

# Fair Value and Impairment Charges: A Guide to Navigating the FASB's Changes

The Financial Accounting Standards Board (FASB) made changes for measuring and disclosing fair value and for recognizing and presenting other-than-temporary impairment (OTTI) charges with the issuance on April 9 of three FASB Staff Positions (FSPs). The first FSP amends FASB Statement of Financial Accounting Standards No. 157, "Fair Value Measurements," (FAS 157 or Statement 157) to provide additional guidance for estimating fair value when there has been a significant decrease in volume and level of activity when compared with normal market activity for the financial instrument or similar instruments. The second FSP amends the OTTI guidance for debt securities. The third FSP requires more frequent disclosures of fair value information for public companies.

While some financial institutions have chosen to early adopt the first and second FSPs, the majority are waiting to adopt the FSPs in the second quarter of the calendar year.

## FSP to Change FAS 157: Determining Fair Value

### The Final FSP

FSP FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly," provides guidance on determining when the volume and level of activity for an asset or liability have significantly decreased as well as when a transaction is not considered orderly. Both are key points because those decisions will affect whether a price quotation or observed transaction price should be adjusted.

The FASB emphasizes that FSP FAS 157-4 does not change the objective of a fair value measurement, even when market activity for the asset has decreased significantly. Fair value is the price that would be received for an asset sold in an orderly transaction – not a forced liquidation or distressed sale – between market participants at the measurement date under current market conditions. In other words, it does not change the fair value definition to be fair value in an active market. Paragraph 15 of FSP 157-4 reiterates Statement 157's objective of fair value measurement: "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions."

FSP FAS 157-4 stresses the use judgment when determining whether a formerly active market has become inactive and when determining fair values in such markets. When determining fair value, an entity's intention to hold the asset or

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liability is not relevant because under FAS 157, fair value is a market-based measurement, not an entity-specific measurement.

A fair value measurement should include a risk premium reflecting the amount market participants would demand because of uncertainty in cash flows; otherwise, the measurement would not faithfully represent fair value. The FASB acknowledges that determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient reason to exclude a risk adjustment.

## The Proposed FSP

The proposed FSP FAS 157-e, "Determining Whether a Market Is Not Active and a Transaction Is Not Distressed," included a two-step model. The first step determined whether factors exist that indicate that a market for an asset is not active. If step one resulted in the conclusion that there is not an active market, step two evaluated whether the quoted price (a recent transaction or broker quotation) is not associated with a distressed transaction.

The proposed FSP FAS 157-e also included a presumption that a quoted price from a market that is not active is a distressed transaction unless there is evidence otherwise. The FASB retained the two-step approach but removed from the final FSP the presumption that all transactions are distressed unless proved otherwise.

## The Framework

The final FSP FAS 157-4 provides the following two-step process:

### ***Step One: Evaluate the Market***

The first step is to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity. One change from the proposed FSP is the use of the term "inactive market." The final FSP does not use the term "inactive market" because that suggests there is no market activity rather than decreased market activity. Factors to consider when evaluating whether there has been a significant decrease in the volume and level of activity in relation to normal market activity include, but are not limited to:

- Few recent transactions;
- Price quotations not based on current information;
- Price quotations that vary substantially (either over time or between market makers);
- A demonstrable change in correlation, that was previously highly correlated, between indexes and recent indications of fair values;
- A significant increase in implied liquidity risk premiums;
- A wide or significant increase in the bid-ask spread;

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- A significant decline for new issuances of the financial instrument or similar financial instruments; and
- A lack of publicly available information.

If the factors are present, then transactions or quoted prices may not be determinative of fair value. If the entity concludes there is a significant decrease in the volume and level of activity when compared with normal market activity, move to step two to evaluate the transactions.

If the above or other relevant factors are not present, then the prices obtained are indicative of fair value and should be used, without adjustment, to determine fair value.

### ***Step Two: Evaluate the Transactions***

Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). An orderly transaction is a transaction that is neither a forced liquidation nor a distressed sale. Some circumstances that might indicate that a transaction is not orderly:

- There was not adequate exposure to the market to allow for marketing activities that are usual and customary.
- There was a usual and customary marketing period, but the seller marketed to a single market participant.
- The seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced).
- The transaction price is an outlier compared to other recent transactions.

An entity should conclude whether a transaction is orderly based on the weight of the evidence. Quoted prices that are not representative of an orderly transaction are not solely determinative of fair value. When estimating fair value, more weight should be placed on transactions that are orderly, and less weight should be placed on transactions for which there is insufficient information to conclude whether they are orderly.

An entity need not undertake all possible efforts to determine whether a transaction is orderly; but on the other hand, an entity should not ignore information that is available without undue cost and effort.

## **Disclosures**

In the period of adoption, entities should disclose a change in valuation technique and related inputs resulting from the application of the FSP and quantify the total effect of the change in valuation technique and related inputs, if practicable, by major category.

