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Will Your CDOs Need Financial Statements?

By Hillel Caplan

Market participants continue to discuss various provisions of FASB's Interpretation No. 46 ("FIN 46")[1] as they wrestle with how to interpret and implement this new accounting guidance with respect to collateralized debt obligation (CDO)[2] vehicles. Less often discussed, however, are some of the operational implications of this new accounting regime, and specifically for purposes of this article, the potential increase in the need for GAAP-basis financial statements to be prepared for the CDO vehicle itself.

Before proceeding, it is important to note that financial statements are currently prepared for relatively few arbitrage cash flow CDO vehicles as the market has historically focused on other ways to measure a CDO's performance. However, for the following reasons, there may be an increased need for financial statements:

(1) The increased incidence of consolidation of existing CDOs - Barring amendments to existing deals, at a macro level, FIN 46's provisions make it more likely that existing CDOs (there is no "grandfathering clause" in FIN 46) will need to be consolidated. In order to perform the consolidation mechanics, the "parent company" (i.e. the primary beneficiary of a variable interest entity, or the majority equity owner in a voting interest entity), needs to combine the financial statements of the "subsidiary" (i.e. the CDO vehicle) with its own and then eliminate certain intercompany balances and transactions. This process presupposes the existence of financial statements for the subsidiary.

It is important to note that due to the way FIN 46's calculations are weighted towards "decision maker" fees, in the absence of a majority equity investor, the collateral manager is likely to be identified as the primary beneficiary of a variable interest entity and thus required to consolidate the CDO vehicle. This could even be true in situations where the collateral manager does not own a single share of the CDO's equity.

(2) The possible use of the equity method (please see sidebar: What is the "equity method"?) of accounting by non-majority equity investors in CDOs that qualify as voting interest entities that are exempt from FIN 46—Although there is no market consensus yet on this approach, there is a line of thinking being discussed in the marketplace that states that

the application of EITF 99-20 is inconsistent with an equity interest in a voting interest entity, and that the use of the equity method would be more appropriate. As is the case with consolidation, the equity method requires financial statements of the investee.

(3) The use of financial statements as a means to determine whether equity distributions are in excess of the vehicle's net income, and may have, therefore, exposed other CDO classes to the entity's expected losses (paragraph 7b of FIN 46). Although this may also be accomplished by other means, assuming financial statements are available, this approach is conceptually sound and relatively easy to accomplish.

Collateral managers, investors and other CDO transaction participants who think they may have a newfound need for financial statements should plan for this possible contingency as early as possible, especially if the party that wants the financial statements is not going to prepare the financial statements themselves. Among the challenges that could be faced are:

- Among trustees that offer to prepare financial statements for CDOs (and not all of them do), there is limited excess capacity to take on new assignments for such work. As an alternative, some trustees offer to provide data electronically that could be used to support the preparation of financial statements by others.
- Older CDOs (i.e. not issued in the last year) will lack historical financial statements which makes determining opening balance sheet account positions more challenging (although this does not necessarily require the creation of financial statements all the way back to the CDO's inception).
- Since most CDO governing documents are silent on the question of financial statements, it is not clear who should bear the cost of preparing financial statements.
- The ability to use hedge accounting for derivatives.
- Different parties to a transaction may have different fiscal years. Paragraph 4 of ARB 51 states that:

"A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations."

The real world application of FIN 46 to CDOs continues to be a developing story. The intent of this article was to raise awareness of an important underlying operational implication of FIN 46 for CDO transaction participants, namely the potential need for GAAP-basis financial statements of the CDO vehicle itself where such a need may not have existed before. As always, it is strongly suggested that market participants seek professional advice with respect to the specific facts and circumstances of their transactions.

What is the "equity method"?

Paragraph 6b. of APB 18 summarizes the equity method of accounting for investments as follows:

"An investor initially records an investment in the stock of an investee at cost, and adjusts the carrying amount of the investment to recognize the investor's share of the earnings or losses of the investee after the date of acquisition. The amount of the adjustment is included in the determination of net income by the investor, and such amount reflects adjustments similar to those made in preparing consolidated statements including adjustments to eliminate intercompany gains and losses, and to amortize, if appropriate, any difference between investor cost and underlying equity in net assets of the investee at the date of investment. The investment of an investor is also adjusted to reflect the investor's share of changes in the investee's capital. Dividends received from an investee reduce the carrying amount of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred which is other than temporary and which should be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method."

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[1] For a detailed discussion of FIN 46, please see our February 2003 issue of *Heads Up* by Jim Mountain.

[2] For purposes of this article, the term "collateralized debt obligation" includes collateralized bond obligations and collateralized loan obligations.