NON-BANK-SPONSORED ASSET-BACKED COMMERCIAL PAPER: IMPLEMENTING THE RESTRUCTURING PLAN

Accounting Standards Board Staff Financial Reporting Commentary[1]

February 2, 2009

In three previous commentaries, the AcSB staff has provided guidance on the measurement, presentation and disclosure of investments in non-bank-sponsored asset-backed commercial paper ("ABCP") in interim and annual financial statements.[2] The guidance contained in those commentaries remains relevant for fiscal years ended December 31, 2008. Implementation of the restructuring plan prior to the completion of investors' financial statements for such fiscal years will constitute a subsequent event requiring financial statement disclosure.

This commentary addresses some of the accounting issues expected to arise from the successful implementation of the restructuring plan developed by the Pan-Canadian Investors Committee for Third-Party Structured Asset-Backed Commercial Paper. Accordingly, it deals with issues to consider in reporting on periods ending after the restructuring is completed. The commentary focuses on issues facing investors that receive notes issued by the new conduit trusts but it does not address issues associated with the margin funding facility in the MAV1 conduit trust.

This commentary is specific to the complex and unique terms of the notes issued under the non-bank-sponsored ABCP restructuring plan and does not address other financial instruments. It deals only with accounting issues for those entities that have adopted

1 This commentary provides the views of the staff of the Accounting Standards Board ("AcSB") on how certain aspects of Canadian generally accepted accounting principles ("GAAP") apply to non-bank-sponsored Asset-Backed Commercial Paper held by investors and the new notes investors will receive under the restructuring plan. The commentary does not address all issues that might arise in practice and assumes that all of the various items of information discussed are material. The staff views reflect input from a number of individuals with expertise in financial reporting, whose contributions are gratefully acknowledged. The commentary has not been approved by the AcSB and, therefore, does not constitute a primary source of GAAP. The commentary does not necessarily apply to entities subject to the standards in the Public Sector Accounting Handbook.

2 See the three preceding AcSB staff commentaries, which include background information, available at:

- www.acsbcanada.org/index.cfm/ci_id/40794/la_id/1.htm (October 29, 2007);
- www.acsbcanada.org/index.cfm/ci_id/42571/la_id/1.htm (January 18, 2008); and
- www.acsbcanada.org/index.cfm/ci_id/44457/la_id/1.htm (April 18, 2008).

The AcSB staff has also recently issued a separate staff commentary providing guidance for determining fair value in inactive markets, available at:

- www.acsbcanada.org/index.cfm/ci_id/47493/la_id/1.htm (November 20, 2008).

FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, Section 3855 of the CICA Handbook – Accounting (the "Handbook"), issued in 2005.

Details of the restructuring plan, the securities subject to the arrangement and the securities to be issued are provided in various documents available to investors through a website maintained by the court-appointed Monitor.[3] The appropriate accounting can only be determined following a careful evaluation of the full terms and conditions of the new notes received under the restructuring.

ACCOUNTING FOR ABCP UP TO THE IMPLEMENTATION OF THE RESTRUCTURING PLAN

Immediately before the restructuring is given effect, measurements of ABCP investments determined at previous dates must be reconsidered in light of all current information available to investors. Accumulated cash in the conduit trusts payable on the exchange of notes is included in the determination of the fair value of the ABCP and is not reported as interest income. Any necessary adjustment of the carrying amount of the ABCP is recognized in net income or in other comprehensive income, depending on how the ABCP has been classified for accounting purposes.[4]

ACCOUNTING FOR THE EXCHANGE OF ABCP FOR NEW NOTES

The exchange of ABCP for new notes is a transaction of substance. The terms and conditions of the various series of ABCP and the terms and conditions of the various classes of new notes that investors will receive in exchange differ significantly. Accordingly, an investor removes its investment in ABCP from its balance sheet, gives initial recognition to the new notes at their fair value[5] and recognizes any resulting gain or loss in net income.

Investors that have classified their ABCP holdings as available for sale will have previously recognized an impairment loss in net income but may also have reported some unrealized gains and losses in other comprehensive income.[6] Any balance of net unrealized gains or losses related to ABCP accumulated in other comprehensive

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3 See: http://documentcentre.eycan.com/pages/main.aspx?SID=35.

4 Entities that have adopted Handbook Section 3855 classify their ABCP investments as held for trading, available for sale or held to maturity. Asset measurement and income recognition requirements specific to each category are then applied to assets according to their classification. Investments classified as held for trading or available for sale will be adjusted to the most recent estimate of fair value. Investments classified as available for sale or held to maturity will be subject to impairment write-downs in net income.

