



U.S. Securities and Exchange Commission

Speech by SEC Staff: Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments

by

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Washington, D.C.
December 11, 2006

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Introduction

Good afternoon. Today, I am going to share some views with you regarding: i) the application of fair value when accounting for certain items; ii) the interplay of revenue recognition and sales of receivables and; iii) the documentation requirements of Statement No. 133.

Fair Value

Inception Gains

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* (Statement No. 157). While Statement No. 157 does not require any new fair value measurements,¹ I would like to discuss one area of change which has been the subject of debate - the recognition of day one or inception gains.

Prior to Statement No. 157, footnote 3 of EITF 02-3, "*Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*" (Issue 02-3) prohibited inception gains for certain derivatives in the absence of: i) quoted market prices in an active market; ii) observable prices of other current

transactions or; iii) other observable data supporting the valuation technique. Statement No. 157 nullifies footnote 3. Given Statement No. 157's exit price notion, fair value at initial recognition is no longer limited to transaction price. Rather, Statement No. 157 states that the entity "shall consider factors specific to the transaction and the asset or liability."² One such factor is whether the transaction occurs in a market other than the entity's principal market. Example 7 in the Implementation Guidance to Statement No. 157 illustrates this concept with the example of a securities dealer transacting with a customer in the retail market. In this example, the dealer's fair value is not necessarily transaction price, since its principal market to exit the transaction may be different.

While this example illustrates that the nullification of footnote 3 of Issue 02-3 may increase the instances in which inception gains are recognized, we have heard that some believe that it is "open season" on inception gains. I would caution those constituents that there continue to be many instances in which day one gains are not appropriate. Statement No. 157 does not allow the practice of "marking to model" when the transaction occurs in the entity's principal market. Rather, transaction prices would generally be used in such a circumstance, and the model would be calibrated to match transaction price. Continuing with the previous example, if the securities dealer transacts with another in the dealer market, absent satisfaction of any of the criteria in Statement No. 157, paragraph 17, transaction price would likely be the best estimate of the fair value. As a result, there would not be any inception gain.

Some have asserted that the use of a pricing model would automatically lead to day two gains even in situations where there was not an inception gain. Again, a word of caution, assuming that an entity uses a pricing model to value its transaction in subsequent periods, footnote 18 of Statement No. 157 would indicate that the pricing model should be calibrated, so that the model value at initial recognition equals transaction price. As a result of calibrating the model, simply using a pricing model to determine fair value would not result in day two gains, unless there were changes in the underlying market conditions.

Multiple Element Arrangements

Continuing with the application of fair value, I would like to discuss multiple element arrangements, outside the area of revenue recognition. Over the past year, we encountered a number of instances where transactions or agreements contained multiple elements and were not otherwise subject to specific authoritative literature. Examples included: i) contract termination agreements; ii) executory contracts including modifications to existing contracts that may have required an upfront payment or; iii) a litigation settlement which required future services or other concessions between the parties. Regardless of the example, the same fundamental questions exist: i) should the arrangement be separated into two or more elements for accounting purposes and; ii) how should the elements be measured.

Regarding the first question - in the situations we encountered, the

arrangements were complex, and the accounting was obviously dependent upon the specific facts and circumstances. While no one factor would be determinative, we asked registrants to consider whether: i) the elements had independent economic value or substance; ii) any of the elements separately would meet the definition of an asset or liability; iii) there are instances where similar elements would be purchased or sold on an individual basis and; iv) the company has a reasonable basis to make an allocation among the elements.

With regard to the second question - how should each of the elements be measured - it is again necessary to consider the substance of the transaction. Some have questioned whether the arrangement should dictate measurement when the agreement specifically states amounts for a given element. We generally believe that fair value is a more appropriate allocation basis than the stated amounts in the contract. For example, Entity A (customer) terminates a long term contract with Entity B (vendor) in which A pays \$1,000 at the time of the settlement to exit the agreement. In addition, as part of the termination agreement, B will provide transition services to A for 6 months at a currently negotiated rate of \$100/month. Assuming the fair value of B's services are \$80/month, Entity A should record a settlement loss of \$1,120³ and monthly expense for the services rendered by B at \$80/month.

Accounting for Inventory at Fair Value

Turning from the novel to the more traditional, over the past year we have received a number of questions regarding whether it is appropriate to record inventory at fair value. Some may recall that this topic was addressed several years ago at this conference by a former member of OCA.⁴ Given the frequency of the question and the fundamental nature of accounting for inventory, I thought I would provide some observations on this topic.

While the FASB continues to advance the use of fair value, ARB 43 continues to be the relevant accounting literature for determining the measurement of inventory. ARB 43 states that "only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value."⁵ Otherwise to account for inventory at fair value, all of the following criteria must be present: i) an inability to determine approximate costs; ii) immediate marketability at quoted market prices and; iii) the characteristic of unit interchangeability. In most situations, including those involving commodity inventories, registrants have the ability to determine the inventory's approximate cost. As a result, the criteria in ARB 43 would not be satisfied. Given the emphasis on information systems and accounting processes that exist today, it would seem rare that a registrant would satisfy this criterion.

Some registrants have also cited industry practice as the basis for measuring inventory at fair value. A reminder regarding this approach - authoritative literature, including ARB 43, takes precedence over industry practice. Others

have argued that elsewhere within GAAP, such as certain AICPA accounting and auditing guides, provide an appropriate basis to measure inventory at fair value. Currently, a similar question is being considered by the EITF, as to whether entities within the scope of the Broker-Dealer Guide should account for physical commodity inventory at fair value.⁶ One alternative is entities within the scope of the Guide should measure commodity inventory at fair value. To date, we have not formulated a view regarding whether fair value is a more appropriate measurement basis for inventory but note that this position would require additional standard setting to eliminate any conflict with the guidance in ARB 43. We continue to follow this issue closely, and I encourage you to stay tuned.

