

Auction Rate Securities

A surprise for Treasurers!

John R. Rieger CPA
Director of Accounting and Financial Reporting
Association For Financial Professionals

What Happened

- In February 2005 PwC (PriceWaterhouseCoopers) issued a capital markets accounting developments advisory (2005-04) that concluded that ARS (Auction Rate Securities) do not qualify as a cash equivalent in accordance with FAS (Financial Accounting Standards) 95. This formal announcement by a non-regulatory agency sent a shock wave throughout the treasury profession since it was a departure from how these were previously handled.

What are Auction Rate Securities

- **Auction Rate Securities (ARS) represent securities such as bonds which carry a long-term underlying maturity, usually from 20 to 30 years. These securities are auctioned off by using a type of Dutch auction process to investors interested in generating a return for a very short time period. ARS are generally set for either 7, 28, or 35 days with an interest rate which is set for the auctioned period of time. At the end of the period, the investor may either hold or sell the security back into the auction. In every circumstance there is a reset of the interest rate based on the market and the bids at the reset period.**
- **There is generally a third party auction agent that collects the information establishes the rates and allocates the ARS by starting at the lowest and moving up to the highest bidder. The market depends upon a match-up of sellers and buyers. This means that if there are more buyers than sellers, some buyers may not receive any securities. If there are more sellers than buyers, then a seller must hold onto their security until a subsequent auction.**

Why are Treasurers Concerned?

- Many treasury professionals with either the express or implied approval of their external auditors had been using these vehicles as a way to improve the return on their liquid cash at least up through the end of 2004.

FAS-95 Definition of Cash and Cash Equivalent

- The FASB (Financial Accounting Standards Board) in November 1987 issued FAS 95- *Statement of Cash Flows*. It is within this statement, paragraphs 7-10 which defines for the company and the auditor what cash and cash equivalents are. In addition it is important to also read the footnotes (1-3) in order to have a better idea of what a cash and cash equivalent is under the FASB provision. Paragraph 8 of FAS 95 states that:
 - ***For purposes of this statement, cash equivalents are short-term, highly liquid investments that are both:***
 - ***Readily convertible to known amounts of cash***
 - ***So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.***
 - ***Generally, only investments with original maturities of three months or less qualify under that definition.***

PwC Argument

The advisory draws on the following points to argue why an ARS should not be qualified as a cash equivalent:

- The original security generally has a long-term life of 20 to 30 years.
- Risk of an auction failure

Legal Authority Issue

- Should an audit firm have unilateral interpretive authority over accounting standards?

Questions

- If ARS was okay as a cash equivalent last year, why not this year?
- What is it? Short-term? Long-term?
- If FASB fails to act, in the event a company fails to pay on their debt, and the cash and cash equivalent covenant was violated because of a non-authoritative decision what are the consequences?

Current

- Treasurers are unclear because of lack of guidance?
- AFP is attempting to address the issue with the FASB.

AFP Issues

- Improved definition of a cash equivalent
- Clarity on the character of ARS and how they should be classified (considering all the ARS variations)
- The legal authority of the CPA firms making unilateral decisions on accounting interpretations