Accounting News: Other-Than-Temporary Impairment of Investment Securities

*This regular feature focuses on topics of critical importance to bank accounting. Comments on this column and suggestions for future columns can be e-mailed to **SupervisoryJournal@fdic.gov.***

During the past year and a half, the longstanding accounting concept of other-than-temporary impairment of investment securities has drawn renewed attention because of actions by the Financial Accounting Standards Board (FASB) and its Emerging Issues Task Force (EITF). In addition, the federal banking agencies issued a revised *Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts* in June 2004 that incorporated this concept into the Agreement's general debt security classification guidelines. In light of these developments, examiners and bankers should understand the currently applicable accounting guidance on impairment and its relationship to the evaluation of securities portfolios during examinations.

Impairment of Securities

From an accounting standpoint, an "impairment" of a debt or equity security occurs when the fair value of the security is less than its amortized cost basis, i.e., whenever a security has an unrealized loss. In this situation, examiners often refer to the security as being depreciated or under water.

The subject of impairment of securities and the need for an institution to consider its accounting consequences for purposes of reporting in accordance with generally accepted accounting principles (GAAP) dates back more than 50 years.[1] The current source of authoritative guidance on accounting for investment securities, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* as amended (FAS 115), was originally issued in 1993. FAS 115 is perhaps best known for requiring investment securities to be categorized into three categories: held-to-maturity, trading, and available-for-sale. However, it also requires that an institution determine whether a decline in fair value below amortized cost for an individual available-for-sale or held-to-maturity security is other than temporary. If the impairment is judged to be other than temporary, the cost basis of the individual security must be written down to fair value, thereby establishing a new cost basis for the security, and the amount of the write-down must be included in earnings as a realized loss.[2,3] FAS 115 further provides that after such a write-down, "the new cost basis shall not be changed for subsequent recoveries in fair value." A recovery in fair value, both for an available-for-sale security and a held-to-maturity security, should not be recognized in earnings until the security is sold.[4]

[1]See paragraph 9 of Section A of Chapter 3 of Accounting Research Bulletin No. 43, which was issued by the American Institute of Certified Public Accountants (AICPA) in 1953, and its predecessor, Accounting Research Bulletin No. 30, which was issued in 1947.

[2]See paragraph 16 of FAS 115. The impairment provisions of FAS 115 are not applicable to trading securities because they are carried on the balance sheet at fair value with unrealized gains and losses included in earnings.

[3]These FAS 115 provisions on impairment of securities have been incorporated into the instructions for the Reports of Condition and Income (Call Report). See the Glossary entry for "Securities Activities" on page A-72 of the instructions.

[4]After an available-for-sale security has been written down for an other-than-temporary impairment, the new cost basis should be used thereafter to determine the amount of any unrealized holding gains and losses. These gains and losses (provided the losses do not represent further other-than-temporary impairments) should be reported in a separate component of equity capital, i.e., accumulated other comprehensive income.

continued from pg. 43

As currently defined under GAAP, the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and must be used as the basis for the measurement, if available.[5]

Guidance on Evaluating Impairment in FAS 115

FAS 115 provides only one explicit example of other-than-temporary impairment. Using language that parallels the definition of impairment for a loan in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* FAS 115 states that if it is probable that an institution "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." However, FAS 115 also refers to two other sources of literature that should be considered in evaluating impairment:

- Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 59, which has been codified as SAB Topic 5.M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities* (SAB 59); and
- American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (SAS 92).

The impairment guidance in SAB 59 and SAS 92 is discussed below.

Recognizing that FAS 115 provided limited guidance on evaluating impairment, the FASB staff addressed this subject in November 1995 in a FAS 115 implementation guide.[6] In the response to Question 46 of the guide, the FASB staff advised that

> recognition of other-than-temporary impairment also may be required if the decline in a security's value is due to an increase in market interest rates or a change in foreign exchange rates since acquisition. Examples of when a decline in the fair value of a debt security may be other than temporary include situations where the security will be disposed of before it matures or the investment is not realizable.

