

# Hot Topic

Update on major accounting  
and auditing activities

## FASB issues FSP amending EITF 99-20

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### Overview

On 12 January 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20* (the FSP). The FSP is the first new standard resulting from the four short-term projects that were announced at a special FASB meeting held on 15 December 2008 to address several accounting and disclosure issues related to financial instruments. The FSP amends EITF Issue No. 99-20, "Recognition of Interest Income and Impairment of Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets" (EITF 99-20).

The FSP eliminates the requirement that a holder's best estimate of cash flows be based upon those that "a market participant" would use. Instead, the FSP requires that an other-than-temporary impairment (OTTI) be recognized as a realized loss through earnings when it is "probable" there has been an adverse change in the holder's estimated cash flows

from the cash flows previously projected, which is consistent with the impairment model in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (Statement 115).

The FSP also reiterates and emphasizes the objective of an OTTI assessment and the related disclosure requirements in Statement 115 and other related guidance, including the requirement that the holder consider all available information when developing the estimate of future cash flows (i.e., past events, current conditions, and expected events).

The FSP is effective for interim and annual reporting periods ending after 15 December 2008 (e.g., 31 December 2008, for a calendar year-end entity). Retroactive application to a prior interim or annual reporting period is not permitted.

We have provided below additional details about the FSP. We also provide an updated summary of the three pending projects announced at the 15 December 2008 FASB meeting.

## Further discussion

### Background of EITF 99-20

EITF 99-20, which provides incremental impairment guidance for a subset of the securities within the scope of Statement 115, generally applies to certain interests in securitized financial assets that have contractual cash flows and are either debt securities under Statement 115 or are required to be accounted for in a manner similar to debt securities under Statement 115, as required by paragraph 14 of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. EITF 99-20 does not apply to interests in securitized financial assets that are of high credit quality (generally considered a 'AA' rating or higher) and cannot be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment. A common example of an instrument within the scope of EITF 99-20 is an "interest-only strip" issued by a special purpose vehicle that owns a pool of mortgages.

EITF 99-20 provides guidance for income recognition and OTTI. It requires a holder of a beneficial interest within its scope to periodically update their estimated cash flows associated with the beneficial interest for purposes of determining whether a change in the accretable yield of the beneficial interest is required. If such evaluation results in a change (favorable or adverse, taking into account both the timing and amount) in cash flows from the cash flows previously projected, then the amount of accretable yield should be recalculated and recognized prospectively as a change in the amount of periodic accretion recognized over the remaining life of the beneficial interest. When there has been an adverse change in estimated cash flows and the fair value of the beneficial interest has declined below its reference amount, as defined in EITF 99-20, an OTTI has occurred.

Prior to the FSP, when estimating cash flows for purposes of interest income recognition and determination of an OTTI, EITF 99-20 required holders of beneficial interests to estimate cash flows using current information and events that a market participant would use in determining the current fair value of the beneficial interest.

### Different impairment models

Debt securities that are not within the scope of Issue 99-20 are subject to the impairment model in Statement 115, which provides an example indicating that an impairment is other than temporary if it is probable that the holder will be unable to collect all amounts due according to the contractual terms.

The main difference between the impairment models in FAS 115 and EITF 99-20 relates to the requirement in the EITF 99-20 model to use market participant assumptions regarding future cash flows. Because of the requirement to use market participant assumptions regarding future cash flows, financial statement preparers expressed concern that the application of EITF 99-20 in a dislocated market can result in an OTTI when the fair value is significantly less than the cost basis, in spite of the fact that the holder has not concluded it is probable they will not be able to collect all previously projected cash flows.

### Amendments to EITF 99-20

In response to the concerns raised by financial statement preparers and other constituents, the FASB decided to amend the impairment guidance of EITF 99-20 to be consistent with Statement 115. A similar change was made to the income recognition guidance.

Specifically, the FSP amends paragraphs 12(a), 12(b) and 13 of EITF 99-20. It removes the reference to "market participants" and instead requires that an OTTI be recognized as a realized loss through earnings when it is "probable" that there has been an adverse change in estimated cash

flows from the cash flows previously projected, which is consistent with the impairment model in Statement 115. Likewise, a probable change in estimated cash flows (favorable or adverse) will result in a change in the amount of accretable yield for the beneficial interest held.

The FSP also retains and emphasizes the OTTI assessment guidance and required disclosures in Statement 115, FSP FAS 115-1 and 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, SEC Staff Accounting Bulletin (SAB) Topic 5M, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities, and other related literature.

