



June 28, 2005

Mr. Lawrence W. Smith
Director, Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Accounting for Auction Rate Securities

Dear Mr. Smith:

The Association for Financial Professionals (AFP) appreciates the opportunity to comment on the recent change in accounting for auction rate securities (ARS). The membership of AFP represents approximately 14,000 finance and treasury professionals employed by over 5,000 corporations and other organizations. Our membership includes a significant number of corporate treasurers who oversee the management of cash and short and long-term investments.

AFP and its members represent the primary users of ARS as a safe and effective corporate cash management tool. AFP is concerned about the recent change driven primarily by the “Big-4” accounting firms to unilaterally and immediately change the historical method of accounting for ARS. This action changed the treatment of ARS from qualifying as a cash equivalent to, in most cases, a short-term investment. This major change in the treatment of ARS was also implemented without any notice or public comment.

The problem began in February, 2005 when PricewaterhouseCoopers (PwC) issued an advisory indicating that auction rate securities which have been commonly accounted for as a cash equivalent by both corporations and external auditors no longer qualified for this treatment and should now be considered a short-term investment¹. The advisory concluded that “*Most auction rate securities have maturities that span many years, and such securities will not qualify as cash equivalents.*” In addition, the advisory suggested that the risk of auction failure contributed to their conclusion.

The Impact on Corporate Treasury

Without prior notification, companies were required to modify current financial statements (balance sheet and cash flow statement) and to restate prior financial statements under threat by the external auditor. Most often, notice was not received by the company until February or later, after the auditor had begun the year-end work for calendar year 2004. As a result, plans for managing cash had to be hastily modified. Debt covenants with cash and cash equivalent compliance requirements had to be reviewed to assure that there were no loan covenant

¹ PricewaterhouseCoopers, Capital Markets Accounting Developments Advisory 2005-04, dated March 4, 2005.

violations. If there were covenant violations triggered by this change, they needed to be remedied by amendments to loan agreements or risk a technical default and the possible withdrawal of financing.

Consequences of the ARS Change

The immediate and unilateral change by the “Big 4” firms in the accounting for ARS introduced instability into the market and is inconsistent with the concept of supporting a stable and transparent financial reporting environment. The change made it appear to the public that companies had done something improper, creating suspicion within the capital markets.

Our members now struggle with a lack of clarity and consistency on how to properly report auction rate securities. ARS had been used and treated as a cash management tool and not as short-term investments since the mid 1980’s. ARS investment transactions are recorded par-in and par-out to retain consistency with traditional cash management accounting. Under these new requirements for short-term investments, they must now be reported as investment purchases and investment proceeds in the cash flow statement, resulting in a distortion of company cash management and investment activities.

The decision by PwC creates difficulty in financial comparability since some auditors are continuing to allow ARS to be classified as a cash equivalent if the amount is not material. Most auditors have now classified ARS as short-term investments, yet some auditors have required a long-term classification because the PwC argument was based on the fact that the underlying security is long-term. Finally, other audit firms have taken the PwC definition of “long-term” in its ARS opinion to the extreme requiring the reclassification of variable-rate demand notes as well, leading to additional questions about the classification and treatment of money market funds. This variability of treatment leads to a lack of transparency across companies’ financial statements, a condition that would have been avoided with notice, debate, and public comment.

AFP Recommendations

The Association for Financial Professionals takes the position that:

- Auction rate securities represent an established, accepted and integral corporate cash management tool and should be accounted for as such.
- In most cases auction rate securities should qualify as a cash equivalent according to the definitions provided by Financial Accounting Standards 95(FAS 95). The Dutch auction infrastructure and the established market developed by the leading auction agents have a proven history of being both liquid and subject to an insignificant level of risk.

AFP specifically recommends that:

- Auction Rate Securities should not be precluded from being a cash equivalent provided they are:
 1. Short-term and highly liquid to the company,
 2. Readily convertible to known amounts of cash, and
 3. Present an insignificant risk of change in value due to changes in interest rate.
- In the event that changes in circumstances affect the above qualifications, Auction Rate Securities should then be reclassified as short-term investments unless facts and circumstances support a classification to a long-term investment. Changes in circumstances would include situations when:

1. There is greater than a remote chance that the short-term investments fails to be highly liquid and convertible into cash, or
2. The risk is not insignificant and there exists a greater than remote probability that there will be a change in value due to changes in interest rate, or
3. Other facts and circumstances, such as change in managements' cash management planning, justify a change.

Rational For Recommendations

Auction rate securities exist within a risk adjusted infrastructure which pre-sets interest and presents an insignificant level of risk. In the established market, the setting of interest rates for the specific period of time and the participation of major investment banks as auction agents² enhances and redefines the risk and liquidity of the ARS system beyond the narrow limits of determining classification solely on the underlying long-term security.

Auction rate securities have proven to be highly liquid investments and there is no substantial evidence that the risk of an auction failure is other than a remote possibility. Most of the failures on record occurred early in the history of ARS when the credit quality of the underlying securities did not always lead to a favorable auction. Now, the underlying securities are generally AA or AAA securities, providing a high level of quality in the auction system. In addition, some ARS also include additional levels of guarantees through measures such as bank letters of credit which secure the credit quality.

