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Heads Up

Audit and Enterprise Risk Services

November 18, 2005
Vol. 12, Issue 11

In This Issue:

- The Model
- Disclosures
- Effective Date
- Appendix A
- Appendix B

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The Impairment Debate: Other-Than-Temporarily Resolved

Decision Reached on the Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments

by Mark Bolton, Deloitte & Touche LLP

With the release of FASB Staff Position FAS 115-1 and FAS 124-1[1] (a single document — the "FSP"), the FASB resolved the accounting controversy generated by the EITF's consensus on Issue 03-1,[2] first reached in March 2004, and the related guidance subsequently proposed in FSP EITF Issue 03-1-a.[3] In most important respects, the FSP reverts to other-than-temporary impairment (OTTI) guidance that predated the original effective date of Issue 03-1. That said, the FSP carries forward other elements of Issue 03-1, most notably the disclosure requirements that have been in effect since the end of 2003. Also preserved is Issue 03-1's guidance regarding when to test cost-method equity securities for impairment.

The Model

The FSP retains Issue 03-1's three-step model:

Step 1 — Determine Whether an Investment Is Impaired

Step 2 — Evaluate Whether an Impairment Is Other Than Temporary

Step 3 — If the Impairment Is Other Than Temporary, Recognize an Impairment Loss Equal to the Difference Between the Investment's Cost and Its Fair Value

Consistent with Issue 03-1, this model must be used for:

- Debt and marketable equity securities within the scope of Statement 115.[4]

[1] FASB Staff Position Nos. FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments."

[2] EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments."

[3] Proposed FASB Staff Position No. EITF Issue 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1, 'The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.'"

[4] FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

Debt securities include those classified as either held-to-maturity or available-for-sale.

- All equity securities held by insurance companies.
- Cost-method equity securities (i.e., equity securities not subject to APB 18[5] or Statements 115 and 124[6] (i.e., cost-method investments).
- Debt and equity securities within the scope of Statement 124 that are held by an investor that reports a "performance indicator" (defined in the AICPA Accounting and Auditing Guide, *Health Care Organizations*).

How does the model work? The following discussion describes how to apply each step of the model, and highlights key differences from the Issue 03-1 model.

Step 1 — Determine Whether an Investment Is Impaired (i.e., Fair Value Is Less Than Cost)

Step 1 of the model remains essentially unchanged from Step 1 of the Issue 03-1 model.

Under Step 1, investments other than certain cost-method investments **must be assessed for impairment in each reporting period; for quarterly filers, this would include interim periods**. Investments must be evaluated for impairment at the **individual security level**, which is the same level used by the reporting entity to measure realized and unrealized gains and losses on debt and equity securities.

Example

InsureCo purchases 100 shares of Company XYZ (XYZ) stock on the last day of each calendar quarter during a one-year period. If, when measuring realized gains and losses, InsureCo determines its cost basis using an average cost method, it would assess impairment for each reporting period using XYZ's average cost basis. If InsureCo uses the specific identification method, impairment would be assessed separately for each lot of XYZ stock that was purchased, using that lot's specific cost basis.

Companies cannot combine separate contracts (e.g., a debt security and a guarantee) when performing an impairment assessment.

Step 1 also discusses how to assess impairment for cost-method investments whose fair value may not be readily determinable. Details of this guidance can be found in Appendix A.

Step 2 — Evaluate Whether an Impairment Is Other Than Temporary

The guidance in Step 2 of the Issue 03-1 model has been replaced. Instead, the guidance now consists of references to impairment accounting literature that predated Issue 03-1, specifically to:

- Paragraph 16 of Statement 115,
- SEC Staff Accounting Bulletin Topic 5.M,[7]
- Paragraph 6 of APB Opinion 18, and
- Issue 99-20.[8]

Déjà vu? Yes. This same approach was previously taken in Issue 03-1-1[9] when that document suspended the original effective date of Steps 2 and 3 of the Issue 03-1 model.

