



FASB Decision on Other-Than-Temporary Impairments

The FASB in a new Staff Position put an end for now to standard setting on other-than-temporary impairments of securities by endorsing existing requirements with relatively few modifications.¹ In a separate action that may also affect the carrying amount of securities, the Board proposed a requirement that would prohibit recognizing unrealized gains or losses on derivative instruments when initially accounting for transactions that took place in markets considered most advantageous to the reporting entity.² This edition of *Defining Issues* describes the adopted and the proposed Staff Positions.

Other-Than-Temporary Impairments

The new Staff Position summarizes the accounting and disclosure guidance on other-than-temporary impairments of securities. It applies to investments in debt and equity securities within the scope of Statements 115 and 124 and to all equity securities held by insurance companies.³ It also applies to investments in other equity securities that are not accounted for by the equity method, referred to as “cost-method investments.”

The Staff Position supersedes EITF D-44 and nullifies the guidance in EITF 03-1 for determining whether impairment is other-than-temporary.⁴ However, it carries forward one paragraph of EITF D-44 and many of the provisions of EITF 03-1, including its disclosure requirements and related examples, its requirements for cost-method investments, and its three-step model (identify the impairment, evaluate whether it is other-than-temporary, and if so, recognize the impairment loss). The Staff Position also incorporates by reference other accounting literature on other-than-temporary impairments.

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¹ FASB Staff Position FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, November 3, 2005, available at www.fasb.org.

² Proposed FASB Staff Position FAS 133-a, Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133, October 21, 2005, available at www.fasb.org.

³ FASB Statements No. 115, Accounting for Certain Investments in Debt and Equity Securities, May 1993, and No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, November 1995, both available at www.fasb.org. The FSP applies only to Statement 124 investments that are held by not-for-profit organizations that present a “performance indicator” as defined in the AICPA Accounting and Audit Guide, Health Care Organizations.

⁴ EITF Topic No. D-44, Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value; EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.

Identifying Impairment. An investment is impaired if its fair value is less than its cost basis. With the exception of cost-method investments, investments are to be assessed for impairment each reporting period, which includes the interim periods of entities that issue interim financial statements. Impairment assessments are made at the individual security level. The Staff Position defines the “individual security level” as the level and method of aggregation the investor uses to measure realized and unrealized gains and losses on its investments, such as using an average cost basis for equity securities with the same CUSIP number. Separate contracts, such as a debt security and a guarantee, may not be combined for purposes of determining impairment.

Whenever the fair value of a cost-method investment is estimated for a different purpose, such as when developing information for Statement 107 disclosures, the investor should use that fair-value estimate to identify whether the related security is impaired.⁵ If the fair value of a cost-method investment is not readily available or not being estimated for other purposes, the investor should estimate fair value when events or changes in circumstances occur during the period that have a significant adverse effect on the investment’s fair value. The Staff Position lists some of these “impairment indicators”:

- A significant deterioration in the investee’s earnings performance, credit rating, asset quality, or business prospects.
- A significant adverse change in the investee’s regulatory, economic, or technological environment or in the general market conditions of either the geographic area or the industry in which the investee operates.
- A bona fide, solicited-or-unsolicited offer to buy the same or a similar security for

an amount less than cost or a completed auction process for the same or similar security indicating a decline in the investment’s fair value.

- Events or conditions 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.

An investor should re-estimate the fair value of an impaired cost-method investment each succeeding reporting period until the investment is no longer impaired. The impaired state may end either because fair value recovers at least up to its cost or because the investor recognizes an other-than-temporary impairment loss.

Other-than-Temporary. Investors who identify impairments must then determine whether the impairments are temporary or other-than-temporary using previously issued guidance. The Staff Position cites SEC Staff Accounting Bulletin Topic 5M (originally issued as SAB 59), paragraph 16 of Statement 115, paragraph 6 of Opinion 18, and EITF 99-20.⁶ It also makes explicit that other-than-temporary does not mean permanent.

If an investor decides to sell an impaired available-for-sale security that is not expected to fully recover prior to the expected time of sale, the security should be considered other-than-temporarily impaired when the decision to sell is made. However, an available-for-sale security’s impairment can be other-than-temporary even when the investor has not made a decision to sell the security.

