

Accounting Research
Special Report**FASB Impairment and Fair Value
Proposals — More Disclosures
Would Benefit Investors****Analysts**

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Related Research

- *Fair Value Disclosures: A Reality Check, June 26, 2008*
- *Fair Value Accounting: Is it Helpful in Illiquid Markets?, April 28, 2008*
- *Other-Than-Temporary Impairments for U.S. Insurers: An Update, August 14, 2008*

Summary

The Financial Accounting Standards Board (FASB) recently proposed modifications to U.S. generally accepted accounting principles (GAAP) that will change the method for determining whether an investment is other-than-temporarily impaired (OTTI) and for identifying inactive markets and distressed transactions when measuring fair value (FV). As proposed, these changes could be effective as soon as the first quarter of 2009. Because much of these proposals hinge on either the intent and/or estimations provided by management, the proposed qualitative disclosures by themselves may not be sufficient for financial market professionals' understanding of the impairment and fair value conclusions reached by an issuer. Transparent, robust disclosures should lessen investor and analyst concerns of overly aggressive application of accounting standards. Fitch believes that if these changes are adopted as proposed, the capital markets would benefit if disclosures by issuers were expanded to allow for thorough and meaningful analysis, regardless of the minimum requirements.

Current and Proposed Accounting Practice

Currently, under U.S. GAAP, an issuer is required to determine whether a non-trading investment is other-than-temporarily impaired when the current fair value of the investment is less than the cost basis (trading investments are carried at fair value and marked to market each period through the income statement). If management does not believe that it will recover its full cost basis, it must write down the security to fair value, taking the difference as a charge to income.

If management believes that full recovery is probable, it must also assert that it has the ability and intent to hold the impaired security to recovery to avoid taking an impairment charge to earnings. Those securities which are classified as available-for-sale but are not deemed other-than-temporarily impaired are marked to market through other comprehensive income (OCI, a component of total equity). The current standards also place a higher burden of proof of recovery on equity investments since only debt instruments have contractual cash flows and maturity dates. Investments classified as held-to-maturity are measured at amortized cost, less any OTTI. See flow chart on page 4 for a schematic of the current standard.

Under the proposed standard, management need not assert that it has the ability and intent to hold an impaired security to recovery but rather management must assert that it: (A) does not have the intent to sell the security, and (B) it is more likely than not that it will not have to sell the security before its recovery. The change from "intent to hold" to "no intention to sell" may provide issuers enough flexibility to avoid OTTI charges. If management believes there are credit losses associated with a security and asserts that it does not intend to sell and it is more likely than not it will not sell before recovery, it would only take the credit loss in earnings and would not write down to full fair value.

The total difference between the cost basis and fair value would be separated into: (A) the amount of total impairment related to credit losses, and (B) the amount of total impairment related to all other factors. The amount of impairment related to credit losses would be deducted from earnings and the remaining difference between FV and cost related to “other factors” would be deducted from OCI. If management is unable to make both of the above assertions, it would recognize the full difference between FV and cost through earnings, consistent with current guidance. In both cases, there would be no earnings adjustment for any subsequent recovery in fair value. The amount recognized in other comprehensive income for held-to-maturity securities would be amortized through OCI over the remaining life of the security in a prospective manner based on the amount and timing of the cash flows. The only added disclosure would include the methodology and key inputs used to measure the portion of the total impairment that relates to credit losses. See flow chart on page 5 for a schematic of the proposed standard.

A Working Example

The table below is an example of an issuer with various debt and equity securities, which compares the accounting for the securities and any related OTTI under both the current and proposed requirements. To underscore how classification and intent would play a role in determining the recognized loss in these investments, we assume that all investments had a cost basis of \$100 at the beginning of the period and had a fair value of \$70 at the end of the period. For debt securities U, V and W, management estimated there would be no credit losses and for debt securities X, Y and Z, management estimated credit losses of \$10 (and thus “other FV losses” of \$20). There is no estimate of credit losses for equity investments because unlike debt securities, equity securities do not have defined principle and interest terms and a stated maturity date.

For those debt instruments for which management has not estimated any credit losses, recognition for any OTTI is primarily based on intent. Management in the example has both the ability and intent to hold debt security U until recovery (as required by the current guidance) and does not intend to sell or believes it is more likely than not it will not sell prior to recovery. In both the current and proposed cases, the impairment would be recorded in OCI and not included in earnings. For debt security V, management cannot assert that it has the ability and intent to hold to recovery and thus must recognize the full \$30 difference in earnings under current guidance. However, it does not believe that it is more likely than not that it will sell, and under the proposal, would not record any charge in earnings, but rather the full \$30 will be recorded in OCI.

