

The Dodd-Frank Act:

Could there be Accounting Consequences?



The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act or Dodd-Frank Act), the landmark regulatory reform legislation was signed into law in the United States in July 2010 and has wide-ranging implications for many industries.

The legislation contains requirements that deal with numerous aspects of corporate governance, financial transactions, executive compensation, public company disclosures, whistleblower procedures and protections, mining and use of certain minerals, and much more; potentially impacting a large number of financial institutions in the United States and around the globe. The entities captured within the Act vary by proposal, but generally a majority of the Act's provisions impact financial institutions operating within regulatory jurisdictions.

Several provisions will have an effect on nonfinancial companies either directly or indirectly through the impact they have on financial institutions with which nonfinancial companies interact.

Certain provisions of the Dodd-Frank Act will have accounting and reporting implications, a selection of which is discussed at a high level below. As U.S. regulators and lawmakers are currently in the development phase of this considerable rule-making process, which is anticipated to last for the foreseeable future, the discussion below is subject to change once rules are finalized. Additionally, further analysis will be necessary to apply the final requirements to your organization's particular facts and circumstances. Although the rule-making process for many aspects of the Act are still under development, a public company that anticipates that the Act may have a significant impact on its business may wish to provide disclosures of the potential impact (for example, in Management's Discussion and Analysis).

Asset-backed Securities

Within Title IX, which is entitled *Investor Protections and Improvements to the Regulation of Securities*, Section 941 of the Dodd-Frank Act requires any securitizer to retain an economic interest in a portion of the credit risk for any asset the securitizer transfers, sells, or conveys to a third party through the issuance of asset-backed securities (ABS). Six federal agencies¹ have proposed a rule that would require sponsors of ABS to retain at least 5 percent of the credit risk of the assets underlying the securities, unless certain exceptions are met. Exemptions are proposed for ABS collateralized by “qualified residential mortgages” and qualifying commercial, commercial mortgage, and automobile loans. Under the proposed rule, securitizers would be prohibited from directly or indirectly hedging the credit risk they are required to retain. Regulators believe that if a securitizer has “skin in the game,” it will have a greater incentive to underwrite higher-quality assets collateralizing the ABS and monitor their ongoing quality. For more information about the proposed rule, see KPMG’s Defining Issues No. 11-29, *Regulators Propose Risk Retention Rule for Asset-backed Securitizations*.

Also within Title IX are provisions requiring several disclosures related to ABS. The SEC has adopted a rule pursuant to Section 943, which requires securitizers of ABS to disclose information about filled and unfilled repurchase requests, and also requires nationally recognized statistical rating organizations (NRSROs) to provide certain disclosures in any report accompanying an ABS credit rating.² Additionally, the Securities and Exchange Commission (SEC) has adopted a rule in order to implement Section 945, which requires issuers of registered ABS to review of the assets underlying the ABS and to disclose the nature, findings, and conclusions of their review.³

Potential Accounting Implications

Companies that normally sell loans and receivables through securitizations, including potentially recourse factoring, will need to determine whether the risk retention provisions will apply to their current programs, including applicability of exemptions. If those provisions apply, then a company would be required to retain credit risk, raising the question of whether the financial assets transferred to the securitization vehicle should be

derecognized. For financial institutions, if more assets are retained in a company’s balance sheet, required capital levels will increase, thereby potentially decreasing the desirability of accessing securitization markets.

In assessing whether financial assets transferred should be derecognized, a company must first assess whether the securitization vehicle should be consolidated based on the guidance in accordance with ASC Topic 810, *Consolidation*. Once the company has assessed whether it is required to consolidate the securitization vehicle, it must then assess whether it should derecognize the financial assets transferred (or participating interests transferred) under the requirements in ASC Topic 860, *Transfers and Servicing*. The consolidation and derecognition requirements are complex and all forms of involvements with the securitization vehicle, including involvement through the required risk retention, would need to be assessed. The proposed rule provides for several alternative forms and structures for risk retention, each of which may impact the consolidation and derecognition analyses differently.

Other Reporting Implications

Included in the newly required disclosures related to ABS is a requirement for issuers to disclose the underwriting criteria used to evaluate assets in performance of the required review. If the pool contains assets that deviate from the disclosed criteria, issuers are required to disclose the amount and characteristics of those assets, the name of the entity or entities that determined the assets should be included in the pool, and the factors used to make the determination. For more information about disclosures required for ABS, see KPMG’s Defining Issues No. 11-7, *SEC Adopts Two Final Rules for Asset-backed Securities*.