Recognition. The loss recognized on an identified other-than-temporary impairment is the difference between the investment’s cost and its fair value at the balance-sheet

date. This establishes a new cost basis for the investment, which is not adjusted for subsequent recoveries of fair value. Investors are required to subsequently account for other-than-temporarily impaired debt securities as though those securities had been purchased on the measurement date of the impairment. The discount or reduced premium recorded for the debt security would be amortized over the remaining life of the security based on the amount and timing of estimated future cash flows.

The Staff Position does not refer to the “tainting” notion in EITF 03-1. Under that tainting notion, a pattern of selling debt securities prior to the forecasted recovery of fair value, although not presumptive, may call into question (or taint) the investor’s assertion of intent to hold securities long enough for the impairment to recover in subsequent periods. However, investors should consider whether decisions to sell securities whose impairment was not considered other-than-temporary before recovery affects their plans to hold other securities until the forecasted recovery of fair value.

Disclosures. The Staff Position requires both quantitative and narrative disclosures. Specified quantitative disclosures are to be presented in a table as of each date for which a balance sheet is presented in annual financial statements. The table should present the following information for each category of investment that the investor discloses in accordance with Statements 115 and 124 and for cost-method investments:

- The amount of unrealized losses and
- The related fair value of investments with unrealized losses.

Companies with investments that are impaired but the impairment loss is not recognized

⁵ FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, December 1991, available at www.fasb.org.

⁶ SEC Staff Accounting Bulletin Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*, available at sec.gov; APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, March 1971; EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*.

must separately disclose those 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 or more months. The reference point for determining how long an investment has been in an unrealized loss position is the balance-sheet date of the reporting period in which the impairment occurred.

Narrative disclosures should be presented as of the date of the most recent balance sheet and should be sufficient to allow financial-statement users to understand both the aggregated, tabular information and the positive and negative information the reporting entity considered in reaching conclusions that impairments were temporary. The disclosures might include:

- The nature of each investment
- The cause of each impairment
- The number of investment positions that are in an unrealized loss position
- The severity and duration of the impairment or impairments
- Other evidence considered by management, including, for example, industry analyst reports, sector credit ratings, and the volatility of the security's fair value.

The narrative disclosures may be presented by investment categories, but unrealized losses significant in themselves generally should also be discussed individually.

The following additional information should be disclosed about cost-method investments as of each date for which a balance sheet is presented in the annual financial statements:

- The aggregate carrying amount of all cost-method investments
- The aggregate carrying amount of cost-method investments that the investor did not

evaluate for impairment, and in that case

- The fact that the fair value of a cost-method investment is not estimated if there are no impairment indicators, and
- Either that Statement 126 exempts the entity from estimating fair value or that the entity determined, in accordance with paragraphs 14 and 15 of Statement 107, that it is not practicable to estimate the fair value of the investment.⁷

Derivative Accounting Proposal

The proposed Staff Position on derivative accounting focuses on the conditions that indicate whether an unrealized gain or loss from the initial mark-to-model measurement on derivative instruments can be recorded and if so, whether to defer or recognize the amount in earnings. The proposed guidance differs from existing guidance by incorporating a most-advantageous-market concept in evaluating fair value at initial recognition.⁸

The most advantageous market, called the “reference market” in the proposal, is the most advantageous market in which the entity would conduct the transaction. The presumption that the transaction price is the fair value of the asset or liability at initial recognition is rebutted only if the transaction took place in a less advantageous market.

For example, if a dealer entered into a transaction in a retail market with one of its non-dealer customers, it may be able to rebut the transaction-price presumption (and potentially record an unrealized gain or loss in income) if the dealer would otherwise transact in the more advantageous dealer market for that derivative instrument. In contrast, the transaction-price presumption would not be rebutted for the non-dealer customer, assuming the retail market is the most advantageous market

in which it can transact. If the transaction-price presumption is not rebutted, the transaction price and the initial fair value estimate would be the same, resulting in no unrealized gain or loss to record at inception.