The FASB staff's response to the next question in the guide deals with the disposal of a security prior to maturity, referencing EITF Topic No. D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security whose Cost Exceeds Fair Value.* The EITF had discussed this issue earlier in 1995 after the FASB staff had been asked about the accounting treatment for a "specifically identified available-for-sale debt security" that an institution "intends to sell at a loss shortly after the balance sheet date." The FASB staff indicated that, in this situation, if the institution "does not expect the fair value of the security to recover prior to the expected time of sale, a write-down for other-than-temporary impairment should be recognized in earnings in the period in which the decision to sell is made."

The EITF Considers Impairment

Despite the various sources of guidance on impairment of securities, accountants and others expressed concern in 2002

[5]See, for example, paragraph 68 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

[6]*A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities: Questions and Answers.*

that the accounting literature discussing the concept of other-than-temporary impairment was ambiguous and had led to inconsistent application of this literature. Late that year, the FASB's EITF decided to pursue the development of additional guidance for determining whether certain investments in securities, including held-to-maturity and available-for-sale securities, have incurred an other-than-temporary impairment. In EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1), the EITF first reached a consensus that certain disclosures about securities with impairment should be included in the footnotes to financial statements prepared in accordance with GAAP. Ratified by the FASB Board in November 2003, these new disclosures were first required in annual financial statements as of year-end 2003.

The disclosures required by EITF 03-1 provide quantitative and qualitative information about all held-to-maturity and available-for-sale securities "in an unrealized loss position for which other-than-temporary impairments have not been recognized." For each date for which a balance sheet is presented in the financial statements, an institution must provide a table that shows, for each category of investment security, the aggregate amount of unrealized losses on securities with impairment and the aggregate fair value of these securities. Furthermore, these disclosures must be shown separately for securities "that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer." An example of the format for these quantitative disclosures is shown below. The institution must also provide, in narrative form, sufficient information about the securities with impairment as of the most recent financial statement date to enable "users to understand the quantitative disclosures." In addition, this narrative disclosure must describe the information the institution "considered (both positive and negative) in reaching the conclusion that the impairments are not other than temporary."

In March 2004, the FASB Board ratified the accounting guidance for determining whether certain investment securities have incurred an other-than-temporary impairment on which the EITF had reached a consensus. EITF 03-1 established a three-step process for determining when an investment is impaired,

Investment Securities in an Unrealized Loss Position for Which Other-Than-Temporary Impairments Have Not Been Recognized

	Less than 12 months		12 months or greater		Total	
Description of Securities	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
U.S. Treasury securities	$ x,xxx	$ xx	$ xxx	$ xx	$ x,xxx	$ xx
Mortgage-backed securities issued by government-sponsored enterprises	xxx	xx	xx	x	xxx	xx
Securities issued by states and political subdivisions	xx	x	xx	x	xxx	xx
Corporate bonds	xxx	xx	x	x	xxx	xx
Equity securities with readily determinable fair values	xx	x	xx	x	xx	x
Total	$ x,xxx	$ xxx	$ xxx	$ xx	$ x,xxx	$ xxx

continued from pg. 45

whether that impairment is other than temporary, and how to measure the impairment loss if the impairment is deemed to be other than temporary. This process was to be applied to individual securities whose fair value had declined below amortized cost.

Although the accounting guidance in EITF 03-1 was scheduled to take effect September 30, 2004, it has been indefinitely delayed by the FASB. This delay occurred after institutions, in preparation for the implementation of the recognition and measurement provisions of the EITF consensus in mid-2004, raised questions and concerns as to whether conservative interpretations of this guidance by certain accounting firms were consistent with what the EITF and the FASB had intended in EITF 03-1. These concerns were focused primarily on available-for-sale debt securities that are impaired solely due to increases in interest rates or sector spreads in the marketplace.

The FASB staff initially sought to clarify the guidance in EITF 03-1 for such securities through the issuance of a proposed FASB Staff Position in early September 2004. However, as a result of the more than 200 comments received, the FASB indicated in November 2004 that it will instead reconsider the relevant accounting literature on other-than-temporary impairment of debt and equity securities. The time frame for this reconsideration is not clear. In the meantime, the FASB has reminded institutions that hold investment securities that they should continue to apply the existing impairment guidance in FAS 115, including SAB 59 and SAS 92, which are referenced in FAS 115. Additionally, the disclosure requirements of EITF 03-1 remain in effect.[7]

SEC Staff Accounting Bulletin No. 59

The SEC staff originally issued SAB 59 in 1985 to discuss other-than-temporary impairments of "noncurrent marketable equity securities." SAB 59 also notes that "other than temporary" should not be interpreted to mean "permanent" impairment. After the issuance of FAS 115, SAB 59 was updated to encompass "marketable securities classified as either available-for-sale or held-to-maturity." Hence, its coverage expanded to include both debt and equity securities.