The issuer’s review requirements and the credit rating agencies’ disclosure requirements also have the potential of impacting agreed-upon procedure (AUP) reports issued by the accounting firms. Some of the proposed rules require public disclosure that would be more consistent with general use reports, while AUP reports are subject to restricted distribution. Efforts are underway to bridge this gap as the rules are finalized.

¹ The six federal agencies proposing the rule are the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency, the Department of Housing and Urban Development, and the Office of the Comptroller of the Currency.

² SEC Release No. 33-9175, Final Rule, Disclosure for Asset-backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, available at www.sec.gov. A securitizer is defined as an issuer of an ABS or a person who organizes and initiates an ABS transaction by selling or transferring assets either directly or indirectly to the issuer.

³ SEC Release No. 33-9176, Final Rule, Issuer Review of Assets in Offerings of Asset-backed Securities, available at www.sec.gov.



Executive Compensation

Also within Title IX of the Dodd-Frank Act, Section 956 requires federal regulators to promulgate rules to enhance disclosure and reporting of compensation arrangements and also to prohibit certain incentive compensation arrangements. Seven federal agencies⁴ have proposed a rule that would implement Section 956. The proposed rule would prohibit covered financial institutions with more than \$1 billion in assets from adopting incentive-based compensation programs that would expose them to inappropriate risks or material financial loss. In order to address the above proposed requirements, institutions may balance risk and financial rewards through, amongst other possibilities, adjusting awards based on quantitative or qualitative risk measures, deferring payment beyond the end of the performance period, using longer performance periods or reducing sensitivity to short-term performance.

Additionally, larger financial institutions (those with consolidated assets of \$50 billion or more, or \$10 billion or more for credit unions) would be required to defer payment of at least 50% of covered employees' annual incentive-based compensation for at least three years. The proposed rule would broadly define incentive-based compensation to mean any variable compensation that serves as an incentive for performance whether it is paid in cash, equity awards or other consideration.

Financial institutions that would be covered include national and state banks, federal branches and agencies of foreign banks, depository institutions and holding companies, insured US branches of foreign banks, savings associations, savings and loan holding companies, credit unions, and registered broker-dealers and investment advisors.

In addition to the proposed rules described above that would implement Section 956 of the Act, a provision in Section 954 of the Act requires the SEC to adopt rules to provide for the recovery of incentive-based compensation paid within three years preceding an accounting restatement. The SEC's schedule to implement Section 954 indicates that the SEC plans to issue a proposed rule between August and December 2011.

For further information, see KPMG's Defining Issues No. 11-18, *Regulators Propose Compensation Rule for Financial Institution*.

Potential Accounting Implications

For institutions implementing the minimum three-year deferral period proposal, a particular area for analysis may be share-based incentive compensation. ASC Topic 718, *Compensation – Stock Compensation*, provides guidance related to awards meeting the definition of a share-based payment, including how to account for such awards when delivery of the underlying shares is restricted beyond the vesting date (i.e., a post-vesting restriction). Generally, such restrictions are considered in the grant date measurement of fair value of the share awards to the extent that the restrictions affect the price that a knowledgeable, willing market participant would pay for the share. However, the proposed rule does not clearly define when the three-year deferral period would begin for awards with multiple vesting conditions. For example, it is not clear when the deferral period would commence if a financial institution granted an award with a condition that cumulative earnings must exceed \$2 billion over a two-year period and then employees must provide service for three years beyond that period. The appropriate accounting (including the appropriate measurement and the period over which the compensation cost is recognized) would depend on interpretation of the proposed rule's deferral requirements.

An additional consideration for affected financial institutions relates to clarifying deferral and clawback provisions, which may impact the determination of the grant date for share-based compensation arrangements. A necessary condition for determining the grant date is a shared understanding of the terms and conditions of the awards. To the extent that the terms are not adequately defined or the awards plan is designed such that significant discretion related to clawback provisions is retained, there may not be a grant date until the end of the deferral period.

Furthermore, when modifications are made to existing compensation arrangements, including as a result of the proposals, institutions will need to consider the applicable ASC Topic 718 guidance related to beneficial and nonbeneficial modifications of equity-settled awards as the type of modification impacts the accounting treatment. Such a consideration is further complicated by the fact that the proposed rule does not provide transition guidance for existing compensation arrangements.

⁴ The seven federal agencies proposing the rule are Federal Reserve Board, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency, the Office of the Comptroller of the Currency, the National Credit Union Administration, and the Office of Thrift Supervision.