The proposed Staff Position would supersede footnote 3 in EITF 02-3. The footnote prohibits an entity from recognizing an unrealized gain or loss upon initial recognition of a derivative instrument unless the fair value of that instrument is obtained from a quoted market price in an active market, is otherwise evidenced by comparison to other observable current market transactions, or is based on a valuation technique incorporating observable market data. However, EITF 02-3 does not specify when or how the unrealized gain or loss should ultimately be recognized. Some entities recognize the unrealized gains or losses in income once the fair value of the derivative instrument can be supported by observable market inputs. Other entities amortize the unrealized gains or losses into income over the term of the instrument.

Unrealized Gains and Losses. According to the proposed Staff Position, if the transaction price for a derivative instrument is rebutted at inception, the corresponding unrealized gain or loss, measured as the difference between the transaction price and the entity's estimate of fair value, can be immediately recorded in income only if a minimum reliability threshold for the entity's estimate is met. The threshold would be met if the estimate was based on any of the market inputs from Levels 1 – 4 of the FASB's proposed fair value hierarchy⁹:

- Level 1 inputs reflect quoted prices in active markets for identical derivative instruments.

⁷ FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, December 1996, available at www.fasb.org.

⁸ The relevant current guidance is in footnote 3 of EITF Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*.

⁹ FASB Working Draft, *Statement of Financial Accounting Standards No. 15X, Fair Value Measurements*, October 21, 2005, available at www.fasb.org.



- Level 2 inputs reflect quoted prices for similar derivative instruments or quoted prices for identical derivative instruments from markets that are not active.
- Level 3 inputs are other than quoted prices that are directly observable for the derivative instrument, such as interest rates, yield curves, volatilities, and default rates.
- Level 4 inputs are not directly observable for the derivative, but are corroborated by other market data through correlation or by other means.

The minimum reliability threshold would not be met and therefore the unrealized gain or loss for the derivative instrument would not be recorded in income if the entity's estimate of fair value was based on entity inputs (Level 5 inputs), such as those derived through extrapolation or interpolation but not corroborated by other market data. In those instances, the unrealized gain or loss at inception would be deferred until the minimum reliability threshold is met or the derivative is settled. If the proposed Staff Position is adopted, entities will need to put procedures in place to monitor when that threshold has been met for derivatives such as long-dated, over-the-counter instruments in illiquid markets.

The minimum reliability threshold would not apply to subsequent fair value measurements of derivative instruments. The proposed Staff Position would prohibit amortizing any deferred amounts into income.

Disclosures. Companies would be required to disclose the following information about their initial recognition of derivative instruments:

- Gross unrealized gains and losses recognized in income during the current period
- Gross unrealized gains and losses deferred, including a reference to where the deferred amounts are recorded on the balance sheet and a reconciliation of beginning and ending deferred balances during the period

The disclosure requirements in the FASB's forthcoming statement on fair value measurements would be applied in subsequent periods.

Applicability and Effective Date. The proposed Staff Position would apply to unrealized gains and losses on both freestanding and embedded derivatives (i.e., when separate accounting for an embedded derivative is required by Statement 133) and would be effective for fiscal years beginning after December 15, 2006, and for interim periods within those fiscal years.¹⁰ The proposal would require retrospective application as of the beginning of the fiscal year in which it was applied, with an adjustment made to the opening balance of retained earnings of that year. Early application of the guidance would be encouraged, but early adopters of the Staff Position would be required to apply all of the provisions of the FASB's forthcoming statement on fair-value measurements at the same time.

The comment deadline for the proposed Staff Position is November 21, 2005.

The descriptive and summary statements above are not intended to substitute for the text of FASB Staff Position FAS 115-1 and FAS 124-1, proposed FASB Staff Position FAS 133-a, or any other cited, actual, or potential requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Those accounting for other-than-temporary impairments of securities and derivatives transactions and complying with SEC filing requirements should refer to the texts of the applicable documents that set out requirements and consult their accounting and legal advisors.

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Contributing authors:

Michael D. Foley
Enrique M. Tejerina
Ryan Richards

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¹⁰ FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, available at www.fasb.org.