

Reporting Considerations

The Federal Housing Finance Agency decision to permit the "sweep" of Fannie Mae's and Freddie Mac's earnings to the Treasury



After the close of the equity markets on September 30, 2014, a Federal court issued an opinion on a case brought by a number of investors against the government about the Federal Housing Finance Agency's decision to permit the "sweep" of Fannie Mae's and Freddie Mac's earnings to the Treasury. This opinion had left the agencies unable to pay dividends on their common and preferred stock. In past years, Fannie Mae and Freddie Mac preferred and common stock had been held (in many cases prior to their defaults as long-term holdings) by various entities, including hedge funds, banks, insurance companies, and others. The September 30, 2014, decision was strongly in favor of the government and adverse to the investors, which resulted in opening prices for the common and preferred stock on October 1, 2014 some 40-60% lower than September 30 closing prices. All the stocks appeared to trade daily and had quoted closing prices on September 30th. For some funds, these price declines were material to net asset value (NAV), and for other entities these amounts may be material to key financial measures (e.g., net income and/or stockholders' equity). Recognizing that this event occurred on a quarter-end reporting date, there was concern that it would receive a heightened degree of attention from both preparers and auditors. Accordingly, representatives of several AICPA Expert Panels, including Investment Companies, Depository Institutions, Insurance, Not-for-Profit, Employee Benefit Plans, and Stockbrokerage and Investment Banking, held a joint call to discuss the following general and industry-specific valuation and financial reporting considerations in connection with this court decision:

1. **Does the company have a policy in place that would address valuation issues of this type?**

Though this event was particularly noteworthy because of its size and timing, many announcements that would be expected to affect securities prices occur after normal market closing time (e.g., acquisition offers made or rescinded, senior personnel changes, FDA approval/rejection of new drug applications, etc.) In consideration of this, some companies which frequently encounter post-close events have adopted explicit cut-off policies for the timing of events to be considered in valuation. For example, many investment companies regulated under the Investment Company Act of 1940 have documented policies and procedures for determining NAV for investor transactions. These funds' prospectuses and/or financial statements may state that the prices for securities and the net asset value per share (NAV) of the fund are determined as of 4pm ET (which is the closing time of major U. S. securities markets). Some of these investment companies have stated explicitly in the accounting policy footnote of their financial statements that this cutoff is used for financial reporting purposes as well. Governing documents (such as partnership agreements) of nonregistered investment companies, for example, hedge funds, may also indicate that pricing and/or net asset value calculation is performed as of 4pm ET.

2. What are some of the considerations when current policy does not explicitly address the issue or the policy does not exist?

Entities should follow their existing policies to determine how this court ruling may affect valuations of the entity's holdings in Fannie Mae and Freddie Mac investments. The entity may review its past practices, including how it previously considered and interpreted relevant accounting guidance and took into consideration similar events, and apply those practices consistently.

Entities may have historical practices (although no explicit written policy) to price investments and/or cutoff for financial reporting purposes at 4pm ET or their past practice may be to take into account after-market activity and cut-off the financial statements later than 4pm ET. Generally speaking, entities with established practices that have been consistently applied, should consider continuing to follow them.

Guidance from ASC 820-10-35-41, together with detailed analysis that each entity would perform, may be relevant:

- b. When a quoted price in an active market does not represent fair value at the measurement date. That might be the case if, for example, significant events (such as transactions in a principal-to-principal market, trades in a brokered market, or announcements) take place after the close of a market but before the measurement date. A reporting entity shall establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment results in a fair value measurement categorized within a lower level of the fair value hierarchy.

Entities that may have been affected by the September 30 court decision but had not previously encountered similar events (or for whom such an event had not previously been material) may consider establishing a policy to identify post-close events that may have a material effect on fair value measurement, and should apply such policy consistently going forward.

3. If not reflected in reported results for a period ending on September 30, would this event require Subsequent Event footnote disclosure?

If not reflected in reported results for the period ending September 30, this event would be considered a "nonrecognized subsequent event." In accordance with ASC 855-10-50-2, some nonrecognized subsequent events may be of such a nature that they must be disclosed to keep the financial statements from being misleading. This decision must be made on the basis of quantitative and qualitative materiality, and requires judgment based on each reporting entity's individual facts and circumstances. Due to the nature of a mutual fund and the fact that its investment portfolio and shares are priced daily, practice in the mutual fund industry is often to not include subsequent event disclosure for market movements occurring after the financial statements are cut-off. However, even mutual funds should consider whether subsequent disclosure is warranted based on the specific circumstances. If disclosure is deemed necessary based on materiality, the nature of the event and an estimate of its effect on the financial statements should be disclosed.