This FSP requires additional disclosures, both on an interim and annual basis, of inputs and valuation techniques used to determine fair value as well as changes to inputs and techniques. It also amends the FAS 157 disclosures to require detail within the trading, available for sale (AFS), and held to maturity (HTM) categories. As amended, FAS 157 defines major security types to be consistent with FAS 115, "Accounting for Certain Investments in Debt and Equity Securities."

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As noted in FSP FAS 157-4, paragraph 20b, to comply with this requirement, financial institutions should include in their disclosure the following major security types, though additional types might be necessary:

- Equity securities (segregated by industry type, company size, or investment objective);
- Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies;
- Debt securities issued by states of the United States and political subdivisions of the states;
- Debt securities issued by foreign governments;
- Corporate debt securities;
- Residential mortgage-backed securities;
- Commercial mortgage-backed securities;
- Collateralized debt obligations;
- Other debt obligations.

## Transition

Revisions resulting from a change in the valuation technique or its application will be accounted for as a change in accounting estimate in accordance with paragraph 19 of Statement 154, "Accounting Changes and Error Corrections."

## FSP to Change FAS 115: Evaluation of Impairment

### The Final FSP

The primary objectives of the second FSP, FAS 115-2 and FAS 124-2, "Recognition and Presentation of Other-than-temporary Impairments," are to make the OTTI guidance for debt securities more operational and to improve the presentation and disclosure in financial statements. In addition, this FSP more closely aligns the recognition of impairment for debt securities with that of loans.

While many debt securities follow the provisions of FAS 115, there are some debt securities that are in the scope of Emerging Issues Task Force (EITF) 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," or the American Institute of Certified Public Accountants' Statement of Position (SOP) 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer."

EITF 99-20 may be applicable for entities holding beneficial interests, including investments such as collateralized mortgage obligations (CMOs) and collateralized debt obligations (CDOs). For many financial institutions, the most common investments affected are nonagency CMOs and trust preferred CDOs. Entities holding such investments should evaluate for application of EITF 99-20. Entities that have separately purchased, or as part of a business combination

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acquired, investment securities with evidence of credit deterioration present at acquisition<sup>1</sup> should follow SOP 03-3 for those debt securities.

FSP FAS 115-2 requires a re-evaluation of cash flows expected to be collected at each balance-sheet date – similar to the model used for EITF 99-20 and SOP 03-3 – for all debt securities for which OTTI has been recognized.

### The Principal Changes

FSP FAS 115-2 and FAS 124-2, “Recognition and Presentation of Other-Than-Temporary Impairments,” makes two meaningful changes to existing practice. The first significant change to current practice relates to an entity’s assertion regarding recovery of fair value declines. In the final FSP, the FASB changed the guidance to move from an assertion about “intent and ability to hold to recovery” to a “do not intend to sell” and “it is more likely than not that it will not be required to sell prior to recovery” assertion. Prior to this change, determining OTTI was based on whether an entity had the intent and ability to hold a security until recovery.

If an entity does not intend to sell the security and if it is more likely than not that it will not be required to sell the security before its anticipated recovery, then the entity should consider all available evidence to estimate the anticipated period over which the cost basis of the security is expected to recover. If the entity does not anticipate recovery of its cost basis, an OTTI should be considered to have occurred and the credit loss component should be recorded in the income statement.

The second change relates to measuring impairment in instances other than when an entity intends to sell or is more likely than not to be required to sell prior to recovery. Prior to the change, if an impairment was deemed to be other-than-temporary, the loss was recognized in earnings as the difference between the cost and fair value measured as of the balance sheet date. This difference encompassed all declines in fair value, which would have included credit as well as items such as changes in interest rates and market liquidity.

### Equity Securities and Mutual Funds

The proposal included both debt and equity securities. However, many respondents cited operational issues and so the board decided the final FSP will apply only to debt securities. Equity securities continue to be evaluated under prior guidance.

<sup>1</sup> For purposes of applying SOP 03-3, an entity should evaluate the security and determine whether there has been evidence of deterioration of credit quality since origination. The term “since origination” means deterioration of credit quality that has occurred subsequent to the original issuance of the security. It is not deterioration subsequent to an entity’s acquisition of the security.

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On April 13, 2009, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 111 (SAB 111), which maintains the previous views related to equity securities. SAB 111 also amends SAB Topic 5.M.<sup>2</sup>, "Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities," to exclude debt securities from its scope as well as change references to the revised guidance in FSP FAS 115-2.

The final FSP reiterates that entities should not "look through" the form of their investment to the nature of the securities held by the investee. For example, an investment in shares of a mutual fund that invests primarily in debt securities would be assessed for impairment as an equity security under this FSP. In other words, mutual funds will continue to be evaluated as equity securities.