ARS has a two-tiered level of "maturity" based on (a) the purchaser's expected maturity (7-day, 28-day, 35-day), or (b) the issuer's stated maturity. Historically, corporations and audit firms considered ARS in light of the first, understanding that the risks inherent in ARS were sufficiently remote to ignore the latter unless situation(s) developed to warrant reclassification.

The inclusion of ARS transactions in the statement of cash flows further muddies the clarity of the statement. Corporations must place ARS transactions in the cash flow statement in the "Cash Flows from Investing" section. The "Investing" section details cash flow for capital expenditures or other non-operational investments³. The cash used by Corporate Treasury Departments to purchase ARS and other cash equivalents constitute operational cash not needed immediately, but which the firm anticipates needing in the near future. Including the net purchases and net sales of ARS (and other historical cash equivalents) suggests investing activities beyond cash management objectives, since it accounts for operational cash activities in a non-operational manner. This, then, materially misleads investors as to the nature of the funds flow by redefining the activities the firm(s) undertake with operational cash flow.

Addressing the PwC Advisory

AFP believes that the arguments and rationale leading to the conclusions made by PwC are faulty or incomplete.

- The advisory did not consider the mitigating effects of the auction rate security infrastructure when the risks and maturity length of the securities were discussed. The argument focused primarily on one component of auction rate securities, the length of

² The Bank of New York, Deutsche Bank North American, Wachovia Bank NA, Wells Fargo Bank NA and Wilmington Trust Company. Source from the Bond Market Association.

³ See Ross, Westerfield, and Jaffe's. "Corporate Finance" 40-41, 1996; and Federal guidelines given online at <http://www.onlinewbc.gov/docs/finance/cashflow.html>

maturity for the original underlying security. It did not consider the ARS system environment or that ARS carry a reduced rate of return and an adjusted yield to reflect the reduced risk of the ARS structure.

- The advisory did not consider that there are varying types of ARS with different levels of risk. The advisory assigned a blanket disqualification of all auction rate securities without defining or establishing the attributes which differentiate an investment that qualifies as a cash equivalent and one that does not.
- The advisory did not quantify an acceptable degree of auction failure rate or define the degree of risk which is or is not acceptable for a cash equivalent. The advisory simply stated that since it was *possible* for an auction to fail, ARS do not qualify as cash equivalents. However, current money market funds have provisions which state that they expressly do not guarantee par value liquidation, yet they qualify as a cash equivalent. In addition, money market funds have no final maturity at all.
- The PwC advisory did not look at the full picture related to ARS. It did not consider that the credit quality of ARS is generally comparable to the credit quality of cash held in traditional financial institutions. Further, the advisory did not recognize that the risk of an auction failure is remote and that there is an insignificant risk of changes in investment value.

FAS 95 Concerns

AFP does not suggest that Financial Accounting Standards (FAS) 95 is in need of fundamental revision. However, FAS 95 does utilize examples which may need updating to assist practitioners to better understand what a cash equivalent would generally look like. FAS 95 was adopted in 1987 when it was assumed that traditional financial institutions were the only acceptable vehicle to hold cash and cash equivalents. As our market-based economy continually evolves with new and more complex investment products available to corporate treasurers, examples or illustrations of one time period do not always fit properly at a later time.

In light of the concerns raised by the PwC Advisory of ARS, we urge FASB to consider issuing additional clarification of FAS 95 to make the standard more responsive to today's markets.

Lack of Due Process in the Current Decision by PwC

AFP is not only concerned with the substance of the PwC Advisory on ARS, but also with the policy question on how accounting standards and interpretations will be set in the future. Essentially, PwC changed the accounting treatment of ARS without any due process and without any opportunity for feedback on the possible impact of the change. Further, the change was made immediately and retroactively. And, while PwC will argue that it did not set a new standard, but only changed an interpretation, the impact of this change was as significant to AFP members as any new accounting standard.

The process surrounding the change in accounting treatment for ARS was in direct contrast to the procedures followed by FASB in adopting new or amended rules. Generally, FASB issues an exposure draft with a comment period to allow interested parties to comment on the effectiveness and impact of the proposal. In addition, the comment period and future effective date allows companies time to plan for accounting changes.

As FASB pursues convergence with the International Accounting Standards Board (IASB) to establish principles-based (objectives-based) standards, the power of the "Big 4" accounting firms becomes even more troubling. While broad based objective standards at the global level contribute to the establishment of a consistent framework, it also creates gaps in the application of the standards as they apply to myriad economic and transactional situations. We are extremely concerned that a large private sector (non-regulatory) body with inherent conflicts of interest, such as an audit firm, can make unilateral accounting interpretations. This type of system risks creating a tainted process.

Summary

The change in how auction rate securities are accounted for has had a tremendous impact upon our membership and we do not believe that it was correct to make this change. AFP believes that auction rate securities, provided they are not subject to liquidity risks or other circumstances, should qualify as cash equivalents. We do not see where the case has been made that ARS are or have been a liquidity risk issue. Finally, we are concerned about the lack of due process. Accounting changes should not come from a private sector audit company, where public comment and feedback are not possible.

In light of the concerns expressed in this letter, AFP would like the opportunity to meet informally with the appropriate staff of FASB. Please contact John R. Rieger, Director of Accounting and Financial Reporting for any additional information or questions (301) 961-8885 jrieger@afponline.org.

Sincerely,

A handwritten signature in cursive script that reads "James A. Kaitz". The signature is written in black ink and is positioned above the printed name and title.

James A. Kaitz
President and CEO