

Case 01-1

The Tale of Stable Mable's Unstable Investment

Stable Mable Credit Corporation ("Stable Mable" or the "Company") is a privately-held consumer finance company that originates and services consumer loans. These loans consist primarily of conventional uninsured home improvement and debt consolidation loans, which are generally secured by liens on residential property. Stable Mable's fiscal year ends on September 30th and the Company's only external reporting requirements are the annual audited financial statements, which are distributed to the shareholders and certain financial lenders.

In October 1997, Stable Mable invested \$20 million in a bond mutual fund (the "Fund Investment"). The Fund's investment strategy is to seek a high level of income, to the extent the principal is not at risk, by trading in U.S. government securities such as U.S. treasury notes, bonds, strips, and GNMA certificates.

Initially, the fair value of the Fund Investment appreciated above Stable Mable's amortized cost basis in the investment. As a result, the Fund Investment had an unrealized holding gain of \$400,000 at the end of the first quarter of fiscal year 1998. Subsequent to December 31, 1997, however, the fixed-income markets were negatively impacted by an increase in U.S. interest rates. As a result, the fair value of the Fund Investment deteriorated below its amortized cost basis to an unrealized holding loss of \$1.3 million at fiscal year-end September 30, 1998.

During fiscal year 1998, the Company adopted the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("SFAS No. 115"). Upon adoption of SFAS No. 115, Stable Mable classified the Fund Investment as *available-for-sale* securities and the unrealized holding loss as a separate component of shareholders' equity pursuant to paragraph 13 of SFAS No. 115, which states, in part:

Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized.

In addition, the Company performed an impairment analysis on the Fund Investment as of fiscal year-end September 30, 1998, pursuant to paragraph 16 of SFAS No. 115, which states:

For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other-than-temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. If the decline in fair value is judged to be other-than-temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of

equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

In applying the foregoing guidance, Stable Mable concluded that the decline in fair value of the Fund Investment below its amortized cost basis in the investment *was not* other-than-temporary as of September 30, 1998 based on the following factors:

- (1) The fair value of the Fund Investment had not been below Stable Mable's amortized cost basis in the investment for an extended period of time (i.e., nine months).
- (2) The fixed-income markets were expected to improve during fiscal year 1999.
- (3) Stable Mable had the intent and ability to continue to hold the Fund Investment for the foreseeable future.
- (4) There were no concerns regarding the financial condition of the fund manager and/or the government-issued securities.

During the audit of the fiscal year 1998 financial statements, Stable Mable's independent auditors, Bean Counters & Co., concurred with the results of the impairment analysis. The audit was completed in January 1999 and the auditor's report, along with the fiscal year 1998 audited financial statements, was issued in February 1999. Prior to the issuance of their report, Bean Counters & Co. indicated in their subsequent events procedures that there was no change with respect to their audit conclusion that the decline in fair value of the Fund Investment *was not* other-than-temporary as of September 30, 1998.

The fair value of the Fund Investment did in fact continue to improve during the first quarter of fiscal year 1999 to an unrealized holding loss of \$950,000 at December 31, 1998. In January 1999, however, the fixed-income markets deteriorated once again and the fair value of the Fund Investment began another steep decline. Accordingly, at fiscal year-end September 30, 1999, the unrealized holding loss had increased to \$1.8 million. In addition, at fiscal year-end September 30, 1999, Stable Mable performed another impairment analysis and concluded that the decline in fair value of the Fund Investment below its amortized cost basis in the investment *was* other-than-temporary based on the following factors:

- (1) The fair value of the Fund Investment had been below Stable Mable's amortized cost basis in the investment for an extended period of time (i.e., 21 months).
- (2) The unrealized holding loss continued to increase during fiscal year 1999 from \$1.3 million to \$1.8 million.
- (3) The fixed-income markets were expected to remain flat during fiscal year 2000.
- (4) Although Stable Mable had the intent and ability to continue to hold the Fund Investment for the foreseeable future, the ultimate recoverability of the full amortized cost basis in the Fund Investment was uncertain.

Accordingly, the Company recognized a \$1.8 million impairment charge against earnings at September 30, 1999.

For several years, Stable Mable had been dissatisfied with the quality of service it was receiving from Bean Counters & Co. As a result of continued poor service during the fiscal year 1998 audit, Stable Mable decided to terminate its relationship with Bean Counters & Co. and engaged Number Crunchers, LLP for the fiscal year 1999 audit. During the new client acceptance procedures, the Number Crunchers lead client service partner, Kent Count, inquired whether an impairment on the Fund Investment would have been more appropriately charged against fiscal year 1998 earnings, rather than fiscal year 1999 earnings. Imon Stable, the CFO of Stable Mable, stated that no impairment charge was recognized as of September 30, 1998 because the results of the impairment analysis did not indicate that the decline in the fair value of the Fund Investment was other-than-temporary. Kent Count is concerned that the impairment charge should have been recognized as of September 30, 1998 instead of September 30, 1999.

In addition, although Stable Mable is a privately-held consumer finance company, the owners anticipate realizing a portion of their investment in the near future through an initial public offering of the Company's common stock. Therefore, the owners would like to conform their financial statements in a manner that is reflective of the SEC's views on accounting issues and financial statement presentation.

Required:

- Should Stable Mable have recorded an impairment charge on the Fund Investment as of September 30, 1998 or 1999?