
*Current Developments at the SEC
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Agenda

- **Restatements**
- **FAS 133**
- **FAS 115**
- **FAS 155**
- **FAS 156**
- **FAS 157**
- **Fair Value Option**
- **Business Combinations**
- **Loan Classification**
- **Cash Flow Issues**



Restatements

Over 1200 in 2005, on track for more in 06

- Restating for immaterial errors?
- Tightening of certain interpretations?
- Deferred maintenance?
- 404 and other measures cause errors to be caught that might have been missed?

What can we learn?

- Which pieces of literature are being misapplied
- Characteristics of companies with errors
- Contributing factors to errors



FAS 133

Derivatives and Hedging

Hedge Documentation and Designation

- Need to re-focus on documentation discipline
- Effectiveness test methodologies
 - Not appropriate to apply a series of tests (i.e., “either or”, “if then”, etc.)
 - Statistical methods
 - Appropriate measures
 - Consistent application of all measures
 - Method used must be documented and applied



FAS 133

Derivatives and Hedging

Hedge Documentation and Designation

- Sufficient specificity of the designation of the hedged item
 - Must be able to identify when it occurs



FAS 133

Derivatives and Hedging

Examples of Assumptions of No Ineffectiveness

- Short cut method (par. 68)
- Critical terms matched (par. 65)/DIG G9
- DIG G7
- DIG G20

Note: This is not an all inclusive list – just some of the most commonly used.



FAS 133

Derivatives and Hedging

Assumptions of No Ineffectiveness

- Application is limited to the scenarios specified in FAS 133 – cannot analogize
- All applicable criteria must be met to qualify
- If no ineffectiveness was assumed and the hedge relationship did not qualify for an assumption of no ineffectiveness – no hedge accounting
 - Many restatements seen in the past year



FAS 133

Derivatives and Hedging

Common Issues Identified

- **Short-cut method**
 - Trust Preferred Securities
 - Brokered CDs
- **Critical terms matched (i.e., par. 65/DIG G9) and DIG G7**
 - Not all terms match (i.e., payment dates)
 - Assumptions of no ineffectiveness when ineffectiveness exists



FAS 133

Current Derivative Disclosures

Balance Sheet

- Where derivatives are presented

Income Statement

- Where derivatives are presented (both derivatives used in hedging and non-hedging relationships)

Other Comprehensive Income

- Activity during the year (i.e., effective portion of cash flow hedges, amounts reclassified to earnings)

Statement of Cash Flows

- Where cash flows are recorded (i.e., operating, unless in a FV or CF hedge and the derivative does not contain a financing element at inception, then it may be recorded with the hedged item)



FAS 133

Current Derivative Disclosures

Footnotes

- Objectives for holding or issuing derivatives
- Derivatives designated in hedging relationships and non-hedging derivatives
- Risk management policy for derivatives designated as hedges, and purpose of derivative activity for non-hedging derivatives
- Qualitative disclosures about objectives and strategies for use of derivatives – Encouraged



FAS 133

Current Derivative Disclosures

Footnotes

- Hedge ineffectiveness recognized in earnings
- Derivative components excluded from assessment of effectiveness (i.e., time value)
- Various fair value, cash flow and FX hedge accounting disclosures



FAS 133

Current Derivative Disclosures

Disclosures – Market Risk and MD&A

- Explain to the investor how the company defines and views key risks and how company mitigates each
- Explain what kinds of hedging instruments company applies to each specific type of hedged item and how company determines they are effective
- Lack of clear disclosure generally gives rise to DCF review focus; some reviews have resulted in restatements



FAS 133

Proposed Derivative Disclosures

- Enhances disclosure requirements of FAS 133
- Key decisions to date
- Proposed disclosures expected to be effective for interim and annual periods ending after December 15, 2007



FAS 115

Other Than Temporary Impairment

- **FAS 115 and SAB Topic 5-M (SAB 59) provide basic guidance**
 - No bright lines
 - No tainting concept like FAS 115's sales from HTM
- **Impairment assessment required when security in unrealized loss position**
- **Management's assertion of "intent" to hold to recovery when portfolio management is outsourced**
- **EITF 03-1 disclosures still apply**



