risk should consider: current derivative exposure, potential future exposure, collateral arrangements, and master netting arrangements, to list a few considerations. Because of the proprietary nature of bank counterparty credit models, bank counterparties typically only provide "termination" values that do not consider nonperformance risk and are not SFAS 157 Fair Values.

*For more information on incorporating nonperformance risk in interest rate and foreign exchange derivative valuations in accordance with SFAS 157, a free downloadable SFAS 157 White Paper is available online at: <http://www.chathamfinancial.com/fas157whitepaper>*

### **Accounting for Derivatives: A Primer**

Once you've determined exactly what assets and liabilities, including derivatives, you'll be required to account for prospectively as a result of the revised consolidation

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rules, you are still left with having to follow specific GAAP applicable to the assets and liabilities now on balance-sheet. With respect to derivatives, SFAS 133, *Accounting for Derivative Instruments and Hedging Activities, as amended and interpreted* (now Topic 815) provides 1,000 or so pages of accounting guidance for derivatives. Within its many pages of rules are some fairly simple principles:

1. Derivatives are accounted for as assets and liabilities
2. Derivatives are required to be measured at fair value
3. Absent meeting the strict "hedge accounting" requirements, all changes in a derivative's fair value should be recorded directly through earnings.

What makes SFAS 133 so complicated (and makes so many accountants and auditors cringe at its very utterance) is the application of special "hedge accounting". The desire for special "hedge accounting" arises from that fact that most reporting entities seek to minimize earnings volatility and record the effects of their hedging activities in a manner that reflects the underlying economics of the transactions. Unfortunately, these results are generally not reflected in an entity's financial statements unless "hedge accounting" is applied. Absent the application of "hedge accounting", entities are left explaining earnings volatility due to changes in the underlying(s) of their derivatives.

"Hedge accounting" is a special, elective model for accounting for derivatives under SFAS 133. Simply put, "hedge accounting" allows a company to appropriately align the accounting with the underlying economics of a transaction by matching the timing of the earnings recognition of the derivative with the asset or liability being hedged. While "elective", the application of "hedge accounting" can only be applied if certain criteria are met, including formal documentation of the hedging relationship.

While we could probably spend at least several newsletters discussing the application of "hedge accounting" in its entirety, below are a few items that entities consolidating derivatives for the first time may want to consider when venturing down the path of applying hedge accounting.

- Date of designation: Typically you would seek to designate newly consolidated derivatives on the date they are consolidated (the effective date of SFAS 166 & 167), assuming all qualifying criteria can be met. Hedge accounting does not begin until a formal designation is made and cannot be applied before the designation is made.
- Income statement classification of derivative fair value changes when hedge accounting is not applied: In a December 11, 2003 Speech by the SEC Staff, the SEC addressed certain classification and disclosure practices related to un-designated derivatives (those not in qualifying "hedge accounting" relationships). Specifically, this speech provided that both the "unrealized" and "realized" gains and losses on derivative instruments that do not qualify or are not designated for "hedge accounting" should be recorded to a single line item on the entities financial statements. For an interest rate swap this means that the periodic cash net settlements made or received should not be recorded to a separate line item (say, interest expense), while the unrealized

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- component (the change in fair value related to the remaining cash flows) is recorded to another line item (say, risk management activities).
- Designation of Derivatives with Fair Values Other than Zero: Many entities who have interest rate swaps that were intended to “fix” the LIBOR component of coupon on the notes issued by the VIE may seek to designate such trades in “Cash Flow” Hedging Relationships upon consolidation. A problem arises when the fair value of said interest rate swap is different from zero (\$0) at the date of designation. Such derivatives are explicitly prohibited from use of the “short-cut method” in paragraph 68 of SFAS 133 and are forced to use a long-haul methodology to assess effectiveness and measure ineffectiveness. Depending on how far the derivative’s value has moved from zero and the time remaining to maturity, it is possible that some of these trades may not meet the “highly effective” criteria necessary for hedge accounting.
  - Features embedded in otherwise “plain vanilla” derivatives: Once you’ve had time to review the confirmation of your swap transactions, you may notice features that require the swap notional adjust to match the debt principal of the notes being hedged. Depending on exactly how these features are documented, you may have what is referred to as a “balance guarantee” swap. These instruments may present some unique valuation and accounting considerations. With respect to Cash Flow Hedge Accounting complying with the “sufficient specificity” criteria in paragraph 28(a)(2) of SFAS 133 is particularly troublesome, often leading to the conclusion that hedge accounting cannot be applied.
  - Capturing the data necessary for SFAS 161 Disclosures: Amongst the requirements in this disclosure guidance is the requirement to disclose the location and fair value of derivatives in the balance sheet and the location and amount of gains and losses related to these derivatives in income statement in tabular formats. Entities that have not yet had to endure the disclosure requirements may want to consider updating their close processes and controls to include the data necessary for disclosure under this Standard.

In closing, the implementation of SFAS 166 and 167 is only further complicated by the need to value and account for any derivatives brought back on balance sheet. While much of the guidance in SFAS 157 and 133 can seem straightforward, the implementation with respect to derivatives can often prove incredibly difficult, giving rise to a certain amount of ambiguity and subjectivity. The business of securitization has changed, and it has certainly not gotten any easier.

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### **About Chatham Financial**

Founded in 1991, Chatham Financial is the largest independent interest rate and foreign exchange derivatives advisory firm. With five global offices, we serve our 1,000 leading private and public companies across many sectors, including Community and Regional Banking, Consumer Products and Retail, Healthcare, Industrial Manufacturing, Institutional Investment, Real Estate, Technology, and Telecommunications and Media. Our 20 member Accounting Team is the exclusive advisor to over 325 clients for meeting their SFAS 133/SFAS 157/IAS 39 Hedge Accounting requirements. Our accounting professionals come predominantly from the Big Four, including four individuals who worked at the FASB.

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