Other Reporting Implications

The proposed rule would also require each covered financial institution to provide its regulatory agency with an annual report on incentive-based compensation arrangements. Also related to reporting of executive compensation, Section 953 of the Act requires the SEC to issue rules requiring proxy statements for annual meetings of shareholders to include a clear description of any compensation required to be disclosed under Item 402 of Regulation S-K, including information that shows the relationship

between executive compensation actually paid and the financial performance of the issuer taking into account changes in stock price, dividends and distributions. Additionally, disclosure would be required of the median annual total compensation of all employees of the issuer other than its chief executive officer (CEO), the annual total compensation of its CEO, and the ratio of those two amounts.



Over-the-Counter Derivatives

Title VII of the Dodd-Frank Act, entitled the Wall Street Transparency and Accountability Act of 2010, establishes a new framework for regulatory and supervisory oversight of the over-the-counter (OTC) derivatives market. Under Title VII, many swaps that are currently executed in the OTC market will be required to be cleared through derivatives clearing organizations (e.g., exchanges or clearing houses), unless the organizations do not accept the swap for clearing. Swaps not cleared through a clearing organization would be reported to the Commodity Futures Trading Commission (CFTC), the SEC, or a swap data repository. The Act imposes capital requirements on swaps entities, which are swap dealers and major swap participants, as well as initial and variation margin requirements for uncleared swaps. Additionally, real-time public data reporting of swap transactions is required under Title VII.

It is important to note that the term “swap,” as defined in the Dodd-Frank Act, is very broad. It encompasses derivatives other than swaps (such as options or many forward contracts) as well as many other types of agreements, contracts, and transactions that have not previously been considered derivatives. The CFTC and SEC have jointly proposed rules to clarify the treatment of certain types of agreements, contracts and transactions, such as insurance products and certain consumer and commercial contracts (e.g., interest rate lock agreements for mortgage loans when entered by a consumer for personal, household, or family purposes).

Title VII’s provisions mark a significant departure from current practices, although certain exemptions will be available, including an “end-user exception” from clearing for a swap counterparty that is not a financial entity, that is using the swap to hedge or mitigate commercial risk and that notifies the CFTC or SEC of how it generally meets its financial obligations associated with entering into uncleared swaps.

Although the rulemaking that will determine the function of clearing organizations is still under development, it is believed that clearing organizations would become central counterparties to many swaps. This would result in swaps between two parties being novated, with the clearing organization becoming the counterparty to each of the parties entering into the swap (rather than those parties being counterparties to each other). The clearing requirements may be applicable not only to swaps initially entered after applicable rulemaking becomes effective, but also to some existing swaps.

Also within Title VII is Section 716, which is commonly referred to as the Lincoln Amendment or the “Swaps Pushout Rule.” In general, after the transition period, Section 716 prohibits the provision of certain types of Federal assistance,

including access to the Federal Reserve discount window and Federal Depositary Insurance Corporation insurance and guarantees, to swaps entities. It is believed that many banking entities that are currently counterparties to a significant volume of swap transactions would be unable to engage in those activities because they receive the above types of assistance. However, banking entities would not be prohibited from having affiliates that are swaps entities, provided the banking entity is part of a holding company structure supervised by the Federal Reserve and provided that the swaps entities comply with certain requirements. Banking entities would also not be prohibited from having limited swap activities, including hedging and similar risk mitigating activities, acting as swaps entities for swaps involving rates or reference assets that are permissible for investment by a national bank, and transacting in credit default swaps that are cleared by a derivatives clearing organization.

It is believed that to respond to the Lincoln Amendment, many banking entities may “push out” their swaps to eligible affiliates. It is expected that swaps will generally be “pushed out” through novation of the contracts, meaning that the eligible affiliate would become the legal counterparty to the swap rather than the banking entity. Because certain limited swap activities would still be permissible for banking entities, a banking entity may push out only prohibited swaps or may push out all swaps.

Potential Accounting Implications

One likely accounting consequence of the requirements to clear swaps pertains to measurements and disclosures of fair value under ASC Topic 820, *Fair Value Measurements and Disclosures*. Fair value measurements take into account counterparty credit risk and collateral. To the extent clearing organizations become central counterparties to swap transactions (instead of the original counterparty) and/or collateral maintenance is required, fair value measurements of swaps will be different from what they would have been absent those characteristics.

Use of clearing organizations as central counterparties may also impact a company’s eligibility to offset swaps in its balance sheet (i.e., to net the swaps). The criteria that must be met for a company to offset amounts are established in ASC Subtopic 210-20, *Balance Sheet – Offsetting*, with additional guidance applicable to derivative instruments provided in ASC Section 815-10-45, *Derivatives and Hedging – Overall – Other Presentation Matters*. For example, a company that historically had derivatives with multiple counterparties would have assessed its eligibility for netting its derivatives on a counterparty-by-counterparty basis. If that company began clearing swaps through one clearing organization that became

the central counterparty to its swaps and with which it had a master netting arrangement, the assessment of eligibility for netting would be made based on the relationship with the clearing organization, which may result in more derivatives being eligible for netting. Additionally, a company would need to consider the expected final guidance from a current FASB project to provide guidance on the criteria that would determine when offsetting is appropriate. The impact of increased netting is to decrease a company's balance sheet, which would have a positive impact on a depository institution's capital ratios.

