



U.S. Securities and Exchange Commission

Speech by SEC Staff: Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments

by

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Introduction

Good afternoon. Today, I will discuss four financial instrument topics.

Classification of Loan Receivables

First, I will discuss the classification of loan receivables. Statement 65¹ and SOP 01-6² indicate that the classification of loan receivables as *held-for-investment* or as *held-for-sale* is dependent upon management intent.³ The classification is important because it impacts the measurement and presentation in the financial statements.

Management assertions. A common question the staff receives in this area is whether we believe there is a default classification under Statement 65 and SOP 01-6. For example, we have heard some assert that absent a positive assertion of the ability and intent to sell a specifically identified loan within one year, all loans default to *held-for-investment*. This approach is similar to the classification of long-lived assets under Statement 144.⁴ There may be other approaches that result in a default classification as *held-for-sale*. All of these approaches have one thing in common — classification of loan receivables based on the lack of a positive assertion by management.

The staff believes such approaches are generally not appropriate because they often result in classifications that are inconsistent with management's intent. In particular, the classification guidance in Statement 144 was not intended to be used to classify loan receivables.⁵ Rather, the staff believes management should make a positive assertion regarding its ability and intent to hold or sell loan receivables and classifying them accordingly. The staff understands this often requires significant judgment. Those judgments should be made considering all relevant information.

Definition of the "foreseeable future." One of the more important judgments is whether management intends to hold its loan receivables for the "foreseeable future." The staff does not believe there are bright line periods that define the "foreseeable future." Rather, management should develop a definition of the "foreseeable future" that is reasonable under the circumstances. That definition often differs for different types of loans.

Some of the factors that may be relevant in determining what period constitutes the "foreseeable future" include:

- The entity's business strategy and current business plans;
- The nature and type of the loan receivable, including its expected life;
- The entity's current financial condition and liquidity demands;
- The current economic environment and related market conditions; and
- The entity's past practices.

The staff has accepted different judgments regarding the definition of the "foreseeable future" when those judgments were reasonably formulated considering all relevant information. For example, the staff has accepted a shorter holding period for a credit card receivable than for an automobile loan receivable because of differences in the characteristics of the loans. However, the staff has disagreed with certain interpretations of the "foreseeable future." For example, an assertion that the "foreseeable future" is an imminent period because management does not precisely budget its loan sale activity was not viewed as reasonable. Additionally, an assertion that the "foreseeable future" is the period between the acquisition date and the date a specific loan is identified for sale was not viewed as reasonable. The staff has also heard some assert that in the current environment the "foreseeable future" represents a period until the market recovers. The reasonableness of that assertion would depend on the relevant factors, including the anticipated market recovery period.

An entity's definition of the "foreseeable future" may change if there are significant changes in the relevant factors. However, management should carefully consider whether a change in its definition that occurs concurrently with a reclassification of loan receivables is appropriate. Additionally, management should provide sufficient and transparent disclosures in the

financial statements when material reclassifications occur.

Unit of account. The last issue I will address on this topic relates to the unit of account. Neither Statement 65 nor SOP 01-6 provides guidance on whether the classification of loan receivables should be made at an individual loan level or at a homogenous group level. The staff has accepted both methods. Management should consider which method is most appropriate given its facts and circumstances, and adopt a consistent accounting policy. For example, if management intends to sell only a portion of a population of similar loans, but has not identified the specific loans to be sold, it may classify a percentage of the entire loan balance as *held-for-investment* and a percentage as *held-for-sale*. This may be more transparent to investors than classifying each individual loan the same pursuant to an individual loan level method. Under either method, management should provide sufficient and transparent disclosures regarding its accounting policy and the resulting impact on its financial statements.

Other Than Temporary Impairment of Securities

My second topic relates to the evaluation of securities for other than temporary impairment. Paragraph 16 of Statement 115⁶ indicates that an other-than-temporary impairment exists if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security. For a debt security that has experienced a market decline unrelated to instrument-specific credit quality, and for an equity security, the factors described in SAB Topic 5M⁷ may indicate that an other-than-temporary impairment exists. I would like to discuss the importance of one of the factors in SAB Topic 5M — the ability and intent to hold a security until an anticipated recovery.

Ability to hold the security. The staff believes that the inability to hold a security until recovery indicates that an other-than-temporary impairment exists regardless of the severity and duration of the market decline. Management should consider all of the relevant factors that may impair its ability to hold its securities until recovery. Such factors may include contractual constraints as well as liquidity and capital needs. For example, if the investment decision-making authority has been unconditionally delegated to a third-party, management has relinquished the ability to hold a security until recovery.

Intent to hold the security. The staff believes that an assertion of management's intent to hold a security until recovery is required to conclude that an impairment is temporary. SAB Topic 5M does not provide an exemption from the assessment of impairment on the basis of the severity and duration of the market decline. However, the necessary evidence supporting management's intent is relative to a consideration of the factors in SAB Topic 5M. Less persuasive evidence of intent may be necessary to conclude an impairment is temporary when the magnitude of the market decline is minor and the duration is short.