Working Example of Current and Proposed Changes to OTTI

	Cost Basis	Fair Value	Est. Credit Loss	Investment Classification	Ability and Intent To Hold Until Recovery	Intend To Sell Before Recovery	More Likely Than Not To Sell Prior To Recovery	Current GAAP			Proposed GAAP		
								Balance Sheet	OCI	Earnings	Balance Sheet	OCI	Earnings
Debt Security													
U	100.0	70.0	—	Available-for-sale	Yes	No	No	70.0	(30.0)	—	70.0	(30.0)	—
V	100.0	70.0	—	Available-for-sale	No	No	No	70.0	—	(30.0)	70.0	(30.0)	—
W	100.0	70.0	—	Held-to-maturity	Yes	No	No	100.0	—	—	100.0	—	—
X	100.0	70.0	(10.0)	Available-for-sale	No	No	Yes	70.0	—	(30.0)	70.0	—	(30.0)
Y	100.0	70.0	(10.0)	Available-for-sale	Yes	No	No	70.0	—	(30.0)	70.0	(20.0)	(10.0)
Z	100.0	70.0	(10.0)	Held-to-maturity	Yes	No	No	70.0	—	(30.0)	70.0	(20.0)	(10.0)
Equity Security													
A	100.0	70.0	NA	Available-for-sale	No	No	No	70.0	—	(30.0)	70.0	(30.0)	—
Total	700.0	490.0	(30.0)					520.0	(30.0)	(150.0)	520.0	(130.0)	(50.0)

NA – Not applicable OCI – Other comprehensive income.
Source: Fitch.

Since management has estimated credit losses for debt instruments X, Y and Z, current requirements would deem the impairment as other-than-temporary (regardless of an ability and intent to hold to recovery) and the resulting difference between amortized cost (\$100) and fair value (\$70) would be recognized in earnings. Under the proposed requirements, when management believes it is more likely than not it will sell prior to recovery, this same treatment would apply (see debt instrument X). However, in those cases under the proposed guidance where management does not intend to sell prior to recovery and it is more likely than not that it would not to sell, only \$10, or the credit loss portion, would be recorded in earnings and \$20 of other losses would be recorded in OCI (see debt instruments Y and Z).

In the example under current requirements, for equity security A, the issuer is unable to assert that it has the ability and intent to hold to recovery and thus would recognize the full \$30 decline in fair value in earnings. The proposal allows management more flexibility to assert that it is more likely than not that it would not sell prior to recovery and therefore records the \$30 in OCI.

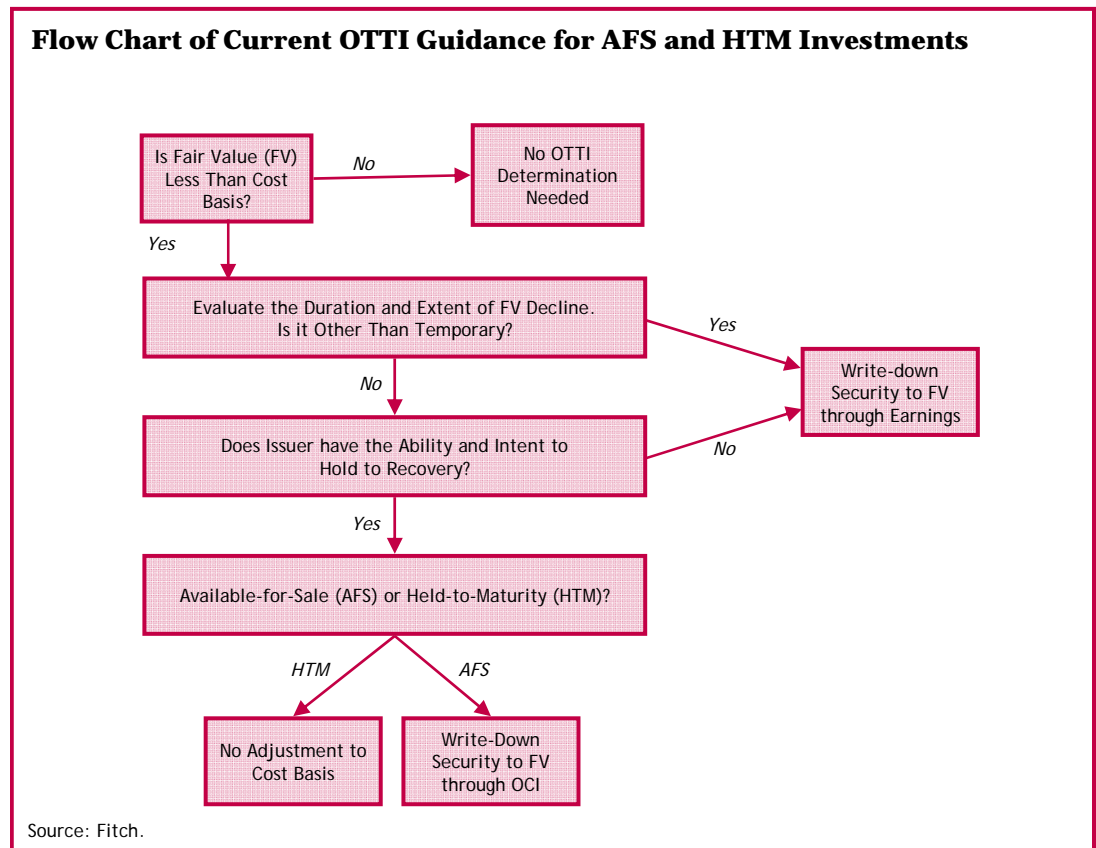
The example above has been kept simple and does not include any valuation estimate differences that may occur between market participants, which would complicate comparability. Such valuation estimates may vary based on how the fair value was determined (for example, differing inputs for a Level 3 fair value estimate, as defined in SFAS 157) and how the credit loss estimate was determined. Estimations of whether there is a credit loss and how to value such loss could differ significantly between investors of similar instruments. We expect the fair value proposal will result in more fair values being determined based on Level 3 estimates. The impact of differing intent and fair value and credit loss estimates at an individual issuer and across a broad range of issuers will make analysis more difficult.

