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New Guidance on “Other-Than-Temporary Impairment”

Companies carrying debt and equity securities at amounts higher than the securities’ fair values will soon have to use more detailed criteria to evaluate whether to record a loss and will have to disclose additional information about unrealized losses, according to a recent Consensus of the FASB’s Emerging Issues Task Force.¹ The impairment accounting guidance is effective for reporting periods beginning after June 15, 2004; the disclosure requirements for annual reporting periods ending after June 15, 2004.

The new guidance effectively codifies the provisions of SEC Staff Accounting Bulletin No. 59 and creates a model that calls for many judgments and additional evidence gathering.² The newly required disclosures add to those the EITF prescribed in an earlier decision on the same issue.³

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(1) EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” Consensus at the March 17-18, 2004 meeting.
 (2) SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities, September 1985.
 (3) EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” Consensus at the November 12-13, 2003 meeting.

SCOPE

The Consensus applies to investments in debt and equity securities within the scope of Statements 115 and 124.⁴ It also applies to investments in equity securities that are both outside Statement 115's scope and not accounted for by the equity method, a group the Consensus refers to as "cost method investments." Beneficial interests in securitized financial assets that are found to be temporarily impaired under EITF 99-20's criteria, in which case no loss would be recognized, are subject to one additional other-than-temporary evaluative criterion in the Consensus. All beneficial interests in securitized financial assets that are found to be impaired under EITF 99-20's or the Consensus's criteria are subject to the disclosure requirements in the Consensus.⁵

The Consensus does not apply to equity-method investments; no model is now planned for them; and the SEC staff will not require registrants to apply EITF 03-1's model to them. Nevertheless, many criteria in the Consensus's model are relevant to evaluating impairments in equity-method investments.

A THREE-STEP MODEL

The Consensus divides the procedures it prescribes into three sequential steps, the second and third being performed only if the prior step indicates it is necessary. The company first determines whether the investment is impaired. If so, the next step is to determine whether the impairment is other-than-temporary. If it is other-than-temporary, the third and final step is to recognize the impairment loss in earnings.

IDENTIFYING IMPAIRMENT

An investment is impaired if its fair value is less than its carrying value. When quoted market prices are available, the fair value is the market price per unit multiplied by the number of units. Discounts, premiums, or other adjustments to the market price should not be used. This is the same fair value measure called for by Statement 115.

If the fair value of a cost-method investment is being estimated for a different purpose, such as for Statement 107 disclosures, the estimate should be used to identify impairment.⁶ If the fair value of a cost-method investment is not readily available and not being estimated for other purposes, the company should estimate fair value when events or changes in circumstances occur during the period that can have a significant adverse effect on the investment's fair value. The Consensus 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 condition 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.

The company 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 or because an other-than-temporary impairment loss is recognized.

"OTHER-THAN-TEMPORARY"?

The criteria for evaluating whether an impairment is other-than-temporary differ depending on the type of investment. The criteria for impaired investments whose recovery depends on market

(4) FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, May 1993, and Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, November 1995. The Consensus applies only to Statement 124 investments that are held by not-for-profit organizations that present a "performance indicator" as defined in the AICPA Audit and Accounting Guide *Health Care Organizations*.

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

(6) FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, December 1991. Statement 107 requires the disclosure of the fair value of cost-method investments unless such a determination is not practicable. In addition, FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, December 1996, made the Statement 107 disclosures optional for certain nonpublic entities.

prices differ from the criteria for impaired investments whose recovery depends on collecting amounts due under a debt agreement. However, the evaluation in all cases assumes that “other-than-temporary” does not mean permanent.

Equity and Prepayable Debt Securities. Two basic criteria govern whether impairments are other-than-temporary for equity securities and debt securities that can contractually be prepaid or otherwise settled so that the investor would not recover substantially all of its cost. Impairments of these investments are temporary, and therefore no loss need be recognized, if:

- The investor’s ability and intent to hold the investment for “a reasonable period of time” is sufficient for a forecasted recovery of fair value, and
- The balance of evidence for and against weighs on the side of recovery within the projected sufficient-time period.

The Consensus does not define the concept “a reasonable period of time.”

Investor’s Ability and Intent. In evaluating its ability and intent to hold an investment, an investor should consider whether its obligations and its cash and working-capital requirements indicate that the investment may need to be sold prior to recovery. A pattern of selling investments prior to the forecasted recovery raises a question about the investor’s intent, but is not presumptive. The investor not need have classified debt securities as held-to-maturity under Statement 115 in order to meet the ability-and-intent condition.

Severity and Duration. The evidence needed to support a conclusion that an impairment is temporary increases with the impairment’s severity and duration. A severe decline in an investment’s value may indicate an other-than-temporary impairment even shortly after an impairment depending on the nature of the event that caused the impairment. For example, consider an investment in an equity security whose market price suddenly and severely declines in response to news that a highly anticipated product will not receive regulatory approval and will be abandoned. The nature of the event causing the severe decline would weigh on the side of concluding that the invest-

ment is other-than-temporarily impaired in the period of the price decline, though all positive and negative evidence would need to be considered in making the judgment.