5 See Handbook paragraph 3855.55.

6 In the case of not-for-profit organizations, references in this commentary to amounts included in other comprehensive income refer to amounts included in net assets in accordance with FINANCIAL STATEMENT PRESENTATION BY NOT-FOR-PROFIT ORGANIZATIONS, paragraph 4400.45 of the Handbook, and Handbook paragraph 3855.76, footnote 1.

income would be reported in net income upon the exchange of the ABCP for new notes by a transfer out of other comprehensive income.

ACCOUNTING FOR THE NEW NOTES

Investors must classify the new notes for the purposes of measurement subsequent to their initial recognition and related income reporting because, like the ABCP, the new notes are financial assets. The new notes do not meet the definition of a loan or receivable because they are debt securities.[7] Determining whether the notes may, or must, be classified as held for trading, available for sale or held to maturity depends on further analysis of their substance (see question 3 below for further discussion of the ability to classify the notes as held to maturity).

1. Are the new notes derivatives?

Questions may arise as to whether the new notes are derivative instruments because their fair value will change in response to changes in financial variables affecting the underlying assets in the conduit trusts. However, none of the classes of notes constitute a derivative in their entirety under the definition in Handbook Section 3855.[8]

2. Do the new notes contain embedded derivatives?

Investors must determine whether the new notes they receive contain any embedded derivatives[9] and whether the economic characteristics and risks of any embedded derivatives are closely related to those of the host debt instrument. Certain classes of notes provide an interest in the underlying credit default swaps of the conduit trusts. The performance of those notes is dependent on the performance of the assets referenced in the swaps held by the issuing conduit trust. Such notes are considered to be, in substance, a hybrid instrument containing a credit derivative that is not closely related to the host debt instrument. Unless the entire note is accounted for as a held-for-trading asset, the embedded derivative would need to be accounted for separately in the same manner as a freestanding derivative.[10] An inability to measure the fair value of an embedded derivative requires that the entire note be classified as held for trading, and accounted for accordingly.[11]

Some classes of notes may include more than one embedded derivative. When accounted for separately from the host debt instrument, embedded derivatives are treated in the aggregate as a single compound derivative.[12]

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7 See Handbook paragraph 3855.19(h).
8 See Handbook paragraph 3855.19(e)(ii).
9 See Handbook paragraph 3855.36.
10 See Handbook paragraphs 3855.37, 3855.A32 and 3855.A34.
11 See Handbook paragraphs 3855.38.
12 See Handbook paragraphs 3855.A31.

In practice, the overall effect of the requirements concerning embedded derivatives may cause the holders of some of the series of new notes to choose to account for the notes as held for trading.

3. Could the new notes be classified as held to maturity?

To qualify as a held-to-maturity asset, a non-derivative financial instrument must provide for fixed or determinable payments and a fixed maturity date and the holder must have the positive intention and ability to hold it to maturity.[13] An investor should use reasonable judgment in determining whether these criteria are met. An investor cannot classify the new notes (or the host debt instrument when embedded derivatives are accounted for separately) into the held-to-maturity category without the intent and ability to hold the notes until the stated maturity date, even though they might be prepaid much earlier. To the extent that a class of notes provides that an investor will receive in full satisfaction of principal and interest only such amounts of collateral as the issuing trust has available to distribute, the notes do not satisfy the criteria for held-to-maturity classification.

INCOME RECOGNITION ON NEW NOTES

An investor will recognize interest income on a host debt instrument classified as available for sale (i.e., excluding separately recognized embedded derivatives) by applying the effective interest method. Any write-down for other than temporary impairment of an available-for-sale asset will be reported in net income when recognized.[14] At the date of disposition, an investor will report in net income any gains or losses on an available-for-sale asset, including unrealized gains or losses accumulated in other comprehensive income.

All unrealized and realized gains and losses on new notes classified as held for trading and embedded derivatives accounted for separately will be reported in net income as they arise.[15]

DISCLOSURE

At the first reporting date following the acquisition of the new notes and each subsequent reporting date, full disclosure of information about an investor's holdings of new notes is essential, with particular emphasis on the associated risks and uncertainties. This topic has been addressed in each of the three previous commentaries. Of particular significance in current financial market conditions are

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13 See Handbook paragraphs 3855.19(g) and 3855.23.

14 The AcSB has recently exposed for public comment a proposed amendment to Handbook Section 3855 to clarify the application of the effective interest method following an impairment write-down.

15 See Handbook paragraphs 3855.66 and 3855.76(a).

disclosures about the basis for determining fair values and the sensitivity of assets to market risk factors associated with the new notes.[16]

When the restructuring occurs after the end of an investor's most recent reporting period and before it completes its financial statements for that period, the investor will need to provide a description of the nature of the event and an estimate of its financial effect.[17]

[16] See FINANCIAL INSTRUMENTS — DISCLOSURES, paragraphs 3862.27 and 3862.40 of the Handbook.

[17] See SUBSEQUENT EVENTS, Section 3820 of the Handbook.