The FSP emphasizes that the holder must consider all available information when developing the estimate of future cash flows, including past events, current conditions, and expected events. All available information would include the remaining payment terms of the instrument (which, for a security backed by "nontraditional loans", could be significantly different from the payment terms in prior periods).

The FSP also emphasizes the guidance included in FSP SOP 94-6-1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk*, and notes by way of example that an entity must consider whether a currently performing interest-only loan will continue to perform when principal payments will be required in the future (including "balloon" payments). In this example, when analyzing the features that may affect an estimate of future cash flows, the entity would consider the value of any collateral or other credit enhancements, whether a guarantor of a loan will be able to perform and whether a senior beneficial interest is expected to suffer losses due to losses by more subordinated beneficial interests.

This analysis should also consider current and expected economic factors that are relevant to the collectibility of the instrument, such as prepayment speeds, the financial condition of the issuer(s), and expected defaults. When considering these factors, an entity should consider industry analysts reports and forecasts, sector credit ratings, and other market data. That is, market expectations cannot be ignored, but must be considered in connection with management's expectations about expected cash flows.

The FSP emphasizes that it is inappropriate to automatically conclude that a security is not impaired because all of the contractual or previously estimated payments have been received. Additionally, it is also inappropriate to automatically conclude every decline in fair value represents an other-than-temporary impairment. However, in considering all available information the holder of a security should not ignore factors that are reflected in the fair value of the security. The FSP highlights that further analysis and use of judgment is often required to assess whether declines in fair value represent declines in the estimated cash flows from the issuer of the security. In the FSP, "a change in estimated cash flows" should be considered in the context of both timing and amount of the estimated cash flows.

### Effective date and transition

As discussed previously, the proposed FSP will be effective for interim and annual reporting periods ending after 15 December 2008, and must be applied prospectively at the balance sheet date of the reporting period for which the assessment is made (e.g., 31 December 2008, for a calendar year-end entity). Retrospective application to a prior interim or annual reporting period is not permitted. Thus, for an assessment made at 31 December 2008 that results in an OTTI, that OTTI would be recognized in the period ended 31 December 2008. The related change in the accretion of income as a result of the adverse change in estimated cash flows would begin

on 1 January 2009. For assessments made at 31 December 2008 that do not result in an OTTI, any change in the accretion of income as a result of a change in estimated of cash flows (i.e., favorable) would likewise begin on 1 January 2009.

### Looking ahead

As previously mentioned, the FSP is the first final standard resulting from the four short-term projects that were announced at a special FASB meeting held on 15 December 2008, which discussed several accounting and disclosure issues related to financial instruments. These issues were raised by constituents in various forums, including recent joint International Accounting Standards Board (IASB) and FASB roundtables on reporting issues arising from the global financial crisis, as well as a series of roundtable discussions sponsored by the SEC on fair value accounting. The remaining three short-term projects, which are pending at various stages of development, include:

- ▶ Enhanced disclosure requirements about the impairment of certain debt securities, loans, and long-term receivables
- ▶ Guidance on whether to allow for the recovery through earnings of an OTTI when evidence exists that a loss has reversed
- ▶ An amendment to clarify the extent of the embedded credit derivative scope exception in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement 133)

Additionally, the FASB has added to its agenda a longer-term comprehensive project to address the complexity in existing accounting standards for financial instruments that will be undertaken jointly with the IASB.

On 24 December 2008, the FASB released for public comment Proposed FASB Staff Position (FSP) No. FAS 107-a, *Disclosures about Certain Financial Assets: An Amendment of FASB Statement No. 107*

(FSP FAS 107-a), which would require additional disclosures about impairments of certain financial instruments. The proposed FSP and its new disclosure requirements will be effective for interim and annual reporting periods ending after 15 December 2008 (e.g., 31 December 2008, for a calendar year-end entity) and will not require disclosures for earlier periods presented for comparative purposes at initial application or in subsequent periods. Because FSP FAS 107-a is intended to be effective for year-end 2008 financial reporting, there is a short comment period that concludes 15 January 2009, so that a final document can be issued by 30 January 2009.

The FASB intends to release an exposure draft in the near term on the proposal to clarify the embedded credit derivative scope exception of Statement 133. The clarification of the embedded credit derivative scope exception is expected to be effective for reporting periods (interim and annual) beginning after 15 December 2008 (i.e., 1 January 2009 for calendar-year companies). However, the FASB concluded that the project regarding the recovery of OTTI (reversals) is lower in priority when compared to its other agenda items and should be addressed later in the first quarter of 2009.

Please refer to our Hot Topic included in both 22 December 2008 A&A news edition and our 26 December 2008 US Week in Review publication for additional information about these three pending projects.

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