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Recognition of Other-Than-Temporary Impairment for Debt Securities

FASB issues additional guidance

The U.S. Securities and Exchange Commission (SEC) completed a study on mark-to-market accounting standards in December 2008. One recommendation to the Financial Accounting Standards Board (FASB) was to evaluate the need for modifications to current other-than-temporary impairment guidance to provide for a more uniform assessment of impairment. Other constituents have also expressed concern to the FASB that the requirements for recognition and measurement of impairment losses for loans are different from those for investments in debt securities. Further challenges include the current market conditions that have caused temporary declines in value that do not always reflect cash flows that are expected to be collected.

In response to these recommendations and concerns, the FASB recently issued FASB Staff Position (FSP) FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. This FSP amends the other-than-temporary impairment guidance for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments in the financial statements. The most significant change the FSP brings is a revision to the amount of other-than-temporary loss of a debt security recorded in earnings.

The final FASB Staff Position document is available at www.fasb.org.

Evaluating whether an impairment of a debt security is other-than-temporary

FSP FAS 115-2 and FAS 124-2 clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security, or (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are done before assessing whether the entity will recover the cost basis of

the investment. Previously, this assessment required management to assert it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in fair value to avoid recognizing an other-than-temporary impairment.

Under the FSP, an other-than-temporary impairment of a debt security is considered to have occurred in the following circumstances:

- The entity intends to sell the security.
- It is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis.
- The entity does not expect to recover the entire amortized cost basis of the security.



In assessing whether the entire cost basis of the security will be recovered, a comparison must be made of the present value of the cash flows expected to be collected from the security to the amortized cost basis of the security. There are numerous factors to be considered when estimating this recovery and the period over which the security is expected to recover. The FSP specifies the following as only a few examples of the factors that should be considered:

- The length of time and the extent to which the fair value has been less than amortized cost;

- Adverse conditions specifically related to the security, an industry, or a geographic area;
- The historic and implied volatility of the security;
- Failure of the issuer of the security to make scheduled principal or interest payments;
- Any changes to the rating of the security by a rating agency; and
- Recoveries or additional declines in fair value subsequent to the balance sheet date.

Even if the entity anticipates that the entire cost basis of the security will be recovered, the entity must still estimate the period over which the security is expected to recover and whether its cash or working capital requirements and contractual or regulatory obligations indicate that the security may need to be sold before the forecasted recovery occurs. If it is more likely than not the entity will be required to sell the security before recovery of its cost basis, as previously indicated, an other-than-temporary impairment has occurred.

Recording an other-than-temporary impairment

Under FSP FAS 115-2 and FAS 124-2, when an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether the entity intends to sell the security or whether it is more likely than not the entity will be required to sell the security before recovery of its cost basis.

In instances when a determination is made that an other-than-temporary impairment exists but the entity does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, this FSP changes the presentation and amount of the other-than-temporary impairment recognized in the statement of earnings. The other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to credit issues in the debt security and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to credit issues is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

The FSP provides only limited guidance on determining the credit portion of the impairment. An entity is required to use its best estimate of the present value of cash flows

expected to be collected from the debt security. One way of estimating that amount would be to consider the methodology in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*. In essence, the entity would discount the expected cash flows at the effective interest rate implicit in the security at the date of acquisition.

Subsequent accounting

An entity must account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment at a cost equal to the previous basis less the other-than-temporary impairment recognized in earnings. Existing premiums and discounts and subsequent changes in estimated cash flows or fair value continue to be accounted for in accordance with existing guidance.

Subsequent increases and decreases (if not an other-than-temporary impairment) in the fair value of available-for-sale securities should be included in other comprehensive income.

The other-than-temporary impairment recognized in other comprehensive income for debt securities classified as held-to-maturity will be accreted from other comprehensive income to the amortized cost of the debt security over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows. That accretion will increase the carrying value of the security and continues until the security is sold, the security matures, or there is an additional other-than-temporary impairment that is recognized in earnings.

Disclosure requirements

This FSP expands and increases the frequency of certain existing disclosures related to other-than-temporary impairments. For example, this FSP requires the further disaggregation of major security types and related information currently required in Statement 115. In addition, the FSP requires that the annual disclosures in Statement 115 and FSP FAS 115-1/124-1 be made for interim periods (including the aging of unrealized losses). This FSP also requires new disclosures to assist users of financial statements in understanding the significant inputs used in determining a decrease in cash flows expected to be collected, as well as a rollforward of that amount each period.

When is adoption required?

FSP FAS 115-2 and FAS 124-2 is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. Earlier adoption for periods ending before March 15, 2009 is not permitted. FSP FAS 157-4 and FSP FAS 115-2/FAS 124-2 must be adopted at the same time.

This FSP applies to existing and future investments held by an entity as of the beginning of the period in which it is adopted. When adopting the FSP, a company must recognize the cumulative effect of initially applying this FSP as an adjustment to the opening balance of retained earnings with a corresponding adjustment to accumulated other comprehensive income.

What should we do now?

Understanding the implications of this FASB Staff Position can assist you in accounting for other-than-temporary impairments in the current economic environment.

FSP FAS 115-2 and FAS 124-2 also includes substantial additional disclosure requirements you should familiarize yourself with and begin planning for. In addition, as the calculation of the cumulative effect adjustment may take significant time and effort, you should consider what resources will be needed to calculate this amount and any related tax effects.

To help you further understand the implications of this FSP, please contact McGladrey & Pullen to arrange a review of your specific situation with one of our audit specialists.