While FSP FAS 115-2 is primarily focused on debt securities, it amends the disclosure requirement for both debt and equity securities.

## The Framework

The final FSP retains the following basic three-step model as established by FSP FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments":

### ***Step 1: Determine whether an investment is impaired.***

An entity determines if the fair value of a debt security is less than its amortized cost. If fair value of the security is less than its amortized cost, the entity must determine if the impairment is OTTI. This step does not represent a change to the prior guidance.

### ***Step 2: Determine whether the impairment is other-than-temporary.***

There are three important changes to this step. First, the requirement to forecast a recovery of fair value has been replaced with a requirement to forecast recovery of cost basis, which is based on the best estimate of the present value of cash flows to be collected.

Second, the assertion on intent and ability to hold to recovery of fair value has been replaced with an assertion on the lack of intent to sell (or be required to sell prior to recovery of cost basis). For example, an entity could be required to sell due to cash or working capital requirements, or contractual or regulatory obligations.

Last, the FSP changes the recognition of impairment by removing the term "probable" and using the term "cash flows expected to be collected." With this change, the FASB is clarifying that an entity should not wait for an event of default or other actual shortfall of cash to conclude that some or all of the cash flows are not likely to be collected.

As a result of these changes, the following is the revised process for step 2:

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<sup>2</sup>Topic 5.M. originated with the issuance of SAB 59, "Views on Accounting for Noncurrent Marketable Equity Securities."

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First, determine whether the entity intends to sell the security or it is more likely than not it will have to sell the security prior to recovery of its amortized cost basis less any current-period credit loss. If so, move to step 3; otherwise continue as follows.

Next, determine whether the entire amortized cost basis is expected to be recovered (that is, whether there is a credit loss). If the present value of the cash flows expected to be collected – discounted at effective interest rate at acquisition<sup>3</sup> – is less than the amortized cost basis, then there is a credit loss.

FSP FAS 115-2 also adds qualitative factors to consider when determining whether a credit loss exists and when estimating the recovery period. A few examples of such factors follow:

- The length of time and the extent to which fair value has been less than the amortized cost basis;
- Adverse conditions specifically related to the security, an industry, or a geographic area;
- The historical and implied volatility of the fair value of the security;
- The payment structure of the debt security and the likelihood of the issuer being able to make payments;
- Failure of the issuer to make scheduled interest or principal payments;
- Any rating changes by a rating agency; and
- Recoveries or additional declines in fair value subsequent to the balance sheet date.

When assessing whether an impairment is other-than-temporary, an entity should consider all available information relevant to how collectible the security is. When estimating cash flows expected to be collected, an entity should include information about past events, current conditions, and reasonable and supportable forecasts.

This requires a renewed focus on estimating cash flows. Under prior guidance, the OTTI assessment was largely qualitative-based because fair value was used instead of cash flows to determine the amount of the OTTI charge – although subsequent accounting used estimated cash flows to determine how much should be recognized as accretion income. However, depending on the fact pattern, some securities with impairment may have simply been placed on nonaccrual. Note that the FSP does not address when a debt security should be placed on nonaccrual status or how to subsequently report income on a nonaccrual debt security.

Under the new guidance, however, recognizing the unrealized loss attributable to credit and noncredit as separate components requires estimating cash flows. Depending on the nature of the security, the process for estimating cash flows expected to be collected can be quite complicated, as discussed below, particularly with securitized instruments such as CDOs and CMOs.

The objective in this second step is to determine whether there has been a credit loss. If the present value of the cash flows expected to be collected is less than the amortized cost basis, then there is a credit loss. An entity that determines

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<sup>3</sup> For securities within the scope of EITF 99-20, the discount rate should be the current yield used and not the effective yield at acquisition.

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that there is a credit loss should move to step 3 for recognition. Otherwise, the impairment is deemed to be temporary and no impairment charge is recorded in the income statement.

## A Note on Estimating Cash Flows in a Securitization

Estimating cash flows in a securitization requires forecasting cash flows of all the assets in the securitization. This includes considering both the amount and timing of cash flows and requires evaluation of any and all relevant assumptions, such as:

- Remaining payment terms of the security;
- Prepayments;
- The financial condition of the issuer or issuers;
- Expected defaults;
- Value of any underlying collateral;
- Credit enhancements;
- Recoveries of current and expected defaults;
- Interest deferrals;
- Balloon payments and interest reset features;
- Effect of government regulatory oversight and programs; and
- Industry analysis reports and forecasts.

The use of dynamic assumptions over the remaining life of the security will result in more accurate forecasts than will static assumptions. For example, assuming default rates or collateral values will remain unchanged over the next 20 to 30 years is simply not realistic. Similarly, the past may not be the most relevant source when developing these assumptions.

Once cash flows have been forecast for the assets in the securitization, those cash flows will need to be assigned to each individual security tranche issued by that securitization. This process is known as a securitization waterfall.