SAB 59 notes that the fair value of individual investment securities may decline below cost for various reasons. It states that these declines in value "require further investigation by management," which "should consider all available evidence to evaluate the realizable value of its investment." Numerous factors should "be considered in such an evaluation and their relative significance will vary from case to case." According to SAB 59, the following are "only a few examples of the factors which, individually or in combination, indicate that a decline is other than temporary and that a write-down" to fair value is required:

- The length of the time and the extent to which fair value has been less than cost;
- The financial condition and near-term prospects of the issuer, including any specific events that may influence the

[7]See FASB Staff Position No. EITF 03-1-1 (www.fasb.org/fasb_staff_positions/fsp_eitf03-1-1.pdf). This FASB Staff Position also references one other existing source of impairment guidance, EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). However, excluded from the scope of EITF 99-20 are "beneficial interests in securitized financial assets that (1) are of high credit quality . . . and (2) cannot contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment." EITF 99-20 further states that "determining whether an other-than-temporary impairment of such beneficial interests exists should be based on SAB 59, SAS 92, and the Statement 115 Special Report," i.e., the FAS 115 implementation guide. This article does not address the impairment guidance in EITF 99-20 for those beneficial interests that are within its scope.

operations of the issuer, such as changes in technology that may impair its earnings potential or the discontinuance of a segment of the issuer's business that may affect its future earnings potential; or

- The intent and ability of the institution to retain its investment for a period of time sufficient to allow for any anticipated recovery in fair value.

The SEC staff has elaborated on the process that institutions should follow when determining whether an unrealized loss on an individual security is other than temporary. In this regard, the SEC staff does not believe it is appropriate to employ "bright line or rule of thumb tests" to evaluate impairment. For example, some accountants and institutions have reportedly used such benchmarks as a 20 percent decline in fair value below cost that has lasted more than one year as their definition of other-than-temporary impairment. Although the quantitative disclosures required by EITF 03-1 distinguish between securities that have had unrealized losses for periods of more than and less than one year, this one-year time period is not an automatic line of demarcation for inferring when unrealized losses become other-than-temporary impairments. The SEC staff has noted that an other-than-temporary decline could occur within a short period of time. This would most likely be the case if the issuer of the security has experienced significant credit deterioration, with or without a payment default, or in the event of a planned sale of a depreciated security. By the same token, depending on the facts and circumstances, a decline in fair value that continues for more than one year may be temporary.

When evaluating impairment, the SEC staff has observed the importance of distinguishing between debt securities and equity securities. Consistent with FAS 115, equity securities exclude preferred stock that must be redeemed by the issuer or can be redeemed at the option of the investor. Hence, an investor must look to a sale of an equity security as the way to recover the investment rather than holding the security until its contractual maturity, as would be the case for a debt security. Therefore, the SEC staff has stated that an investor's "ability to hold an equity security indefinitely would not, by itself, allow an investor to avoid an other-than-temporary impairment," which is compatible with the need to consider the near-term, rather than long-term, prospects of the issuer of the equity security.

The SEC expects that institutions will use a systematic methodology to perform their impairment analyses and will fully document all of the factors considered. Moreover, efforts to forecast recoveries in the fair value of individual securities are fraught with uncertainty. In cases where the severity and duration of the unrealized loss on a security increase, the impairment analysis should become more robust and extensive. The longer the forecasted recovery period, the less reliable the estimate of when the fair value of a security will increase up to or beyond its amortized cost. Thus, the SEC envisions that projected recoveries of fair value will be supported by objective evidence.

