

CPRAlert

Canadian Performance Reporting

MD&A DISCLOSURES ABOUT NON-BANK ASSET-BACKED COMMERCIAL PAPER

Companies holding non-bank Asset-Backed Commercial Paper (ABCP) have seen a high quality cash equivalent become a long-term investment with unclear realization prospects. Investors want to understand the extent to which an entity is exposed to ABCP, and how that exposure is affecting the entity's current financial condition and future prospects. While this Alert is focused on ABCP issues, it may also be applicable to other investments where the circumstances are similar.

SUMMARY

This Alert discusses MD&A disclosures around ABCP. It suggests disclosure that:

- supplements financial statements with additional information about each ABCP program held by the entity;
- reviews the effects of the ABCP on compliance with debt covenants, and liquidity generally;
- discusses the impact of the ABCP on the entity's strategy; and,
- discusses the impact of market conditions in general on the entity's prospects.

BACKGROUND

Asset-Backed Commercial Paper has been a popular short term investment, with maturities that mostly range between 90 and 180 days from date of issue. A trust issues the paper, the proceeds of which are used to acquire a diverse pool of assets, such as accounts receivable, credit card receivables, car loans, home loans, and mortgages. In addition, trusts may undertake derivative transactions to enhance the yields of the underlying assets. Repayment of the paper is funded from the cash flow stream of the underlying assets and the issuance of new paper. As well, liquidity support, usually in the form of a bank-provided liquidity line, is available in the event of a "market disruption".

The total Canadian Asset-Backed Commercial Paper market of about \$120 billion comprises two distinct groups: \$87 billion Asset-Backed Commercial Paper issued by trusts sponsored by the major banks, and \$33 billion Asset-Backed Commercial Paper issued by non-bank trusts. Banks have provided liquidity support for the trusts they sponsor. It is the non-bank sponsored Asset-Backed Commercial Paper that is experiencing the current liquidity problems.

As the US sub-prime credit crisis deepened in August, many issuers of ABCP were unable to place new ABCP, causing them to request funding under their liquidity support agreements to retire outstanding paper. Providers of the liquidity support, however, took the view that a "market disruption" had not occurred or that other conditions for support had not been met. This resulted in issuers of ABCP being unable to repay maturing paper, causing the liquidity crisis. In addition, the terms of the derivative transactions have placed further constraints on some trusts' operations.

The trusts are not publicly traded investment vehicles. Accordingly, there are generally no requirements for the issuer trust to provide financial statements outlining the trust's assets and liabilities and liquidity position. It should be noted that the mix of assets and liabilities in the trusts differs from trust to trust and the extent to which any impairment in value exists could vary significantly among the population of trusts.

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As a result of the widespread funding issues, a group of stakeholders in the ABCP created the “Montreal Accord” that called for a standstill on transactions in order to permit a resolution of the issues. Subsequently, the Pan-Canadian Investors Committee for Third-Party Structured Asset Backed Commercial Paper was formed to oversee the restructuring resulting from the Montreal Accord. In late December, it was announced that an agreement in principle had been reached to restructure the paper, subject to the approval of the investors and various other parties. Under the restructuring, the ABCP will be exchanged for longer-term notes that will more closely match the maturity dates of the underlying assets.

In December, the Canadian Securities Administrators (CSA) announced that they had established a committee that will focus the CSA’s actions in respect of global credit and liquidity issues. As part of its activities, the CSA has initiated targeted reviews of continuous disclosure of those issuers identified as holders of ABCP.

PROCESS TO DETERMINE FAIR VALUE

In January, the staff of the Accounting Standards Board (AcSB) published *Non-Bank-Sponsored Asset-Backed Commercial Paper: Year-end Reporting Issues – Financial Reporting Commentary*. That guidance addresses how GAAP applies to ABCP held by investors and expands upon earlier material published by the AcSB staff in October 2007.

In Q3, most entities that held any significant amount of ABCP recorded a reduction to estimated fair value. The Q3 reduction, that appears to be in a range between 5% and 25% of face value, needs to be revisited to determine fair value as of the year-end. For year-end reporting, more information may be available about the nature of the assets and liabilities behind the paper and the terms and conditions of any notes to be exchanged for the ABCP, pursuant to the agreement announced in late December. That additional information will likely enable management to make a more informed assessment of fair value as of the year end.