Understanding the assets in a securitization, developing assumptions about how those assets will perform, forecasting cash flows, and distributing those cash flow forecasts to each tranche through the securitization waterfall requires specialized skills and software that some entities are not equipped to perform. As a result, those entities will require the use of third-party consultants to perform these analyses and computations. Even with the use of third-party consultants, entities will need to carefully evaluate and accept the assumptions used to derive the resulting cash flow estimates.

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**Step 3: Recognize an impairment loss.**

When an OTTI has occurred, the amount of impairment depends on whether an entity intends to sell the security, or if it is more likely than not that it will have to sell the security prior to recovery.

If the entity intends to sell the security or it is more likely than not it will have to sell the security prior to recovery of its amortized cost basis less any current-period credit loss, the entire impairment is recognized in earnings equal to the difference between the amortized cost basis and its fair value, which is consistent with prior guidance.

If a credit loss exists but the entity does not intend to sell (and it is not more likely than not that it will be required to sell before the anticipated recovery of its remaining amortized cost basis), the OTTI is separated as follows:

- The amount related to credit loss is recognized in earnings.
- The amount related to other matters is recognized in other comprehensive income.

Although the net charge to the income statement represents only the credit loss component, both the credit and noncredit components will be presented in the income statement. The total OTTI charge will be reduced by the amount recognized in other comprehensive income (OCI).

**Example Income Statement Presentation**

Total other-than-temporary impairment losses	(\$10,000)
Portion of loss recognized in OCI (before taxes)	<u>4,000</u>
Net impairment losses recognized in earnings	<u>(\$6,000)</u>

FSP FAS 115-2 provides that one way for an entity to measure the amount of credit loss is to measure impairment on the basis of the present value of expected future cash flows, as outlined in paragraphs 12-16 of FASB Statement 114, "Accounting by Creditors for Impairment of a Loan." Under the provisions of FAS 114, the expected cash flows are discounted at the effective interest rate implicit in the security at the date of acquisition. In other words, the rate used to calculate the present value of cash flows expected to be collected is the rate in effect before recognizing any OTTIs and not a rate that has been adjusted to reflect those impairments. The remainder of the impairment (those declines due to other factors such as liquidity and interest rates) would be recognized as part of OCI rather than as part of earnings. (See Appendix B for an illustration of this scenario.)

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The following table summarizes the three key questions and conclusions for each fact pattern.

Does the entity intend to sell the security? (That is, has the entity decided to sell?)	Is it more likely than not that the entity will be required to sell the security prior to recovery of its amortized cost basis?	Will the entire amortized cost basis be recovered?	Conclusion
No	Yes	No <sup>4</sup>	Entire impairment is recognized as an OTTI in earnings.
Yes	N/A	No <sup>4</sup>	
No	No	No	Impairment charge is separated: 1. Amount representing the credit loss is charged to earnings. 2. Amount related to all other factors is charged to OCI.
No	No	Yes	Impairment is considered to be temporary.

## HTM Debt Securities

Several comment letters submitted to the FASB suggested that for HTM debt securities, only credit losses should be recognized in the income statement, and the fair value should be disclosed in the notes to the financial statements. However, the FASB decided to require recognition of noncredit losses on HTM debt securities in OCI in order to present the carrying amount at fair value at impairment. Because the noncredit component is in OCI – and there is no accompanying FAS 115 adjustment to record the fair value – an entry must be recorded to accrete the discount at each subsequent balance sheet date. As a result, for HTM debt securities the charge is accreted from OCI to the amortized cost over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows. Note that this entry does not impact the income statement. To accommodate the new requirements, entities may want to establish new general ledger accounts. (See Appendix A for illustrative journal entries.)

<sup>4</sup> Because the entity has either a) decided to sell the security or b) it is more likely than not that the entity will be required to sell the security prior to recovery of its amortized cost basis, the entire amortized cost will not be recovered.

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### Subsequent Accounting for Debt Securities

For debt securities classified as AFS and HTM, the revised amortized cost basis of the security is equal to the previous amortized costs less the OTTI recognized in earnings. The difference between the new amortized cost basis and the cash flows expected to be collected are accreted in accordance with existing guidance as interest income. Under prior guidance, the entire impairment was accreted into net interest margin. Under FSP FAS 115-2, the accretion into net interest margin will be lower compared to prior guidance. (See Appendix A.) Subsequent changes in the fair value of AFS securities are accounted for in OCI.

The following illustrates the change in the amortized cost and subsequent recognition. For simplicity, the accrued interest receivable is not included.

- A \$100,000 bond is purchased, for which the entire principal amount matures at the end of 10 years. The coupon is 6 percent, which is an interest payment of \$6,000 paid annually. The purchase price was \$95,800 to yield 6.5866 percent. Total undiscounted cash flows expected to be collected is \$160,000. The security is classified as AFS.
- At the end of year three, there is OTTI. The revised cash flows expected to be collected are \$85,000 of principal and revised interest payments of \$5,000, which results in revised undiscounted cash flows expected to be collected of \$120,000. The fair value is \$70,000 and the present value of the revised cash flows expected to be collected, discounted at the effective yield, is \$81,727.

