

The FASB Proposes Changes for Fair Value and Impairment Charges

The Financial Accounting Standards Board (FASB) issued on March 17, 2009, two meaningful proposals related to fair value and impairment charges for comment. One proposal seeks to amend the FASB Statement of Financial Accounting Standards No. 157 (FAS 157), "Fair Value Measurements," to address the definition of an active market and a distressed transaction. The other proposal seeks to change the recognition and presentation for certain impairment charges on both debt and equity securities.

Proposed FSP FAS 157-e

Proposed FASB Staff Position (FSP) FAS 157-e, "Determining Whether a Market Is Not Active and a Transaction Is Not Distressed," proposes a two-step model. The first step determines whether factors exist that indicate a market for an asset is not active. Assuming step one results in the conclusion that there is not an active market, the second step is performed to evaluate whether the quoted price (a recent transaction or broker quote) is *not* associated with a distressed transaction.

This model, which represents a meaningful change in approach, presumes a quoted price from a market that is not active is a distressed transaction, unless there is evidence otherwise. If the quoted price is deemed to be associated with a distressed transaction, a valuation technique other than one that uses the quoted price without significant adjustment should be used to determine fair value.

Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b

One significant change suggested in this proposal is related to management's assertion regarding recovery of fair value declines. The proposal moves from an assertion about "intent and ability to hold to recovery" to a "do not intend to sell or is more likely than not to be required to sell prior to recovery" assertion.

Currently, preparers must assess whether an entity has the intent and ability to hold a security to recovery of its cost basis in determining whether the impairment is other-than-temporary.

Under the proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, "Recognition and Presentation of Other-Than-Temporary Impairments," an entity would be required to assess whether it intends to sell the security or is more likely than not (generally, considered to be a 50 percent threshold) to be required to sell the security prior to recovery. If the entity does not intend to sell the security and it is not likely that the entity will be required to sell the security prior to recovery, the security would not be considered other-than-temporarily impaired unless there are credit losses associated with the debt security.

Another significant change relates to the measurement of impairment in instances *other than when* the entity intends to sell or is more likely than not to be required to sell prior to recovery. Under the current practice, if an impairment is deemed to be other-than-temporary, the loss is recognized in earnings as the difference between the cost and fair value measured as of the balance sheet date. This difference encompasses all declines in fair value, which would include not only credit but also such items as changes in interest rates and market liquidity.

The FASB is proposing to bifurcate the components of fair value when an other-than-temporary impairment exists as follows: The credit component would be recognized in earnings, and the other components would be recognized in other comprehensive income in instances *other than when* the entity intends to sell or is more likely than not to be required to sell prior to recovery. Although the net charge to the income statement represents only the credit component, both the credit and noncredit components will be presented in the income statement. The following is an illustrative presentation of the income statement:

Impairment losses on securities	\$XX,XXX
Noncredit-related losses on securities not expected to be sold (recognized in other comprehensive income)	(X,XXX)
Net impairment losses	<u>\$XX,XXX</u>

To recap, the changes in this proposal would result in the following:

- If the entity intends to sell the security or it is more likely than not that the entity will be required to sell the security prior to recovery of its cost basis, the entire impairment would be recognized as an other-than-temporary impairment in earnings, which is consistent with the existing rules.
- If the entity does not intend to sell the security and it is more likely than not that the entity will not be required to sell the security prior to recovery of its cost basis, the security would not be considered other-than-temporarily impaired *unless* there are credit losses associated with the debt security. If credit losses exist, only the amount of the total impairment charge related to credit losses would be recognized in earnings. One way of estimating this amount would be to consider the measurement methodology described in FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan." The remainder of the impairment (those declines due to other factors such as liquidity and interest rates) would be recognized as part of other comprehensive income rather than in earnings. This is a significant change from current practice.

This proposal essentially will require entities to answer two key questions and proceed as follows:

Question 1:

Does the entity intend to sell the security or is it more likely than not that the entity will be required to sell the security prior to recovery of its cost basis?

Yes – The entire impairment would be recognized as an other-than-temporary impairment in earnings.

No – Go to Question 2.

Question 2:

Are credit losses associated with the debt security?

Yes – Determine the impairment charge representing credit losses by using the best estimate of the impairment amount due to credit, and recognize that amount as a charge to earnings. The remainder of the impairment would be recognized as part of other comprehensive income.

No - The security would not be considered other-than-temporarily impaired.

The Comment Period

The FASB has proposed the effective dates for both proposals to apply prospectively for interim and annual periods ending after March 15, 2009. Comments are due by April 1, 2009. The board expects to discuss the comments it receives at its April 2, 2009, meeting.

Read the FASB's summary: www.fasb.org/action/sbd031609.shtml

Read proposed FSP FAS 157-e at: www.fasb.org/fasb_staff_positions/prop_fsp_fas157-e.pdf.

Read proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b at: www.fasb.org/fasb_staff_positions/prop_fsp_fas115-a_fas124-a_and_eitf99-20-b.pdf.

Contact Information

If you have any questions about the FASB's proposed changes, please contact **Sydney Garmong** with Crowe Horwath LLP at **202.333.0375** or sydney.garmong@crowehorwath.com.

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