Suggested Disclosures

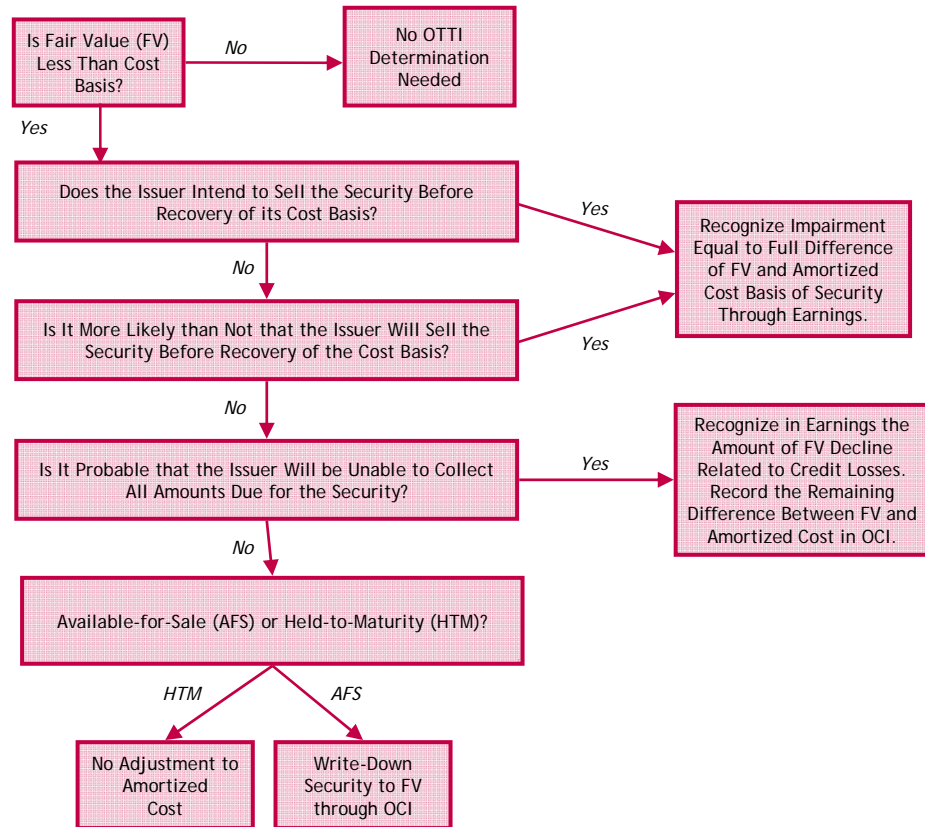
While many issuers resist increased disclosures, expanded disclosure would allow market participants to better understand the impairment and fair value conclusions reached by an issuer. Absent increased disclosures, investors and analysts may assume the issuer has taken the least conservative approach to valuation and impairment. Therefore, under the proposed guidance, Fitch believes that the below disclosure suggestions would prove beneficial for those using the financial statements:

- A tabular presentation of investments (separated between various types of debt and equity) classified as available-for-sale and held-to-maturity that would summarize the types of information similar to that shown in the table on page 2. The presentation ideally would include the following information:
 - Separate disclosures for investments that management has asserted it does not intend to sell before recovery and is more likely than not it will not sell prior to recovery, and for investments where it is unable to make such assertions:
 - Total cost basis.
 - Par value of debt securities, to get a more complete understanding of the investments being held.
 - Total amount of OTTI recognized in earnings (current period and cumulative).
 - Amount recognized in earnings for credit losses (current period and cumulative).
 - Total amount of “other losses” recognized in OCI (current period

- and cumulative).
- How management estimated credit losses, including key inputs and sensitivity analysis of those key inputs.
 - If it was determined that there were no credit losses, how management made that determination, including key inputs and sensitivity analysis of those key inputs.
 - How management determined whether it was more likely than not it would sell prior to recovery.
 - A tabular sensitivity analysis for Level 3 fair value measures. The sensitivities of fair value measurements to changes in significant assumptions are particularly important when valuations are model-based. (See Fitch, “Fair Value Disclosures: A Reality Check”, June 26, 2008)
 - Additional disclosures that may be helpful in understanding the Level 3 fair value measures include:
 - The proportion of values that were derived from models because the current market transactions were deemed distressed.
 - The total difference between observed distressed prices and the FV recorded.



Flow Chart of Proposed OTTI Guidance for AFS and HTM Investments



Source: Fitch.

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