Under the prior and the revised guidance, the present value of the cash flows expected to be collected was, and will continue to be, calculated. However, under the prior guidance, the accretable discount was higher because of the larger net OTTI charge recognized in earnings. Income was recognized based on a revised effective yield of 9.3067 percent. Under the revised guidance, the accretable discount is smaller because the net OTTI charge recognized in earnings is smaller. Income is recognized on the effective yield at acquisition, or 6.5866 percent.

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In FSP FAS 115-2, the FASB acknowledges this change will result in an improvement for financial reporting because the amount recognized in net interest margin will be based solely on the amount accretable based on expected cash flows rather than accretable based on the difference between expected cash flows and the fair value. (This example is further illustrated in Appendix B.)

Prior Method		Revised Method	
Par amount	\$100,000	Par amount	\$100,000
Discount	(3,207)	Discount	(3,207)
Amortized cost	96,793	Amortized cost	96,793
Impairment	(26,293)	Net impairment (credit losses)	(15,066)
Amortized cost	<b>\$70,500</b>	Amortized cost	<b>\$81,727</b>
Par amount	\$100,000	Par amount	\$100,000
Discount – nonaccretable	(15,000)	Discount – nonaccretable	(15,000)
Discount – accretable (9.3067%)	(14,500)	Discount – accretable (6.5866%)	(3,273)
Amortized cost	70,500	Amortized cost	81,727
FAS 115 adjustment	0	FAS 115 adjustment	(11,227)
Carrying amount	<b>\$70,500</b>	Carrying amount	<b>\$70,500</b>
Carrying amount at the end of year 10, prior to principal receipt	\$85,000	Carrying amount at the end of Year 10, prior to principal receipt	\$85,000

## Subsequent Changes in Cash Flows

Subsequent decreases in the estimated cash flows would result in another test for impairment. In subsequent tests for impairment, the fair value would be compared to the amortized cost for purposes of measuring impairment. (This is illustrated in Appendix A.)

For subsequent increases in cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the change is accounted for as a prospective adjustment to the yield.

For debt securities within the scope of EITF 99-20, entities should refer to that guidance to account for changes in cash flows expected to be collected.

## Disclosures (applicable to both debt and equity securities)

Where the components of accumulated OCI are presented in the financial statement, entities are required to present separately the amounts related to HTM and AFS for which a portion of an OTTI has been recognized in earnings.

Disclosures should include information for interim and annual periods that enable users to understand the types of AFS and HTM debt and equity securities held, including information about investments in an unrealized loss position for

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which an OTTI has or has not been recognized. In addition, for interim and annual periods, information should be disclosed that enables users of financial statements to understand the reasons that a portion of an OTTI of a debt security was not recognized in earnings, and the methodology and significant inputs used to calculate the portion of the total OTTI that was recognized in earnings.

FSP FAS 115-2 expands and increases the frequency of certain existing disclosures including those in FAS 115 and FSP FAS 115-1. The following table provides an overview of the general requirements. The new requirements, added by FSP 115-2, are noted in red.

	Interim	Annual	Periods in which an OTTI of a debt security is recognized and only the amount related to a credit loss is recognized in earnings
By major security type, financial institutions should include the following major security types, although additional types may still be necessary: <ul style="list-style-type: none"> <li>Equity securities (<b>segregated by industry type, company size, or investment objective</b>);</li> <li>Debt securities issued by the Treasury and other U.S. government corporations and agencies;</li> <li>Debt securities issued by states and political subdivisions of the United States;</li> <li>Debt securities issued by foreign governments;</li> <li>Corporate debt securities;</li> <li><b>Residential</b> mortgage-backed securities;</li> <li><b>Commercial mortgage-backed securities</b>;</li> <li><b>Collateralized debt obligations</b>; and</li> <li>Other debt obligations.</li> </ul>	X	X	
<b>By major security type, for AFS and HTM securities, the amortized cost basis.</b>	X	X	
The disclosures required by FAS 115.	X	X	
<b>By major security type, the disclosures required by FSP FAS 115-1. These include debt securities for which a portion of an OTTI has been recognized in OCI.</b>	X	X	
<b>By major security type, the methodology and significant inputs used to measure the amount of the credit loss.</b>			X
<b>Tabular roll-forward of the amount related to credit losses recognized in earnings.</b>	X	X	

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## Transition

FSP FAS 115-2 is applied to investments held as of the beginning of the period in which it is adopted. The cumulative effect (inclusive of tax effects) of the initial application is recognized as an adjustment to the opening balance of retained earnings with a corresponding adjustment to accumulated OCI. This adjustment is calculated by comparing the present value of the cash flows expected to be collected to the cost basis of the debt security. If a security had previously recognized OTTI, the cost basis of such security should be adjusted by the amount of the cumulative effect adjustment before taxes.