Anticipated recovery period. In order to conclude that an impairment is temporary, management must evaluate whether it believes the fair value of the security will recover, and if so, estimate the recovery period. The staff believes that all available information, positive and negative, should be considered in estimating the recovery period. The weight attributable to the information considered should be commensurate with the extent to which it is objective, verifiable, and relevant. Some information to consider may include:

- The severity and duration of the impairment;
- The historical and implied volatility of the security;
- Recoveries or additional declines in fair value subsequent to the balance sheet date;
- The financial condition and near-term prospects of the issuer; and
- Whether the market decline was affected by macroeconomic conditions or by specific information pertaining to an individual security.

Although the staff does not have bright lines in mind, there are practical limitations on the period of time that management can incorporate into the anticipated recovery period for an available-for-sale security. As the forecasted recovery period lengthens, the uncertainties inherent in management's estimate increase, which results in the need for more persuasiveness evidence to conclude an impairment is temporary.

Initial Adoption of Statement 159

My third topic pertains to the initial adoption of Statement 159.⁸ In conjunction with the initial adoption of Statement 159, an entity may elect the fair value option for existing held-to-maturity or available-for-sale securities.⁹ The staff believes that any such election does not relieve management of its requirement to assess those securities for other than temporary impairment at the preceding balance sheet date.¹⁰ If an other-than-temporary impairment exists, the impairment loss should be reported in earnings in the period preceding adoption of Statement 159, and not included in the Statement 159 transition adjustment. Likewise, management is required to reassess the continued classification of its held-to-maturity securities at the balance sheet date preceding the initial election of the fair value option for those securities.¹¹ If continued classification as held-to-maturity is no longer appropriate, management should reclassify the security to available-for-sale in the period preceding adoption of Statement 159. Reclassification into trading prior to the adoption of Statement 159 would not seem appropriate.¹² Consistent with paragraph 29 of Statement 159, the staff believes that a reclassification of a held-to-maturity security in the period preceding the initial adoption of the fair value option for that security would not call into question the continued classification of other held-to-maturity securities provided the adoption of Statement 159 is substantive.

Accounting for Equity Derivatives

Finally, I will discuss the accounting for equity derivatives. Statement 133¹³ provides an exception from derivative accounting for contracts issued or held by a reporting entity that are both (a) indexed to the company's stock, and (b) classified in stockholders' equity. If this exception is not applicable, those contracts are generally subject to fair value accounting as a derivative asset or liability.

The contractual terms of equity derivative transactions are often documented in a Confirmation¹⁴ that incorporates certain provisions contained in one or more ISDA Agreements.¹⁵ The provisions of these ISDA agreements are voluminous and complex. A thorough analysis of these provisions is required to determine whether the contract is indexed to the company's stock, as interpreted by EITF 01-6,¹⁶ and classified in stockholders' equity, as interpreted by EITF 00-19.¹⁷

Indexed to the company's stock. The staff has not taken any definitive position on whether the provisions of the relevant ISDA Agreements¹⁸ are consistent with the indexation requirements in EITF 01-6, although we are aware of diversity in practice. Pending clarification in EITF 07-5¹⁹, the staff believes management should carefully consider all of the applicable provisions in the transaction Confirmation and related ISDA Agreements in formulating a judgment regarding the application of EITF 01-6.

Classification in stockholders' equity. Unlike the diversity regarding indexation, EITF 00-19 is clear that equity classification is precluded if an entity does not control the ability to share settle the contract. The staff understands that the ISDA Agreements incorporated into many equity derivative contracts contain provisions that may allow the counterparty to net-cash settle the contract upon the occurrence of events outside the control of the entity. To address this issue, the transaction Confirmation often includes an overriding provision to allow the entity to share settle the contract upon the occurrence of events outside its control. Absent this provision, the contract may not meet the equity classification requirements in EITF 00-19. The staff would like to remind management of the importance of carefully considering all of the applicable provisions in the transaction Confirmation and related ISDA Agreements in applying EITF 00-19. Considering the complexity of the issues, the staff encourages management and auditors to consult with the Office of the Chief Accountant when specific questions arise regarding the application of EITF 00-19.

That concludes my prepared remarks. Thank you for your time.

Endnotes

¹ FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*

- ² AICPA Statement of Position No. 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*
- ³ Statement 65, paragraph 6 and SOP 01-6, paragraph 8
- ⁴ FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, paragraphs 30-33
- ⁵ Statement 144, paragraph 5(d)
- ⁶ FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
- ⁷ SAB Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*
- ⁸ FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*
- ⁹ Statement 159, paragraph 28
- ¹⁰ FASB Staff Position Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, paragraph 7
- ¹¹ Statement 115, paragraph 6
- ¹² Paragraph 15 of Statement 115 states, in part, "... transfers into or from the trading category should be rare." The provision in paragraph 29 of Statement 159 that allows for a transfer of a security into the trading category is not applicable until an entity adopts Statement 159.
- ¹³ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, paragraph 11(a)
- ¹⁴ The Confirmation details the agreed-upon commercial terms of a specific transaction.
- ¹⁵ ISDA agreements are contracts developed by the International Swaps and Derivatives Association, Inc. for the purpose of transacting in derivatives. They contain standard definitions and contractual provisions that can be amended or deleted in the Confirmation relating to the individual transaction.
- ¹⁶ EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock'"
- ¹⁷ EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

¹⁸ For example, the applicable conditions of the 2000 ISDA Definitions and the 2002 Equity Definitions may be incorporated into an equity derivative contract.

¹⁹ EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock"

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