Revenue Recognition and Transfers of Financial Assets

Moving on to revenue recognition and transfers of financial assets - we are aware of instances in which a vendor (transferor), which is unable to satisfy the revenue recognition criteria that apply to particular transactions, transfers the rights to future cash flows related to such transactions and, by virtue of the transfer, asserts that revenue recognition is now appropriate. This is based, in part, on the assumption that, if evaluated independent of revenue recognition, the transfer would satisfy the sales criteria under Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Statement No. 140). Certainly, it is important to highlight the relevance of the individual facts and circumstances in evaluating any of these transactions. However, in many instances, these transactions have been inappropriately characterized as sales of trade receivables.

When evaluating the accounting for these arrangements, generally the first step should be to determine whether revenue and a corresponding receivable should be recognized. If revenue recognition is dependent upon the transfer being accounted for as a sale, revenue recognition is likely inappropriate. If revenue recognition is inappropriate, then the right to the underlying cash flows is not a receivable. Since Statement No. 140 only applies to transfers of financial assets, this type of arrangement seems more appropriately characterized as a financing transaction - similar to a sale of future revenues pursuant to EITF 88-18, *Sales of Future Revenues*. Registrant's may also want to keep in mind the guidance in the AICPA Technical Practice Aids on software revenue recognition where extended payment terms are transferred or converted to cash without recourse to the vendor. Upon satisfaction of the revenue recognition model, the underlying cash flows would constitute a receivable and would then be eligible for sales treatment under Statement No. 140.

Hedge Documentation

Finally, I will conclude with some remarks regarding derivatives. At last year's conference, certain issues surrounding the short-cut method were highlighted.⁷ Today, others will be discussing issues regarding hedge effectiveness testing. Many of these issues are the result of the complexities

of applying hedge accounting. However, a surprising number of the issues that we address relate to the basic elements of hedge accounting, in particular hedge documentation.

Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement No. 133) establishes that at inception, an entity must formally document the hedge relationship.⁸ It is important to note that Statement No. 133 does not specify the form of the documentation for one to receive hedge accounting. In fact, we have been presented and have accepted a variety of approaches. However, each of the required elements must be documented for the relationship to receive hedge accounting. For example, if a company fails to document its approach for assessing effectiveness, the related documentation is insufficient, and hedge accounting would not be appropriate.

Some have questioned why a documentation deficiency should result in a failure to receive hedge accounting, while others have wondered whether hedge documentation must be perfect in order to receive hedge accounting. We have also received questions relating to modifications to hedge documentation and at what point a change to the documentation is a de-designation and re-designation event.

Regarding the question of whether the documentation is sufficient - if the documentation includes all of the elements such that it is clear what the entity has done, then the documentation is sufficient. However, if any of the required elements are missing, hedge accounting would seem inappropriate. While many aspects of a hedge relationship can be complex and, therefore, subject to differing forms of documentation, it seems that certain aspects of the documentation - for example, the identity of the hedged item and the hedging instrument - should be quite clear from the documentation in order for hedge accounting to apply. Because there is no bright line for determining whether the relationship is sufficiently clear, companies and their auditors must apply judgment in evaluating the sufficiency of the documentation.

One final element of hedge documentation that recently seems to be problematic is the requirement for a group of individual transactions that are part of one hedging relationship to be sufficiently homogeneous. Regarding forecasted transactions, paragraph 29 of Statement No. 133 requires the individual transactions within a group must share the same risk exposure. Over the past year, we have seen fact patterns where it is questionable whether this is the case.

As with other elements of hedge accounting, we do not believe there is a specific manner in which the similarity of the hedged items must be demonstrated. However, the documentation must be sufficiently clear that the group of hedged items share the same risk exposure. For certain strategies where each of the transactions in the group share the same fundamental attributes (timing, location, and variability) that determination may be rather obvious and may not require any significant effort. In other instances, where the transactions may have different characteristics - for

example a group of forecasted sales of commodities that have different delivery locations - a company may need to perform additional analyses to support its assertion. In addition, to the extent that there are changes in the nature of composition of the group of transactions, the company may be required to update its analysis periodically throughout the life of the relationship.

This concludes my remarks. Thank you for your attention today, and I hope you enjoy the remainder of the conference.

Endnotes

¹Statement No. 157 Summary

²Statement No. 157, paragraph 17.

³The \$1,120 consists of the \$1,000 initial payment plus the incremental amount of the monthly payment above fair value of \$20 for 6 months or \$120.

⁴2000 Twenty-Eighth Annual National Conference on Current SEC Developments December 4, 2000 -Remarks by R. Scott Blackley

⁵ARB 43, Chapter 4, Statement 9.

⁶EITF 06-12, *Application of AICPA Audit and Accounting Guide, Brokers and Dealers in Securities, to Entities That Engage in Commodity Trading Activities*

⁷Remarks before the 2005 AICPA National Conference on Current SEC and PCAOB Developments by Mark Northan Professional Accounting Fellow U.S. Securities and Exchange Commission

⁸Regarding cash flow hedges, paragraph 28(a) of Statement 133 requires entities to formally document the hedge relationship including: i) an entity's risk management objective and strategy for undertaking the hedge; ii) the hedging instrument; iii) the hedged transaction; iv) the nature of the risk being hedged; and v) how the hedging instrument's effectiveness will be assessed.

<http://www.sec.gov/news/speech/2006/spch121106jdm.htm>