The transition adjustment applies to debt securities to which OTTI had been taken in the past and are still held in portfolio, regardless of when the prior-period impairment was recognized previously. An entity cannot elect to omit the cumulative effect adjustment, other than for reasons based on materiality.

The accompanying appendixes provide illustrative journal entries and an example for an AFS debt security.

## FSP to Change FAS 107: Frequency of Disclosures for Public Companies

On Jan. 30, 2009, the FASB issued proposed FSP FAS 107-b and Accounting Principles Board (APB) 28-a, "Interim Disclosures About Fair Value of Financial Instruments," to require more frequent disclosures under FAS 107, "Disclosures About Fair Value of Financial Instruments." The proposal is largely in response to concerns expressed about the lack of fair value disclosures – particularly for loans – in interim financial statements. The FASB sought comment on the practicality of requiring these disclosures on an interim basis and the timing that would be necessary to create processes and controls in order to comply.

The FASB proceeded with issuing a final FSP to increase the frequency of disclosures about fair value of financial instruments. FSP FAS 107-1 and APB 28-1, "Interim Disclosures About Fair Value of Financial Instruments," requires additional qualitative (that is, the methods and significant assumptions used to estimate fair value) and quantitative disclosures for interim periods in addition to the existing annual requirement. The FSP applies only to public companies.

When initially adopted, this FSP does not require disclosures for earlier periods for comparative purposes. In periods after initial adoption, comparative disclosures are required only for periods that end after the FSP's initial adoption.

## Effective Dates

All three of the FSPs discussed here – FSP FAS 157-4; FSP FAS 115-2 and FAS 124-2; and FSP FAS 107-1 and APB 28-1 – are effective for interim and annual reporting periods ending after June 15, 2009. Early adoption is permitted, upon meeting

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certain qualifications, for periods ending after March 15, 2009. Earlier application to periods ending before March 15, 2009, is not permitted.

If an entity chose early adoption of the FSP to amend FAS 157, then the FSP to amend FAS 115 also had to be adopted. Likewise, if an entity chose early adoption of the FSP to amend FAS 115, the FSP to amend FAS 157 also had to be adopted. If an entity chose early adoption of the FSP to amend FAS 107, all three FSPs had to be adopted.

For entities that chose early adoption, the adjustment was made as of Jan. 1, 2009. For entities that did not choose early adoption, the adjustment is made as of April 1, 2009.

The FSPs are available, under 'FASB Staff Positions' at [www.fasb.org/st](http://www.fasb.org/st).

## PCAOB Developments

On April 21, 2009, the Public Company Accounting Oversight Board (PCAOB) issued Staff Audit Practice Alert No. 4, "Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-than-temporary Impairments," to inform public company auditors about potential implications of the FSPs recently issued by the FASB on reviews of interim financial information and annual audits. The practice alert specifically addresses the following topics: 1) reviews of interim financial information; 2) audits of financial statements, including integrated audits; 3) disclosures; and 4) auditor reporting considerations.

The practice alert reminds public company auditors that they should make inquiries of members of management who have responsibility for financial and accounting matters as part of a review of interim financial information. It also reminds auditors to determine whether any matters described in AU Section 380, "Communication With Audit Committees," such as significant changes in accounting policies, should be communicated.

Among other procedures, an auditor is required to obtain an understanding of the company's process for determining fair value measurements and disclosures when performing audit procedures related to fair value and OTTI. In addition, the auditor is responsible for determining whether the FSPs have been appropriately adopted and applied. Finally, the auditor is responsible for determining whether appropriate transition and recurring disclosures have been made.

The full text of the PCAOB practice alert can be found at:

[www.pcaob.org/Standards/Staff Questions and Answers/2009/04-21 APA 4.pdf](http://www.pcaob.org/Standards/Staff_Questions_and_Answers/2009/04-21_APA_4.pdf)

## Contact Information

If you have any questions, please contact Sydney Garmong of Crowe Horwath LLP at 202.333.0375 or [sydney.garmong@crowehorwath.com](mailto:sydney.garmong@crowehorwath.com).

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## Appendix A: Illustrative Journal Entries for HTM Security

Assume an entity previously had recorded OTTI in the amount of \$5,000 on a HTM security:

### Illustrative Journal Entry: Initial OTTI (Pre-FSP)

DR	Loss on HTM security (income statement)	\$5,000	
CR	HTM security – discount (contra-asset)		\$5,000
DR	Deferred tax asset – FAS 109 (asset)	\$2,000	
CR	Tax benefit (income statement)		\$2,000

To record OTTI, and related tax effect at 40%, for HTM security.