AICPA Statement on Auditing Standards No. 92

Issued in 2000, SAS 92 provides guidance to auditors in planning and performing auditing procedures with respect to investment securities as well as derivatives and hedging activities. It states that evaluating whether unrealized losses on individual debt and equity securities are other than temporary "often involves estimating the outcome of future events." As a consequence, "judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred" at the date of the finan-

continued from pg. 47

General Debt Security Classification Guidelines

Type of Security	Classification: Substandard	Doubtful	Loss
Investment quality debt securities with "temporary" impairment	—	—	—
Investment quality debt securities with "other-than-temporary" impairment	—	—	Impairment
Sub-investment quality debt securities with "temporary" impairment	Amortized Cost	—	—
Sub-investment quality debt securities with "other-than-temporary" impairment, including defaulted debt securities	Fair Value	—	Impairment

NOTE: Impairment is the amount by which amortized cost exceeds fair value.

cial statements. These factors are both subjective and objective and include "knowledge and experience about past and current events and assumptions about future events."

SAS 92 cites the following as examples of these factors:

- Fair value is significantly below cost and:
  - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - The decline has existed for an extended period of time.
  - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The institution recorded losses from the security subsequent to the end of the reporting period.

Several of these factors correspond to those identified by the SEC staff in SAB 59. In addition, the existence of the final factor as an indicator of an other-than-temporary impairment loss at the date of the financial statements is consistent with the guidance in EITF Topic No. D-44 on the planned sale of a security.

Because management, and not the auditor, is responsible for the preparation of an institution's financial statements and the proper application of generally accepted accounting principles, SAS 92 directs the auditor to evaluate management's impairment assessment process, including the factors management has considered, and the resulting conclusions. Thus, SAS 92 establishes a clear expectation that management will maintain appropriate documentation to support its conclusions.

Examination Considerations

The *Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts,* which the federal banking agencies revised in June 2004, incorporates the other-than-temporary impairment concept.[8] It provides that "[i]f an institution's process for assessing impairment is considered acceptable, examiners may use those assessments in determining

[8]See FDIC Financial Institution Letter (FIL) 70-2004, dated June 15, 2004, which can be accessed at www.fdic.gov/news/news/financial/2004/fil7004.html.

the appropriate classification of declines in fair value below amortized cost on individual debt securities." Although the Uniform Agreement focuses on debt securities, an institution's impairment assessment process must cover both debt securities and any equity securities (not held for trading) in order to satisfy applicable accounting standards. The general debt security classification guidelines set forth in the Uniform Agreement are presented on the previous page.

Thus, each institution's accounting or investment policies should include provisions directing management to evaluate individual securities whose fair value is less than amortized cost at each quarter-end to determine whether any other-than-temporary impairments have been incurred. These evaluations should be documented to show how management has considered the factors enumerated in FAS 115 and its implementation guidance, SAB 59, and SAS 92, and any other relevant factors, in reaching its conclusions concerning the impairment of individual securities.

For institutions with audited financial statements or that otherwise prepare statements in conformity with GAAP, the disclosures required by EITF 03-1 about securities in an unrealized loss position represent a useful tool for examiners. Optimally, these financial statements should be available during pre-examination planning. Otherwise, examiners should obtain the financial statements early in the examination. A review of the required disclosures will provide insight into the quality of an institution's impairment assessment process. If the process appears to be adequate at the most recent year-end, examiners should verify that quarterly evaluations of individual securities in an unrealized loss position are being properly performed. Consistent with the Uniform Agreement, an acceptable impairment assessment process may serve as the basis for any adverse classifications of impairment on individual investment securities in the examination report.

In contrast, at an institution whose policies do not incorporate an impairment assessment process or whose process has not been implemented adequately, examiners should seek management's commitment for appropriate corrective action. When these deficiencies are present, examiners normally should focus their impairment review on those available-for-sale and held-to-maturity securities for which fair value is significantly less than cost. These are case-by-case evaluations based on the facts and circumstances surrounding each investment that require the examiner to exercise judgment.[9] To support a conclusion that an individual security, whether investment quality or sub-investment quality, is other-than-temporarily impaired, an examiner should document the results of his or her consideration of all relevant factors, including those cited above in the accounting literature. This documentation should identify clearly the objective evidence used in the impairment analysis and the sources of this evidence. These findings should be described in the examination report as the basis for assigning a Loss classification to the excess of the cost of the security over its fair value.

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[9]However, as provided in the Uniform Agreement, an unrealized loss on a debt security for which there has been a payment default will generally be presumed to be an other-than-temporary impairment.