



REGULATORY INTERPRETATION 2000-RI-03

Date: April 24, 2000

Subject: Refinancing Corporation (REFCORP) Financial Statement Presentation

Request Summary:

In December 1999, the Chief Financial Officers Council of the Federal Home Loan Bank (Bank) System asked the Bank System Controllers to change the financial statement presentation of the REFCORP payment, a charge to retained earnings in the Statement of Capital, to an expense item on the Statement of Income beginning with the first quarter 2000 report. The Controllers in turn requested permission from the Federal Housing Finance Board (Finance Board) to make this change.

Background:

In 1989, the Bank Presidents' Conference and the Bank System's independent auditor, Deloitte & Touche, agreed that the REFCORP obligation represented payments made to the U.S. government on behalf of mandatory members in lieu of dividends, and that these payments should not be expensed in the income statement, but should be charged to retained earnings in the Statement of Capital. They also agreed that since each Bank's share of the \$300 million REFCORP obligation was based on an allocation formula prescribed in the Federal Home Loan Bank Act (each Bank's share of the total obligation varied from year to year as a function of net income and relative level of advances to SAIF insured institutions), the amount due from each Bank should be disclosed as a contingency related to future years. Because the amounts to be allocated to each of the Banks could not be determined, only the total amount due by the Banks to REFCORP was known, and so a liability was not recorded for the Banks. PricewaterhouseCoopers (PwC), the successor independent auditor for the Bank System, concurred with this accounting treatment.

Analysis or Discussion:

PwC has advised the Banks that the Bank System can either continue to present the REFCORP payment as a charge to retained earnings or present it as an income statement item. Other government sponsored enterprises, such as the World Bank, have similar payment obligations and present them in their financial statements as charges to retained earnings. The enactment of the Gramm-Leach-Bliley Act in 1999 has changed circumstances however, for the Bank System. The System's members have all become voluntary and the argument that the REFCORP payment is being made on behalf of mandatory members in lieu of dividends is no longer persuasive. The REFCORP obligation has changed from a pro rata portion of a fixed dollar amount (\$300 million) to 20 percent of net earnings, and now appears in substance to be a tax that could be currently expensed in the income statement. Under GAAP, tax expenses are typically presented

on the face of the income statement above net income. PwC has advised the staff of the Finance Board that the change in accounting presentation requested by the CFOs and the Controllers can be made without restating prior period financial statements based on APB Opinion No. 20, Accounting Changes, ¶ 19a, which provides that "Financial statements for prior periods included for comparative purposes should be presented as previously reported."

Interpretation:

Finance Board staff has concluded that the REFCORP payment is no longer being made in lieu of dividends; that the payment is now known to be 20 percent of each Bank's net earnings; that the payment is in substance a tax and should be currently expensed; and that the payment should appear on the face of the income statement beginning in the first quarter of 2000. Under 12 C.F.R. § 989.3, any financial statements issued by an individual Bank must be consistent in both form and content with the financial statements presented in the combined Bank System annual or quarterly financial statements prepared and issued by the Finance Board.

In determining what disclosures the Bank System should make about this change in accounting presentation, staff reviewed closely related authoritative accounting guidance on changes in accounting principle. APB Opinion No. 20, at paragraph 17 regarding general disclosures, states:

The nature of and justification for a change in accounting principle and its effect on income should be disclosed in the financial statements of the period in which the change is made. The justification for the change should explain clearly why the newly adopted accounting principle is preferable.

Beginning with the first quarter of 2000, the following *pro forma* disclosures will be made in the combined Bank System financial reports.

Note 4 - Change in Accounting Presentation

Historically, the Bank System has reported its REFCORP obligation as a charge to retained earnings. This treatment was deemed appropriate in 1989 when Congress imposed the REFCORP obligation on the Banks, as the payments were considered for reporting purposes to have been made on behalf of mandatory members. Each Bank's share of the payment could not be determined until after year-end due to the allocation formula prescribed by the Federal Home Loan Bank Act and therefore it could not be currently expensed. Title VI of the Gramm-Leach-Bliley Act made membership in the System voluntary and changed the REFCORP payment from a fixed annual dollar amount (\$300 million) to 20 percent of each Bank's net earnings. As a result of these statutory changes, the Bank System will present its REFCORP payments as a current expense on the statement of income.

This change in accounting presentation will reduce net income by 20 percent, but will have no effect on retained earnings. Net income for the current period was reduced from \$___ to \$___. The reduced net income resulted in reduced returns on average capital and average total assets. The return on average capital was reduced from ___percent to ___percent, and the return on average total assets was reduced from ___percent to ___percent. Returns on average capital for 1999 and 1998 would have been reduced by about 173 basis points, and returns on average total assets would have been reduced by about 9 basis points.

There are no other effects of this change in accounting presentation.