Investors will want to understand how management determined fair value. While there may be little data available, there are generally accepted and applied methods for determining fair values, including using prices of similar securities in comparable circumstances as a reference point. The financial instruments accounting standards require disclosure of the key factors in arriving at the valuation of the commercial paper, such as comparable discount rates. It is suggested that the MD&A supplement the financial statements with information about each ABCP program that the entity holds, including:

- when available, details of the nature of the assets and liabilities backing the paper;
- when available, the terms and conditions of any new notes that will replace the original paper;
- information about face value; and
- additional information about the valuation process, for example rationale for significant assumptions such as the discount rate and timing of cash flows.

ABCP AND DEBT COVENANTS

In most circumstances, ABCP that was acquired as a cash equivalent will have been written down and reclassified as a long-term asset. This may affect terms such as ratios included in debt and other agreements. Accordingly, entities may wish to discuss in their MD&A how the write-down and reclassification of ABCP are affecting these agreements, including:

- the likelihood that triggers in debt covenants will require early repayment of debt, including the entity’s proximity to the trigger;
- risks such as the likelihood of a change in credit rating and the possible consequences of such a change;
- any steps management is taking to mitigate the impact of an impending violation of a debt covenant;
- when a debt covenant has been violated, the effect of the violation and actions being taken to rectify the situation; and
- the impact on any other agreements of reclassifying long-term debt as a current liability as a result of a covenant violation.

ABCP AND LIQUIDITY GENERALLY

Even when there is no impact on financial covenants, the write-down of ABCP and its elimination from cash and cash equivalents may have an impact on the entity's ability to meet its obligations as they come due. The effect of the removal of these funds from cash equivalents should be discussed, including the action management is taking to ensure that obligations continue to be met on a timely basis. For example, management may have negotiated an increase in lines of credit to provide liquidity until proceeds from the ABCP are realized.

ABCP AND STRATEGY

When the amounts of ABCP held are significant, a number of strategy-related disclosures may be appropriate:

- the purpose for the ABCP holdings;
- the timeframe within which the funds had been expected to be utilized;
- changes to plans as a result of the illiquidity in ABCP holdings, including their anticipated effect on any previously disclosed targets; and,
- any alternative actions being taken to offset the shortfall in cash, for example by disposing of assets, borrowing, reducing dividends or share repurchases, or by issuing shares.

MARKET CONDITIONS IN GENERAL

The credit and liquidity issues that impacted the global economy in 2007 have resulted in credit markets being less readily accessible. Accordingly, the MD&A should discuss how changing credit market conditions are affecting the entity. In particular, this discussion should address how these conditions have affected the entity's lines of credit, ability to roll over existing debt and raise new finance. In addition, the MD&A should explain the entity's financing plans in this environment.

CONCLUSION

All entities with significant investments in ABCP should provide accurate, complete and transparent information about these investments and their impact on the entity's financial condition and future prospects. We hope this *CPR Alert* will help stimulate thought about the MD&A disclosures that may be needed.

Entities may wish to review the following materials that have addressed ABCP:

- *Non-Bank-Sponsored Asset-Backed Commercial Paper: Year-end Reporting Issues – Financial Reporting Commentary*, published by the staff of the Accounting Standards Board in January 2008, available at www.acsbcanda.org
- *Canadian Securities Administrators Update on Actions Related to Global Credit and Liquidity Issues*, published in December 2007, available at www.osc.gov.on.ca
- *Non-Bank-Sponsored Asset-Backed Commercial Paper – Financial Reporting Commentary*, published by the staff of the Accounting Standards Board in October 2007, available at www.acsbcanda.org
- *The ABCP Liquidity Crunch – questions directors should ask*, a Director Alert, published by CICA in October 2007, available at www.cica.ca
- *Ernst & Young Inc. Restructuring Document Centre* (contains information about the activities of the Pan-Canadian Investors Committee for Third-Party Structured Asset Backed Commercial Paper), available at <http://documentcentre.eycan.com/pages/main.aspx?SID=35> ■

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