Forecasted Recovery of Fair Value. Evidence of a forecasted recovery of fair value is required support for concluding an impairment is temporary. As the forecasted-recovery period lengthens, the reliability of the forecast declines. For example, one would not be able to rely on the ability to indefinitely hold an equity security, which has no contractual payment stream. The investor should objectively weigh all reasonably available information, including:

- The fair value of the investment after the balance-sheet date but before the financial statements are issued,
- The relevant regulatory, economic, or technological environment,
- The general market condition of either the geographic area or the industry in which the investee operates, and
- Forecasts about the investee’s financial performance and near-term prospects, such as earning trends, dividend payments, asset quality, and analysts’ or industry specialists’ forecasts.

Debt Securities with Contractual Recoveries. To assess the potential recovery of impaired debt securities that cannot be prepaid or otherwise settled so that the investor would not recover substantially all of its cost, the investor needs to evaluate both the probability of collecting all amounts due under the security’s contractual terms and the ability and intent to hold the investment until a forecasted recovery, which in certain cases may mean until maturity. The assessment of ability and intent is much like the assessment of ability and intent for impaired investments whose recovery depends on market prices. The factors described above apply once more.

What differs in assessing potential recovery for this set of impaired securities is evaluating the probability of collecting all amounts due under the security’s contractual terms. Consider, for example, a bond purchased at par value with no provisions allowing repayment for less than par. The investor assessing recovery needs to evaluate the probability of collecting the par value at

the bond's maturity date. All available information should be considered, including evidence from rating agencies and fair-value fluctuations caused by factors other than interest rates.

Guarantees or other credit enhancements should be considered only if they would reimburse the investor for the investee's failure to satisfy its payment obligations and if the guarantee or other credit enhancement is contractually included in the terms of the purchased debt security. Thus, a separate instrument purchased to provide a credit enhancement for a debt security should not be considered in evaluating whether the debt security is other-than-temporarily impaired, even if the instrument providing the credit enhancement is specifically designed for the debt security.

RECOGNITION

The loss recognized from an other-than-temporary impairment should equal the difference between the investment's carrying value and its quoted market price or, if that is unavailable, another measure of fair value. This establishes a new cost basis for the investment. Subsequent accounting would follow the guidance in SOP No. 03-3.⁷ However, recoveries in fair value to the old cost basis should not be recognized.

DISCLOSURES

The EITF last fall required disclosures about unrealized losses on investments subject to Statements 115 and 124 for annual periods ending after December 15, 2003, requirements that are incorporated in the new Consensus on Issue 03-1 and now applicable to cost-method investments for annual periods ending after June 15, 2004. The new Consensus also requires several additional disclosures for cost-method investments.

The disclosure requirements apply only to annual financial statements. However, as is the case with any annual disclosures, the interim reports of SEC registrants could be affected by interaction with the requirement in Regulation S-X to update

annual disclosures if events subsequent to the end of the most recent fiscal year have a material effect on the registrant.⁸

Tabular. Information about investments with unrealized losses should be disclosed in a table as of each date for which a statement of financial position is presented in annual financial statements.⁹ 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.

Investments that have been in a continuous unrealized loss position for less than 12 months should be presented separately from 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. Narrative disclosures should be presented as of the date of the most recent statement of financial position 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 the investment(s),
- The cause(s) of the impairment(s),
- The number of investment positions that are in an unrealized loss position,
- The severity and duration of the impairment(s),

(7) AICPA Statement of Position No. 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, December 2003.

(8) Rule 10-01(a)(5).

(9) Comparative information is not required for periods prior to initial application.



- 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 individually significant unrealized losses generally should also be discussed individually.

Additional Disclosures for Cost-Method Investments. The following additional information should be disclosed about cost-method investments as of each date for which a statement of financial position is presented in the annual financial statements.¹⁰

- The aggregate carrying amount of cost-method investments,
- The aggregate carrying amount of any cost-method investments that were not evaluated for impairment, and in that case
 - The fact that the fair value of a cost-method investment is not estimated if there are no identified events or changes in circumstances that are likely to have a significant adverse effect on the investment’s fair value, and
 - Either that the entity is exempt from estimating fair value by Statement 126 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.

BENEFICIAL INTERESTS IN SECURITIZED FINANCIAL ASSETS

Entities with beneficial interests in securitized financial assets should continue to apply EITF 99-20 to determine if an impairment is other-than-temporary. However, if the finding under EITF 99-20’s guidance is that an impairment is temporary, the entity should apply EITF 03-1’s additional requirement to assess whether the investor has the ability and intent to hold the investment until recovery.¹¹

The Consensus’s disclosure requirements apply to investments with unrealized losses subject to EITF 99-20.



Because the requirements of the new Consensus are effective soon, affected companies will have to move promptly to be prepared to apply them.

Reporting entities should not take the summary and descriptive statements in this presentation as a substitute for the EITF’s Consensus and related literature. Nor should reporting entities assume that any such statements apply to their particular circumstances. They should refer to the text of the relevant requirements, consider the requirements in relation to their particular circumstances, and consult their accounting and legal advisors.

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(10) Comparative information is not required for periods prior to initial application.

(11) EITF 99-20 currently refers to SAB 59, which requires SEC registrants to consider ability and intent.