The entity adopts FSP FAS 115-2 and determines \$1,500 of impairment is noncredit related:

### Illustrative Journal Entry: Adoption of FSP

DR	HTM security – Unamortized discount (contra-asset)	\$1,500	
CR	HTM security – Noncredit component (contra-asset) <i>(new account no. 1)</i>		\$1,500

To record adoption of FSP FAS 115-2, and re-establish the amortized cost basis, for prior OTTI on HTM security in accordance with paragraph 46 of FSP FAS 115-2.

DR	Accumulated OCI on HTM security (equity) <i>(new account no. 2)</i>	\$900	
DR	Deferred tax asset for OCI HTM component (asset) <i>(new account no. 3)</i>	600	
CR	Deferred tax asset – FAS 109 (asset)		\$600
CR	Retained earnings (equity)		900

To record adoption of FSP FAS 115-2 with impact on equity and related tax effects at 40% for prior OTTI on HTM security in accordance with paragraph 45 of FSP FAS 115-2.

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Subsequent to adoption of FSP FAS 115-2, the entity determines there is an additional OTTI of \$2,000 to be recognized:

### Illustrative Journal Entry: OTTI Subsequent to Adoption of FSP

DR	Loss on HTM security (income statement)	\$2,000	
CR	Loss on HTM security – Noncredit component (income statement) <i>(new account no. 4)</i>		\$750
CR	HTM security – Discount (contra-asset)		1,250
DR	OCI – HTM non-credit component (equity) <i>(new account no. 2)</i>	\$450	
DR	Deferred tax asset for OCI HTM component (asset) <i>(new account no. 3)</i>	300	
CR	HTM security – Noncredit component (contra-asset) <i>(new account no. 1)</i>		\$750
DR	Deferred tax asset – FAS 109 (asset)	\$500	
CR	Tax benefit (income statement)		\$500

To record OTTI on HTM security and related tax effect at 40%, subsequent to adoption of FSP FAS 115-2.

Subsequent to adoption of FSP FAS 115-2, the entity records accretion:

### Illustrative Journal Entry: Accretion for Noncredit Component

DR	HTM security – Noncredit component (contra-asset) <i>(new account no. 1)</i>		
CR	Deferred tax asset for OCI HTM component (asset) <i>(new account no. 3)</i>		
CR	OCI – HTM noncredit component (equity) <i>(new account no. 2)</i>		

To record accretion from OCI to amortized cost basis for HTM debt security in accordance with paragraph 34 of FSP FAS 115-2.

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## Appendix B: Implementation Example and Illustrative Journal Entries for AFS Debt Security

A \$100,000 bond is purchased, and its entire principal amount matures at the end of 10 years. The coupon is 6 percent, which results in an annual interest payment of \$6,000. The purchase price was \$95,800 to yield 6.5866 percent. Total undiscounted cash flows expected to be collected are \$160,000. The security is classified as AFS.

### At Inception

Interest Rate	6.00%
Interest Payment	\$6,000.00
Contractual Life (Years)	10
Par	\$100,000.00
Discount	(4,200.00)
Amortized Cost	\$95,800.00
Effective Yield	6.5866%

### Event A

At the end of year three, there is OTTI. The revised cash flows expected to be collected are \$85,000 of principal, and revised interest payments are \$5,000, which results in revised undiscounted cash flows expected to be collected of \$120,000. The fair value is \$70,500 and the present value of the revised cash flows expected to be collected, discounted at the effective yield, is \$81,727. If the FSP had been in place at the time the initial OTTI was taken, the pro forma table shows how the calculation would have differed.

### End of Year 3: OTTI Charge Pre-FSP

Revised Payments	\$5,000.00
Remaining Life	7 years
Revised Principal	\$85,000.00
Amortized Cost	\$96,792.51
OTTI	(26,292.51)
Fair Value	\$70,500.00
Revised Effective Yield	9.3067%

### Pro Forma: PV of Cash Flows (End of Year 3)

Revised Payments	\$5,000.00
Remaining Life	7 years
Revised Principal	\$85,000.00
Amortized Cost	\$96,792.51
Credit Loss	(15,065.66)
PV of Cash Flows	\$81,726.85
Effective Yield	6.5866%

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### Illustrative Journal Entry: Initial OTTI (Pre-FSP)

DR	Loss on AFS security (income statement)	\$26,292.51	
CR	AFS security – Discount (contra-asset)		\$26,292.51
DR	AFS security – FAS 115 adjustment (contra-asset)	\$26,292.51	
CR	OCI – FAS 115 (equity)		\$15,775.51
CR	Deferred tax asset – FAS 115 (asset)		10,517.00
DR	Deferred tax asset – FAS 109 (asset)	\$10,517.00	
CR	Tax benefit (income statement)		\$10,517.00

To record OTTI, and related tax effect at 40%, for AFS security.