Another potential accounting consequence of the Title VII requirements described above results from the potential novation of existing derivatives, either by a banking entity pushing out the swap or through submission of the swap to a clearing organization. An assessment would need to be made

as to whether the exchange of one counterparty to the swap for a different counterparty would result in the swap being accounted for as the continuation of the existing swap or as an extinguishment of the existing swap combined with issuance of a new swap. This assessment and the resulting accounting will depend on the particular facts and circumstances, including whether the transaction includes exchange of any consideration or revision of any other terms. For a swap that had previously been designated as a hedging instrument in a hedge accounting relationship, such a change may require each counterparty to assess its ability to continue hedge accounting under the original hedging relationship, considering the structure and specificity of its original hedge documentation and the prospective hedge effectiveness criterion in ASC Topic 815, *Derivatives and Hedging*.



The Volcker Rule and Living Wills

The “Volcker Rule,” incorporated in Section 619 of Title VI of the Act, includes a general prohibition against banking entities engaging in proprietary trading and limits their ability to invest in, or sponsor, hedge and private equity funds.

Section 165 of Title I of the Act proposes the development of resolution plans, referred to as “living wills,” by nonbank financial companies designated as systemically important and banking holding companies with consolidated assets of \$50 billion or greater. Resolution plans are a mechanism intended to provide regulators with a more comprehensive view of an institution’s interconnected structure, risk exposures, transactions with affiliates, and dependencies on, and by, other parts of the financial services industry (e.g., involvement in payment systems, custodial or clearing operations, large sweep programs, and capital market operations, etc.).

The Federal Deposit Insurance Corporation and the Federal Reserve Board have proposed joint rules to implement the living will requirement. The proposal places the onus on financial institutions to plan for potential economic and market events that

could have a significantly negative impact on their businesses. A framework to prepare and maintain this information needs to be established in order to comply with the specific requirements, including data management, information security, and appropriate governance. It is generally anticipated these plans may force companies to restructure, including downsizing.

Potential Accounting Implications

Both the Volcker Rule and the living will provisions could lead institutions to sell parts of their businesses in order to comply with the regulations. Restructurings have the potential to decrease an institution’s profitability, impacting previous projections used to support existing assets, such as goodwill and deferred tax assets. Valuation of these deferred tax assets will therefore need to be reassessed in accordance with ASC Topic 740, *Income Taxes*. Any divestitures will also require institutions to consider the requirements of ASC Topic 360, *Property, Plant, and Equipment*, related to impairment or disposal of long-lived assets. Additionally, there will likely be a number of significant tax and transfer pricing issues to be addressed.

Conflict Minerals – Potential Reporting Implication

Section 1502 of the Dodd-Frank Act, found within Title XV – Miscellaneous Provisions, intends to try and curb the violence and exploitation in the Democratic Republic of Congo or any adjoining country (DRC countries) by exposing companies that use minerals derived from this region through disclosure and public pressure. The SEC has proposed rules to implement Section 1502 that would require an issuer to provide investors additional disclosures in its financial reports if the issuer uses so-called “conflict minerals” that are necessary to the functionality or production of a product it manufactures, or contracts to be manufactured. Conflict minerals include cassiterite, columbite-tantalite, gold, wolframite, or their derivatives, or any other minerals that the U.S. Secretary of State determines is financing conflict in the DRC countries. These materials are used in diverse products such as mobile telephones, computers, jet engine components, electronic and communications equipment, and lighting, electrical, heating, and welding applications. Because of their

widespread use, the proposed disclosures would affect many companies and industries. As proposed, an issuer would be required to make certain disclosures in the body of its annual report if conflict minerals are necessary to the functionality or production of its products. An issuer that concluded its conflict minerals did not originate in DRC countries would be required to disclose this assertion and describe the inquiry process used to reach that determination. An issuer that uses conflict minerals that originated in a DRC country would be required to disclose that in its annual report and furnish a report that would include a description of the measures taken by the issuer to exercise due diligence about the source and chain of custody of its conflict minerals.

For more information about the proposed rule, see KPMG’s Defining Issues No. 10-55, *SEC Proposes Rules for Disclosures about Conflict Minerals and Extractive Industry Payments*.

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