FAS 115

Other Than Temporary Impairment

- **Facts and circumstances of each determination may differ**
 - Security purchased and price at purchase
 - Call or other security features and market response to those features
 - Time horizon for recovery of security carrying amount
 - Severity of decline



FAS 115

Other Than Temporary Impairment

- **DCF reviews have focused on need for a clear policy for determining when to test for impairment and when to recognize impairment**
- **DCF would expect that assertions about intent to hold and ability to hold to recovery would be consistent with ALCO and other forecast documentation and that company would have control over the decision to sell securities**



FAS 155

- **Elimination of DIG Issue D-1**
- **Issue originated with beneficial interests in securitization transactions**
- **FAS 155 would allow a fair value option**
 - Applies to ALL hybrid financial instruments that contain an embedded derivative that would otherwise be required to be bifurcated
 - Election to be made upon inception
 - Irrevocable
 - Instrument-by-instrument basis
- **Clarifies FAS 133 scope exception for I/O's and P/O's**
 - Most will not qualify for the exception – FAS 133 will apply to these instruments
- **Is effective for fiscal years beginning after December 15, 2006 (early adoption permitted)**



FAS 156

Scope

- **Transfers of financial assets & servicing is retained - accounted for as a sale**
 - Change from interpretations of FAS 140
- **Guaranteed mortgage securitizations where the transferor retains all of the resulting securities and classifies them as trading or AFS (i.e., swap and hold transactions)**
 - Option to separately recognize or leave combined with the securities if classified as HTM still available
- **Acquisition or assumptions of servicing rights**
 - These transactions were not previously covered by FAS 140



FAS 156

Amendments to FAS 140

- **All servicing rights are recognized at fair value**
 - Change from FAS 140's allocation of the carrying value based on relative fair value
- **Subsequent accounting – can elect either:**
 - Amortization method - (method in FAS 140 prior to the amendment)
 - Fair value measurement method – fair value with changes in earnings



FAS 156

Amendments to FAS 140

- **Fair value measurement method:**
 - One time irrevocable election to measure at fair value
 - Election must be made as of the beginning of the fiscal year
 - On election, the difference between the carrying amount and fair value shall be recorded as a cumulative-effect adjustment to retained earnings
 - New classes of servicing – can elect fair value on recognition of the class
 - Separate display on the face of the balance sheet, and new disclosure requirements



FAS 156

FAS 115 Implications

- **Permits a one-time reclassification of securities classified as AFS to trading**
 - **Securities identified as economic hedges of an entity's exposure to changes in fair value of its servicing rights**
 - **Entity must elect fair value for servicing rights these securities relate to**



FAS 157

Fair Value Measurements

- **Defines fair value as:**
 - The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date
- **Provides a framework on how to measure FV**
 - When to measure FV left to other Standards



FAS 157

Fair Value Measurements

- **Creates a FV Hierarchy:**
 - **Level 1 – quoted prices in active markets for identical assets or liabilities (P x Q)**
 - **Block discounts no longer permitted**
 - **Level 2 – directly or indirectly observable inputs for the assets or liabilities**
 - **Level 3 – unobservable inputs**
 - **Entity's assumptions about inputs a market participant would use**



FAS 157

Fair Value Measurements

- **Price**
 - Assumes orderly transaction between market participants
 - Exposure to market
 - Hypothetical transaction at measurement date
 - Exit price
- **Principal market**
 - Market to sell an asset or transfer a liability with greatest volume and level of activity for the asset or liability
 - most advantageous market (in absence of principal market)



FAS 157

Fair Value Measurements

- **Market participants**
 - Independent
 - Knowledgeable
 - Able to transact
 - Willing to transact