### Event B

At the beginning of year seven, the entity adopts FSP FAS 115-2. The present value of the cash flows expected to be collected is determined:

#### Beginning of Year 7: Adoption of FSP FAS 115-2

Revised Payments	\$5,000.00
Remaining Life	4 years
Revised Principal	\$85,000.00
Amortized Cost	\$75,633.19
Reversal of Prior OTTI	7,320.10
PV of Cash Flows	\$82,953.29
Fair Value	\$70,000.00
Effective Yield	6.5866%

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### Illustrative Journal Entry: Adoption of the FSP

DR	AFS security – Unamortized discount (contra-asset)	\$7,320.10	
CR	AFS security – FAS 115 adjustment (contra-asset)		\$7,320.10
To record adoption of FSP FAS 115-2, and re-establish the amortized cost basis, for prior OTTI on AFS security in accordance with paragraph 46 of FSP FAS 115-2.			
DR	Accumulated OCI on AFS security (equity)	\$4,392.06	
DR	Deferred tax asset – FAS 115 (asset)	2,928.04	
CR	Deferred tax asset – FAS 109 (asset)		\$2,928.04
CR	Retained earnings (equity)		4,392.06
To record adoption of FSP FAS 115-2 with impact on equity and related tax effects for prior OTTI on AFS security in accordance with paragraph 45 of FSP FAS 115-2.			

### Event C

At the end of year eight, the entity determines there is OTTI to be recorded. The entity revises the cash flows expected to be collected:

#### End of Year 8: Additional OTTI Charge

Revised Payments	\$4,500.00
Remaining Life	2 years
Revised Principal	\$80,000.00
Amortized Cost	\$83,911.45
Credit Loss	(5,310.35)
PV of Cash Flows	\$78,601.10
Fair Value	\$65,000.00
Effective Yield	6.5866%

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**Illustrative Journal Entry: OTTI Subsequent to Adoption of FSP**

DR	Loss on AFS security (income statement)	\$18,911.45	
CR	Loss on AFS security – Noncredit component (income statement) <i>(new account)</i>		\$13,601.10
CR	AFS security – Discount (contra-asset)		5,310.35
DR	AFS security – FAS 115 (contra-asset)	\$5,310.35	
CR	OCI – FAS 115 (equity)		\$3,186.21
CR	Deferred tax asset – FAS 115 (asset)		2,124.14
DR	Deferred tax asset – FAS 109 (asset)	\$2,124.14	
CR	Tax benefit (income statement)		\$2,124.14

To record OTTI on AFS security and related tax effect at 40%, subsequent to adoption of FSP FAS 115-2.

A summary of the above transactions:

Year	Par	Unaccrued Balance	Amortized Cost	Unrealized Loss / Gain (FAS 115)	Fair Value	Interest Income	Accretion Income	Total Interest Income	Effective Yield
		\$(4,200.00)	\$95,800.00						
1	\$100,000.00	(3,890.03)	96,109.97	\$890.03	\$97,000.00	\$6,000.00	\$309.97	\$6,309.97	6.5866%
2	100,000.00	(3,559.64)	96,440.36	(1,440.36)	95,000.00	6,000.00	330.39	6,330.39	6.5866
3	100,000.00	(3,207.49)	96,792.51	(26,292.51)	70,500.00	6,000.00	352.15	6,352.15	6.5866
Event A: OTTI		(26,292.51)	(26,292.51)	26,292.51					
		(29,500.00)	70,500.00	0.00	70,500.00				
4	100,000.00	(27,938.75)	72,061.25	(4,061.25)	68,000.00	5,000.00	1,561.25	6,561.25	9.3067
5	100,000.00	(26,232.19)	73,767.81	(2,767.81)	71,000.00	5,000.00	1,706.56	6,706.56	9.3067
6	100,000.00	(24,366.81)	75,633.19	(5,633.19)	70,000.00	5,000.00	1,865.38	6,865.38	9.3067
Event B: Adopt FSP		7,320.10	7,320.10	(7,320.10)					
		(17,046.71)	82,953.29	(12,953.29)	70,000.00				
7	100,000.00	(16,582.91)	83,417.09	(14,417.09)	69,000.00	5,000.00	463.81	5,463.81	6.5866
8	100,000.00	(16,088.55)	83,911.45	(18,911.45)	65,000.00	5,000.00	494.36	5,494.36	6.5866
Event C: OTTI		(5,310.35)	(5,310.35)	5,310.35					
		(21,398.90)	78,601.10	(13,601.10)	65,000.00				
9	100,000.00	(20,721.75)	79,278.25	(6,278.25)	73,000.00	4,500.00	677.15	5,177.15	6.5866
10	100,000.00	(20,000.00)	80,000.00	0.00	80,000.00	4,500.00	721.75	5,221.75	6.5866
						\$52,000.00	\$8,482.77	\$60,482.77	

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