Recognition of other-than-temporary impairment for debt securities

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Evaluating whether an impairment of a debt security is other-than-temporary

The Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Section 320-10-35, *Investments—Debt and Equity Securities – Overall – Subsequent Measurement*, outlines the factors that should be considered when determining whether a security is other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security or (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are performed before assessing whether the entity will recover the cost basis of the investment. This is in contrast to the guidance pertinent to equity securities, which requires management to assert it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in fair value to avoid recognizing an other-than-temporary impairment.

Under ASC 320-10-35, an other-than-temporary impairment of a debt security is considered to have occurred in the following circumstances:

- The entity intends to sell the security.
- It is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis.
- The entity does not expect to recover the entire amortized cost basis of the security.

In assessing whether the entire cost basis of the security will be recovered, a comparison must be made of the present value of the cash flows expected to be collected from the security to the amortized cost basis of the security. There are numerous factors to be considered when estimating this recovery and the period over which the security is expected to recover. The guidance specifies the following as only a few examples of the factors that should be considered:

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

Even if the entity anticipates that the entire cost basis of the security will be recovered, the entity must still estimate the period over which the security is expected to recover and whether its cash or working capital requirements and contractual or regulatory obligations indicate that the security may need to be sold before the forecasted recovery occurs. If it is more likely than not the entity will be required to sell the security before recovery of its cost basis, as previously indicated, an other-than-temporary impairment has occurred.

Recording an other-than-temporary impairment on debt securities

Under ASC 320-10-35, when an other-than-temporary impairment has occurred on a debt security, the amount of the other-than-temporary impairment recognized in earnings depends on whether the entity intends to sell the security or whether it is more likely than not the entity will be required to sell the security before recovery of its cost basis.

In instances when a determination is made that an other-than-temporary impairment exists but the entity does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, the other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to credit issues in the debt security and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to credit issues is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

Estimating credit losses

In determining the credit portion of the impairment, an entity is required to use its best estimate of the present value of cash flows expected to be collected from the debt security. ASC 320-10-35 does not prescribe one particular method to be followed when developing the present value of cash flows expected to be collected but refers to methods outlined in ASC Section 310-10-35, *Receivables – Overall – Subsequent Measurement*, ASC Subtopic 325-40, *Investments—Other – Beneficial Interests in Securitized Financial Assets*, and ASC Subtopic 310-30, *Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality*.

ASC 310-10-35-25 (which is written in the context of impaired loans) requires estimated future cash flows to be discounted using the effective interest rate implicit in the loan. When applying this guidance to a debt security, the discount rate generally would be the rate used by management to recognize interest income on the security and would give consideration to purchase premiums and discounts. When the instrument has a variable rate, ASC 310-10-35-28 permits an entity an accounting policy election to calculate the effective interest rate (a) based on the factor (such as interest rate index) as it changes over the life of the loan or (b) using the factor in effect at the date the loan meets the impairment criteria. ASC 310-10-35-28 requires an entity to apply this accounting policy election consistently. It also stipulates that projections of changes in the factor should not be made for purposes of determining the effective interest rate or estimating expected future cash flows. Thus, applying the guidance in ASC 310-10 would preclude the use of a forward yield curve in estimating or discounting expected cash flows.

ASC 325-40-35-6, which applies to debt securities that are beneficial interests in securitized financial assets that are not of high credit quality, requires cash flows to be discounted using a rate equal to the current yield used to accrete the beneficial interest. In the context of variable rate securities, this guidance emphasizes that routine changes to the interest rate should not result in the recognition of other-than-temporary impairment.

ASC 310-30 applies to certain acquired loan and debt securities that have evidence of deteriorated credit quality at the time of the acquisition such that it is probable at acquisition that the holder will not collect all contractually required payments. This guidance provides that the effective interest rate is the discount rate that equates the present value of estimated future cash flows with the purchase price of the security and is subsequently adjusted upward due to significant increases in expected future cash flows. ASC 310-30-35-14 addresses the rate to be used for variable rate instruments and provides that future changes in the interest rate index should not be made for purposes of determining the effective interest rate or estimating expected future cash flows. Thus, applying the guidance in ASC 310-30 would preclude the use of a forward yield curve in estimating or discounting expected cash flows. This guidance also provides for decreases in expected cash flows attributable to a change in the contractual rate to be addressed through a prospective reduction to the yield rather than as an impairment loss.

Subsequent accounting

An entity must account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment at a cost equal to the previous basis less the other-than-temporary impairment recognized in earnings. Existing premiums and discounts and subsequent changes in estimated cash flows or fair value continue to be accounted for in accordance with the relevant guidance.

Subsequent increases and decreases (if not an other-than-temporary impairment) in the fair value of available-for-sale securities should be included in other comprehensive income.

The other-than-temporary impairment recognized in other comprehensive income for debt securities classified as held-to-maturity will be accreted from other comprehensive income to the amortized cost of the debt security 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. That accretion will increase the carrying value of the security and continues until the security is sold, the security matures or there is an additional other-than-temporary impairment that is recognized in earnings.

Disclosure requirements

The relevant disclosure requirements for investment securities are primarily outlined in ASC 320-10-50 and are required in interim and annual financial statements. The disclosure requirements are extensive and include tabular presentation of securities in an unrealized loss position segregated by the length of time the investments have been in a continuous unrealized loss position of less than 12 months and 12 months or longer. An entity is also required to disclose the information considered in reaching a conclusion that unrealized losses are not other-than-temporary, as well as the methodology and significant inputs used to estimate credit loss.

Standard-setting activity

In connection with its comprehensive project on accounting for financial instruments, the FASB issued a proposed Accounting Standards Update (ASU), Financial Instruments—Credit Losses (Subtopic 825-15), which proposes a new accounting model intended to require more timely recognition of expected credit losses on financial assets that are not accounted for at fair value through net income. For additional information on the proposed ASU, refer to our article, FASB proposes new credit impairment model, and white paper, Credit impairment – A long and winding road. Refer to the FASB's website for current information about all aspects of its comprehensive project on accounting for financial instruments.

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