FAS 157

Fair Value Measurements

- **Transaction price presumed to be FV**
 - **Can be rebutted**
 - **Related party transaction**
 - **Transaction occurs under duress**
 - **Unit of account differences with different rights**
 - **Market transaction occurs is different from than market the asset would be sold or liability would be transferred**
 - **Retail vs. wholesale issues**
 - **Example – loan commitments**
- **Effective for financial statements issued for fiscal years beginning after November 15, 2007**



Loan Commitments

- **SAB 105 issued in March 2004**
 - Servicing and other internally-developed intangibles should not be included in the value of a loan commitment accounted for as a derivative under FAS 133
- **Interaction with FAS 157**
 - Fair value of loan commitment to be measured under SAB 105 not expected to change significantly
 - Footnote 3 of EITF 02-3 removed
 - Day 1 fair value of loan commitment under SAB 105 should be recognized



Fair Value Option Exposure Draft

- **Permit election to measure most financial assets and liabilities, and certain firm commitments, at their fair values**
 - reduce earnings volatility resulting from the mixed-attribute accounting model
 - avoid the time, effort, and systems needed to comply with FAS 133's hedge accounting requirements



Fair Value Option Exposure Draft

- **FV election**
 - initial recognition
 - events that triggers a new basis of accounting for the item (e.g., a business combination)
 - Irrevocable election
- **Changes in FV of the entire financial instrument are recognized in earnings as they occur**
 - Different than hedge accounting where you can designate the hedged risk



Fair Value Option Exposure Draft

- Election can be made on an individual contract-by-contract basis
- Concurrent documentation of FV election
 - Documentation requirements omitted from the Standard – left to Company and Auditors judgment
- No eligibility criteria under the ED
 - Different than IFRS
- Potential benefits
 - Simplifies hedge accounting for the warehouse
 - Loan commitments not subject to FAS 133
 - Interaction with SAB 105



Business Combinations

Purchase Price Allocation Matters

- **Rigorous allocation of purchase price**
 - Valuations not always updated for data obtained after closing that was not available during due diligence
- **Customer relationship intangibles**
 - **Common issues identified**
 - Stale appraisals
 - Use of appraisal to value different assets that are not similar as those covered by appraisal
 - Use of appropriate capital ratios
- **DCF reviews in 2007 expect to address more business combinations**



Loan Classification SoP 01-6 Criteria

- **Held for investment (HFI)**
 - Management must have both intent and ability to hold for the foreseeable future or until maturity
- **Held for sale (HFS)**
 - Loans that do not meet HFI criteria
- **Analogies to FAS 144 criteria for held for sale is NOT appropriate for loans**



Loan Classification Sales of HFI

- **SoP 01-6 has no tainting notion like FAS 115 for sales of HTM securities**
- **Classification to HFS once management has made the decision to sell loans previously classified as HFI**
- **Decision to sell – must consider**
 - Budgets
 - ALCO packages
 - Plans and Forecasts
 - Treasury
- **Judgment required in determining whether a decision to sell has been made**



Statement of Cash Flows

Correct classification of cash flow activity

- **Loans held for sale**
 - **FAS 65 and SoP 01-6 – loans should only be classified as held for investment when management has intent and ability to hold for the foreseeable future or maturity**
 - **FAS 102 - cash receipts and payments resulting from acquisition and sales of loans that are originated or purchased for resale should be classified as operating**
 - **Subsequent transfers to or from held for sale do not impact cash flow classification**



Statement of Cash Flows

Correct classification of cash flow activity

- **FAS 115 Securities and Retained Interest**
 - Cash receipts and payments resulting from purchase or sale of trading securities should be classified as operating
 - Cash receipts and payments resulting from purchase, sale or maturity of AFS securities should be classified as investing
 - Cash receipts from the maturity of retained interests accounted for like AFS or HTM securities should be classified as investing, even if the retained interest resulted from the sale of held for sale loans



Statement of Cash Flows

Transparent presentation

- Avoid “other –net” line items
- Either include discontinued ops within each category or present breakout of categories related to discontinued ops cash flows
- Clearly identify all non-cash investing and financing transactions
 - Exchanging loans for securities
 - Transferring loans to held for sale



Questions?



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