[5] APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*.

[6] FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*.

[7] SEC Staff Accounting Bulletin Topic 5.M, "Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities."

[8] EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets."

[9] FASB Staff Position No. EITF Issue 03-1-1, "Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1, 'The Meaning of Other-Than-Temporary Impairment And Its Application to Certain Investments.'"

Step 2 also incorporates and clarifies guidance previously provided in Topic D-44,[10] namely:

- When an investor **has decided to sell** an impaired available-for-sale security and the investor does not expect the fair value of the security to fully recover prior to the expected time of sale, the security must be deemed other-than-temporarily impaired in the period in which the decision to sell is made.
- Notwithstanding the above, an investor must recognize an impairment loss when the impairment is deemed other than temporary, **even if a decision to sell has not been made**

Step 3 — If the Impairment Is Other Than Temporary, Recognize an Impairment Loss Equal to the Difference Between the Investment's Cost and Its Fair Value

Step 3 of the model remains essentially unchanged from guidance provided in Issue 03-1. If Step 2 of the model indicates that an impairment is other than temporary, then an impairment loss must be recognized in earnings. That loss is measured as the difference between the investment's cost and its fair value **at the balance sheet date** of the reporting period. A partial recovery in fair value subsequent to the date of the balance sheet cannot be factored into the impairment measurement. The fair value of an OTTI investment becomes its new cost basis; subsequent recoveries in fair value cannot be recognized.

What is the subsequent accounting for an OTTI debt security? According to the FSP, the security should be accounted for as if the investor had purchased the debt security at fair value on the measurement date of the OTTI. The discount or reduced premium recorded for the security, based on its new cost basis, would be amortized prospectively over the security's remaining life, based on the amount and timing of future **estimated** cash flows (which may differ from a security's contractual cash flows).

Disclosures

The FSP carries forward the disclosure requirements and examples set forth in Issue 03-1. It also clarifies that investments that fall within the scope of Issue 99-20 must be included in the required tabular disclosures.

Effective Date

The FSP applies to reporting periods beginning after December 15, 2005. Earlier application is permitted.

[10] EITF Topic No. D-44, "Recognition of Other-Than-Temporary Impairment Upon the Planned Sale of a Security Whose Cost Exceeds Fair Value."

Appendix A: Cost-Method Equity Securities

This table summarizes when cost-method equity securities must be assessed for impairment.

Characteristics of Cost-Method Equity Securities	"Fair Value" To Use In Impairment Assessment
Investments for which the investor has already estimated fair value (e.g., for disclosure under FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*)	For reporting periods in which the estimate has been made, use that estimate to determine if the investment is impaired. If the investment's fair value is less than its cost, it is considered impaired, and Step 2 of the impairment model must be applied to determine if the impairment is other than temporary.
Investments for which the investor has not estimated fair value during the reporting period	Evaluate whether an event or change in circumstances has occurred in the reporting period that could have had a significant adverse effect on the fair value of the investment. If an impairment indicator (see Appendix B) exists, estimate the fair value of the investment, and proceed to Step 2 of the impairment model if the fair value of the investment is less than its cost.
Investments tested for impairment in previous reporting periods under Step 2 of the impairment model that were determined at that time not to be other-than-temporarily impaired.	Continue to evaluate whether the investment is impaired (i.e., estimate the fair value of the investment) **in each subsequent reporting period** until the investment recovers its fair value up to or beyond its cost, or the investor recognizes an OTTI loss.

Appendix B: Impairment Indicators for Cost-Method Equity Investments

The FSP notes that impairment indicators may include, but are not limited to, the following:

- A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee;
- A significant adverse change in the regulatory, economic, or technological environment of the investee;
- A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates;
- A bona fide offer to purchase (whether solicited or unsolicited), an offer by the investee to sell, or a completed auction process for the same or similar security for an amount less than the cost of the investment; and
- Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

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