Statutory Issue Paper No. 124

Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, An Amendment to SSAP No. 43—Loan-Backed and Structured Securities

STATUS

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- revised yield been applied since inception, and investment income is correspondingly decreased or increased.
- 16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new currently estimated cash flows results in a negative yield

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Step 2: Evaluate Whether an Impairment Is Other Than Temporary

- 3. There are numerous factors to be considered when determining whether an impairment is other than temporary and their relative significance will vary from case to case. The Emerging Accounting Issues Working Group (working group) has been asked if the phrase "other than temporary" should be interpreted to mean "permanent". The working group1 believes the Statutory Accounting Principles Working Group consciously chose the phrase "other than temporary" as the analysis was not intended to determine whether an individual security or investment was "permanently impaired." The fair value of assets may decline for various reasons. The market price may be affected by general market conditions, which reflect prospects for the economy as a whole, or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the fair value of its investment.
- 4. The working group believes that the following items are only a few examples of the factors, which, individually or in combination, indicate that a security's decline in value is specific to an issuer's fundamental credit difficulties, or that a non-interest related decline is other than temporary and that a write-down of the carrying value is required:
 - a. The length of time and the extent to which the fair value has been less than cost;
 - b. The financial condition and short-term prospects of the issuer, including any specific events that may influence the operations of the issuer, such as changes in technology, that may impair the earnings potential of the asset or the discontinuance of a segment of the business that may affect the future earnings potential; or
 - c. The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in value.
- 5. An interest related impairment should be deemed other-than-temporary when an investor has the intent to sell an investment, at the reporting date, before recovery of the cost of the investment. The investor should consider whether its cash or working capital requirements and contractual or regulatory obligations indicate that the investment may need to be sold before the forecasted recovery occurs. The term "interest related" includes a declining value due to both increases in the risk free interest rate and general credit spread widening. Credit spreads can widen or contract for a variety of reasons, including supply/demand imbalances in the marketplace or perceived higher/lower risk of an entire sector. If the declining value is caused, in whole or in part, due to credit spreads widening, but not due to fundamental credit problems of the issuer, the change in credit spreads is deemed to be interest related. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due.
- 6. Unless evidence exists to support the assertion that the decline in fair value below carrying value is temporary, a write-down, accounted for as a realized loss, should be recorded. In accordance with the guidance of the SSAPs, such loss should be recognized in income for the period in which other than temporary impairment is determined to have occurred. The adjusted carrying value reflecting the impairment loss of the individual security or investment shall be the new cost basis of the individual security or investment.
- 7. The working group has also been asked if it is appropriate for reporting entities, independent auditors or state examiners to apply predefined thresholds to the phrase "other than temporary"? The working group is aware that certain insurers, independent auditors and state examiners, over time, have developed quantitative thresholds as "rules of thumb" to assist in the evaluation of asset impairment. One rule of thumb in particular suggests that if the fair value is less than its carrying value by 20 percent or more, then it is considered to be other than temporarily impaired. Another suggests that an asset is other than temporarily impaired if the fair value has been less than cost for more than 6 months. The use of a numerical threshold may

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provide the basis for a preliminary assumption that – without considering all relevant circumstances – an impairment may have occurred. Identifying the impairment is only the beginning of the analysis; it cannot appropriately be used as a substitute for a full analysis of all relevant qualitative considerations. Exclusive reliance on such thresholds removes the ability of management to apply its judgment, a concept inherent to the impairment model.

Step 3: If the Impairment is Other Than Temporary, the Cost Basis of the Individual Asset Shall Be Written Down to a New Cost Basis and the Amount of the Write-Down Is Accounted for as a Realized Loss

8. If an impairment is considered other than temporary, the cost or carrying value of the asset should be written down to reflect its value in accordance with the relevant SSAP. A company's management should follow the impairment guidance in the SSAP pertaining to that particular asset class while considering various factors on a case-by-case basis in determining the amount of the realized loss that should be recorded.

Generally Accepted Accounting Principles

- No additional guidance obtained from GAAP.

OTHER SOURCES OF INFORMATION

- No additional guidance obtained from state statutes or regulations.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 43—Loan-Backed and Structured Securities
- SSAP No. 3—Accounting Changes
- SSAP No. 4—Definition of Assets and Nonadmitted Assets
- SSAP No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve
- INT 06-07: Definition of Phrase "Other Than Temporary"

Generally Accepted Accounting Principles

- FASB Statement No. 115: Accounting for Certain Investments in Debt and Equity Securities
- FASB Statement No. 125: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- FASB Emerging Issues Task Force No. 99-20: Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

No additional guidance obtained from other sources of information.